



Test for December 11, 2023

Economics (University of Nairobi)



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UNIVERSITY OF NAIROBI

UNIVERSITY EXAMINATIONS 2023/2024

FOURTH YEAR TEST FOR THE DEGREE OF BACHELOR OF ECONOMICS
AND BACHELOR OF ECONOMICS AND STATISTICS

XET 402: INSTITUTIONAL ECONOMICS

DATE: DECEMBER 11, 2023

TIME: 10 A.M–11 A.M

INSTRUCTIONS:

This test is divided into three sections A, B and C. Answer ALL questions

SECTION A: (10%)

Question 1

For each statement, state whether it is true, false, or uncertain. (10 marks)

- i. A restaurant can have both formal and informal institutional orientations. **(True)**
- ii. Static efficiency approach explores the process of how institutions change over time. **(False)**
- iii. According to New Institutional Economics, it is satisfactory to describe firms by whether their Marginal Cost=Marginal Revenue. **(False)**
- iv. Complete incentive contracts offer a “first best” solution. **(False)**
- v. Foreclosure competition allows small firms to access significant data sources. **(False)**
- vi. After Professor Embarambamba promises that no one would fail, students never study. This is an example of adverse selection problem. **(False)**
- vii. A factory that pollutes a river has negative externalities on residents along the river. If the factory and residents can negotiate, an efficient result can be achieved only if the property right of the river is assigned to the residents. **(False)**

SECTION B: (10%)

Question 2: Which of these statements about the New School of Institutional Economics is true? (2 marks)

- i. It gained prominence after the Keynesian and Monetarist schools of Economic Thought.
- ii. **It had a proper theoretical basis.**
- iii. It assumed rationality.
- iv. It emerged in 1918.

Question 3: The Transaction Cost Theory is not associated with the following. (2



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marks)

- i. Markets and firms being substitutes.
- ii. Bounded rationality.
- iii. Uncertainty.
- iv. All of the above

Question 4: Suppose that a half of the used cars offered for sale at Soko Mjinga market are reliable and half are unreliable. If Teresa Mendoza is willing to pay Kshs. 2,000,000 for a reliable car, but only 800,000 for an unreliable one. How much will she offer for a car? (2 marks)

- i. 2,000,000
- ii. 800,000
- iii. 1,400,000
- iv. 1,500,000

Question 5: What is the term given to the problem caused by Mike Rose who has been employed by Harvey Specter at Suits Limited but pursues his own interests rather than the interests of the employer?

- i. Principal–agent problem
- ii. Adverse selection
- iii. Organizational misbehavior
- iv. Hold-up

Question 6: The Coase theorem tells us that in the presence of external costs in production. (2 marks)

- i. The government must intervene in the market to ensure that an efficient level of output is produced.
- ii. Then under certain conditions, private parties can arrive at an efficient solution without government involvement.
- iii. Private parties can negotiate to produce the goods at a level where marginal willingness to pay for the good by consumers is zero.
- iv. Private parties can never arrive at an efficient solution.

SECTION C: (10%)

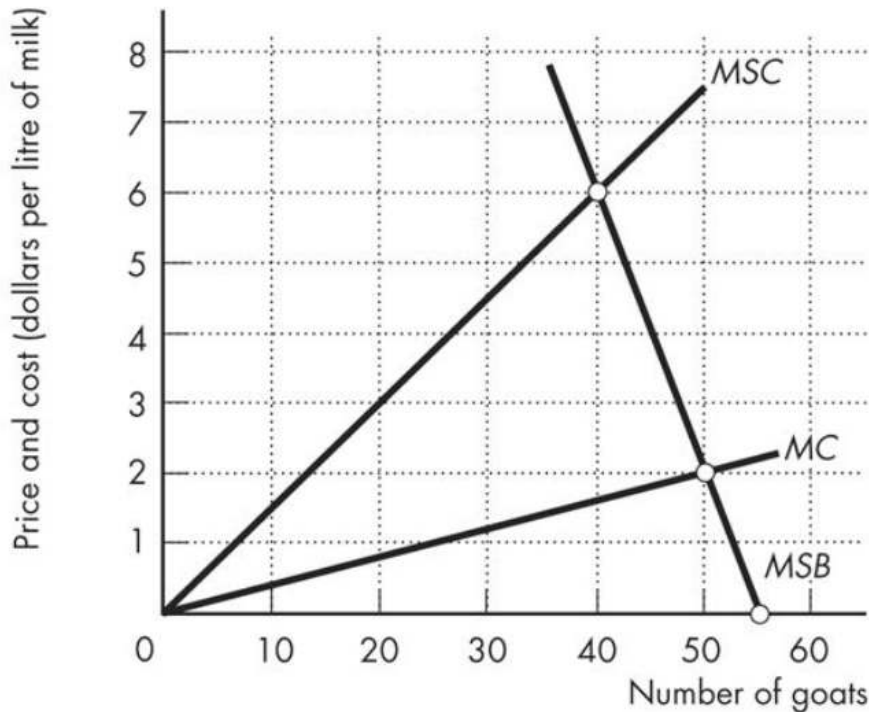
Question 7: Raymond Reddington, a potential investor, has approached his good and long-term friend Dembe Zuma for a loan worth Ksh. 10,000,000 to start his hotel business. Reddington is expected to reimburse Zuma Kshs. 15,000,000 after five months whether the business makes profits or not. Assuming the probability of Reddington repaying the loan is 50%, should Zuma lend Reddington cash? (Hint: apply the trust rule) (3 marks)



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- i. Yes
- ii. No
- iii. Remain indifferent.

Question 8: The figure below shows the marginal private cost curve, marginal social cost curve, and marginal social benefit curve for raising goats on a common pasture.



a) What is the efficient quantity of goats? (3.5 marks)

A) 55 goats. B) 0 goats. C) 35 goats. D) 40 goats. E) 50 goats.

b) If property rights to the pasture are granted to a farmer so that the farmer owns the pasture, the farmer raises? (3.5 marks)

A) 0 goats. B) 35 goats. C) 50 goats. D) 40 goats. E) 55 goats.



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