

Problem set 4 – ECON 4921, October 17, 2007

- 1) Weitzman(1985 AER) argues that the source of excessive unemployment lies in the microeconomics of compensation systems, not in the functioning of the macroeconomy.
 - a. Explain why an economy moving from a wage to a profit sharing system may reduce its unemployment levels.
 - b. Explain why a move from a wage economy to a profit sharing economy will make all workers better off.

- 2) A bureau has a sponsor (e.g. local council). The sponsor grant budgets and the bureau head decide the activity level of the bureau. The bureau head cares about $U(X,Z)$, where X is size, $Z=B-C(X)$ is budgetary slack, B is the budget, and $C(X)$ is minimum cost of X . Society's willingness to pay for X is $W(X)$. Let X_a be social optimum defined by $W'(X_a)=C'(X_a)$.
 - a. Show that the level of X is smaller than X_a when the sponsor set the budget, perceiving the bureaus response.