Department of Economics
Course: Economics of Organization and Information
Exam. March 11th , 2013 Max. duration: 4 h
Use of calculator, and dictionary allowed

Answer (in Swedish or English) all questions below! Answers should be short and to-the-point. Irrelevant text will reduce your grade.

1. Define in a few sentences the following concepts:

a. risk premium	(2 p)
b. influence activities	(2 p)
c. incentive compatibility constraint	(2 p)
d. residual decision making rights	(2 p)
e. reneging	(2 p)

2. In a number of corporate scandals around the world the top management of big firms have been exposed trying to make the companies earnings look better than they actually are.

a) Use the theory of incentive compensation to explain why proper auditing of the company becomes more important the stronger the compensation received by the CEO is tied to reported earnings. (5 p.)

b) Suggest and justify two (the ones that you believe are most important) measures that can be taken by the shareholders to reduce the CEO:s temptation to manipulate the financial numbers of the firm. Briefly explain why your proposals should work! (5 p.)

3. The European Central Bank (ECB) which controls the money supply in the European Monetary Union (EMU) is run by an executive board of five members including the president. The board is appointed by political leaders from all EMU member countries. The members are usually appointed for eight year non-renewable terms.

The typical problem that a central bank is facing is that since the role of the central bank is to safeguard the value of the currency it may run into conflict with political decision makers. Political decision makers tend to be more interested in promoting economic activity in the short run, e.g. to improve employment, when an election is approaching, than in maintaining a stable value for the currency.

a. Explain why giving executive board members eight year non-renewable terms may contribute to a higher degree of central bank independence than shorter renewable terms would. (4 p)

b. What general incentive problem would you expect to arise with this system ? (3 p)

c. Discuss how the age of the member could affect the problems addressed in a. and b. above ? (3 p)

4. Assume that a worker is being paid 40 000 € per year and that, if fired, his best wage would be 32 000 €.

a) How large is the quasi rent earned by this person? (2 p)

Let us assume (for simplicity) that the worker will work for one year only for this employer, and that the worker can gain 1000 €s by shirking. The probability that he will get caught if shirking is 0.1 .

b) Will shirking be worthwhile in strict economic terms for this person? Justify your answer in a few sentences. (4 p)

c) What is the minimum salary that the employer would have to pay this person to make him conclude that shirking would not be in his best interests in strict economic terms? (4 p)