Exam Statistics
Mean = 19.6, Median = 20, Standard Deviation = 2.5, Max = 23.5, Min = 14

Tentative Grade Thresholds
A (21), A- (19), B+ (18), B (15), B- (14), C+ (13), C (12)

Part One, Multiple Choice Questions (one point each)
1 B, 2 C, 3 C, 4 D, 5 B, 6 D, 7 A, 8 B, 9 D, 10 B, 11 D, 12 C, 13 A

Part Two, Short-Answer Questions (Three points each)
For each question, a clear statement of the correct answer was worth two points. The remaining two points were awarded based on the quality of the argument offered in support of the answer. The following are sketches of the correct answer. They are not ideal answers.

1. What, according to Hayek, is the information needed to operate effectively in a complex market economy? Why, according to Hayek, can the “information problem” be solved by “the price system”?

Hayek believes that centralized allocation decisions would be very difficult to do well because there is a tremendous amount of relevant information in the world, what Hayek calls “particular circumstances of time and place.” Hayek believes that it would be very difficult for any agency to acquire the relevant information. Moreover, Hayek argues that the “man on the ground” is better positioned to respond appropriately to the constant changes that make goods sometimes more valuable and other times less valuable.

According to Hayek, knowledge of market prices is sufficient for decision makers to make good economic decisions that are mutually coordinated. Consumer must simply determine whether the market price is higher or lower than their reservation prices. Producers must simply determine whether market price is higher or lower than their marginal costs. When agents react rationally to market prices, they collectively produce an equilibrium that equates all of their reservations and all of their marginal costs to the market price—that is coordination writ large.

2. If so, why so? If not, why not? A good answer will take a stand, provide a detailed argument, and illustrate the argument with well chosen examples.

“In some cases the imposition of a tax on production and consumption of a good reduces economic efficiency; in other cases, the imposition of a well designed tax promotes economic efficiency”

The key to answering this question is to separate goods into those without third party effects and those with third party effects. In the case of no third party effects, placing a tax on a good produces an equilibrium such that the marginal benefit of the last unit consumed is greater than the marginal cost of producing the good. This must be so because the consumer equates marginal benefit to price plus tax while the marginal cost that is relevant to the producer is net of tax.

In the case of negative externalities, however, a tax may restore economic efficiency. Without a tax, the consumer matches private marginal benefit to private marginal cost and ignores the negative effects of consumption and production on third parties. Thus, too much of such a good is produced
and consumed. However, if the government levied a tax on the good that accurately estimated the marginal cost to third parties of production and consumption, then consumers would consume up to the point where private marginal benefit equaled the sum of private and third party marginal cost. Such an arrangement would restore efficiency.

Part Three—Essay (Six Points)

Why, according to the authors of the four readings, is the existence of the Euro threatened? Along the way explain what high interest rates, fiscal austerity and a fiscal union have to do with the threat to the euro. For full marks, give a specific reference to at least one of the readings assigned for this discussion.

There are lots of different ways that students might successfully answer this question. But all of those ways require students to properly explain what high interest rates, fiscal austerity and a fiscal union have to do with the threat to the euro.

A good place to begin is to recognize that the proximate threat to the euro has the proximate cause of the threat that Greece and some other countries have deficits and outstanding debt so large that market participants believe they cannot repay without help from other euro-member nations. High interest rates threaten the euro because high interest rates make it less likely that Greece can repay its debt for the simple reason that the annual costs of debt management include interest payment to those who hold Greek bonds.

Fiscal austerity means that a country greatly lowers its government expenditures relative to its tax receipts so that it needs to borrow less and, eventually, has funds available to repay its debt. The Great recession has created a situation where many nations have increased expenditures to provide a social safety net at the same time they have experienced a decrease in tax revenues. In Greece, the increases in deficits due to the recession added to deficits that were occurring even during periods of low unemployment. Many believe that Greece routinely depended too heavily on borrowing to finance its expenditures and was too lax in collecting taxes from its citizens. Potential borrowers to Greece are concerned that new purchases of Greek bonds entail great risk because they believe that Greece may well be unable to pay off those bonds. Thus, potential borrowers seek evidence that Greece will reform its financial situation by drastically lowering expenditures and raising taxes—fiscal austerity.

Fiscal union is relevant to the threat to the euro because there is not currently a fiscal union among the euro nations. A fiscal union would mean that there was one central fiscal authority for the euro nations. That entity would collect taxes and govern spending for the Euro-zone nations. That entity would also be able to issue “euro bonds” that were backed by the collective taxes of all the euro nation participants. If there were fiscal union, then all euro nations would be obligated to pay off bonds even if those bonds were issued to support those nations like Greece who ran more frequent and larger deficits.

A good answer to the essay will explain why the euro is threatened in a way that shows that the author understands the role of high interest rates, fiscal austerity, and fiscal union in euro crisis.