

Economics 1: Spring 2012

Governments Create/Correct Markets

J. Bradford DeLong, Lanwei Wang, and a
cast of thousands...

February 13, 2012

Midterm Logistics

- The exam will take place on Wednesday, February 22 from 11:10 AM - 12:00 PM. We will need to start handing out exams a few minutes before the official start, so please arrive promptly and get seated quickly so we can be ready to start right at 11:10.
- No blue books are necessary; you will write directly on the exam. No calculators, cell phones, or electronic devices are allowed in the exam. Time will be announced periodically during the exam. If you are worried about keeping track of time, please wear a wristwatch that day.

Midterm Logistics II

- To give you ample space during the exam, we have divided the students, based on GSI, into different rooms for the exam. Students (except DSP) should report to classrooms on Feb. 22 at 11:10 AM as follows:
 - Wheeler Aud: Ashley Clark, Haozhe Wang, Eric Huff, Natarajan Chakrapani, Jason Barbose, Sean LaGuardia. Sit by GSI.
 - 106 Stanley: Sarah Thomason
 - 1 Pimentel: Katherine Murtha, David Puzey, Frankie Le, Fahd Majeed. Sit by GSI.
 - 105 North Gate: Gaurav Shetti
- GSI names and emails are in "GSI-section info" under the Resources tab on bspace. Please go to your assigned room. It is not good if exams go to the wrong GSIs.

Midterm Logistics II

- Open review sections...
- I'm going to be here: in Wheeler Friday 11-12...

Ladies and Gentlemen, to Your i>Clickers...

- A big reason not to use markets for absolutely everything is:
 - A. Markets are not necessarily win-win once you allow for general equilibrium effects
 - B. Markets cannot be adjusted to deal with problems like pollution and resource depletion.
 - C. Markets work well only if the distribution of wealth is fair.
 - D. Markets can go very wrong when they get out of equilibrium if there are quantitative dependencies
 - E. Markets are not always competitive.

Summing Up: The Role of the Government in Creating Markets

- Property
- Contract
- Liability
- Reducing asymmetric information

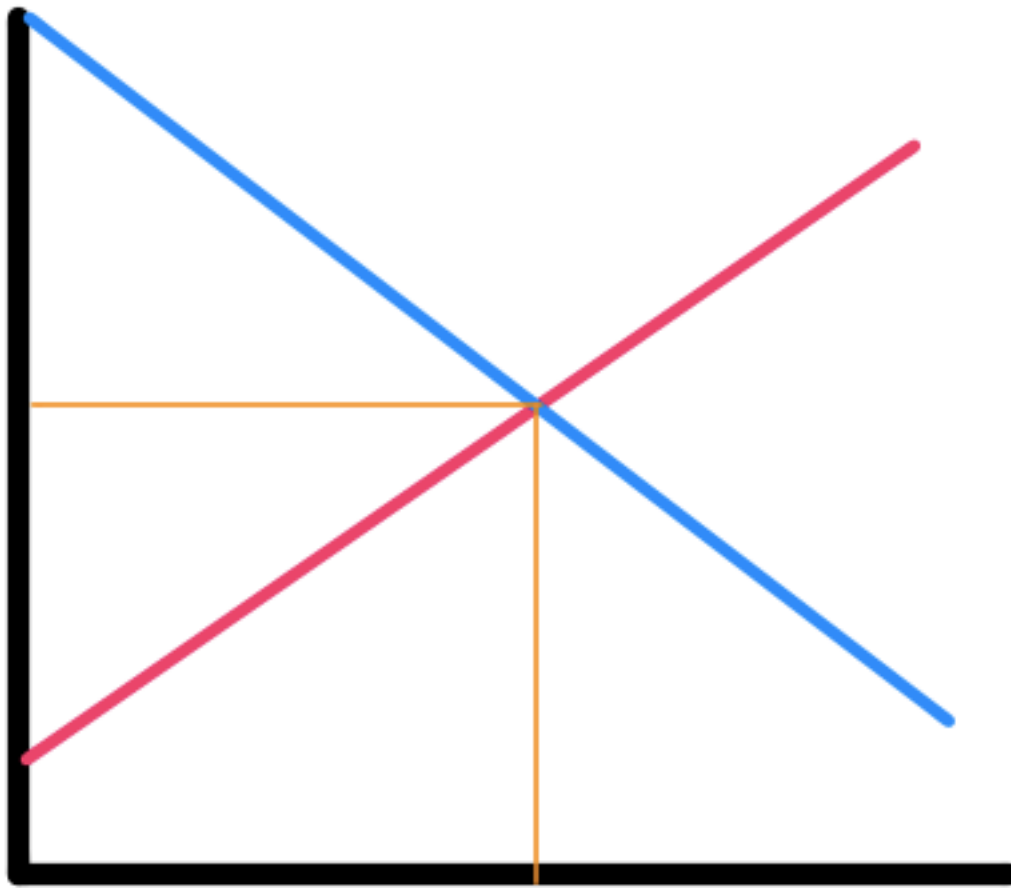
Governments Correct Markets

- What if you establish a nice economic system, and you find that something is going wrong with it?
- Externalities:
 - Pollution
 - Congestion
- Solution: taxes and subsidies

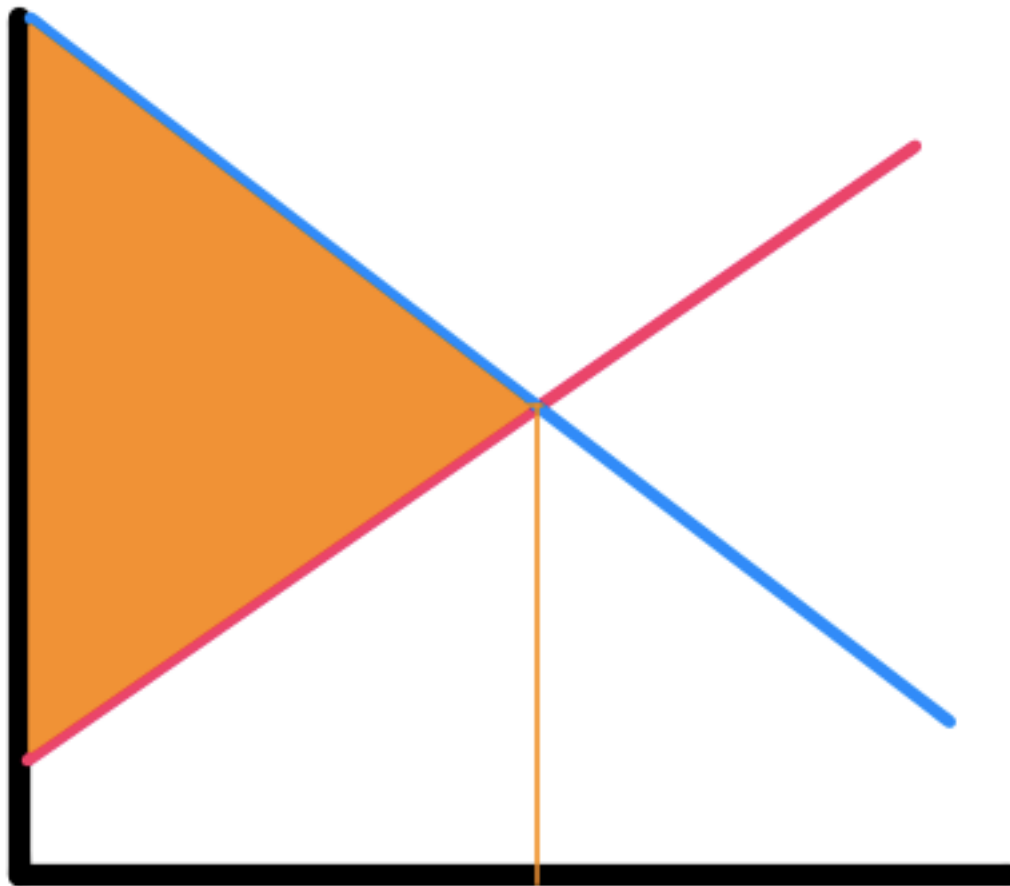
Can Government Implement These Solutions?

- Public choice
- “Maybe so, Gene, but I guarantee you every single one of them was at my last fundraiser...”
- The long twilight struggle against the tobacco companies...
- The long twilight struggle for a sensible carbon policy...

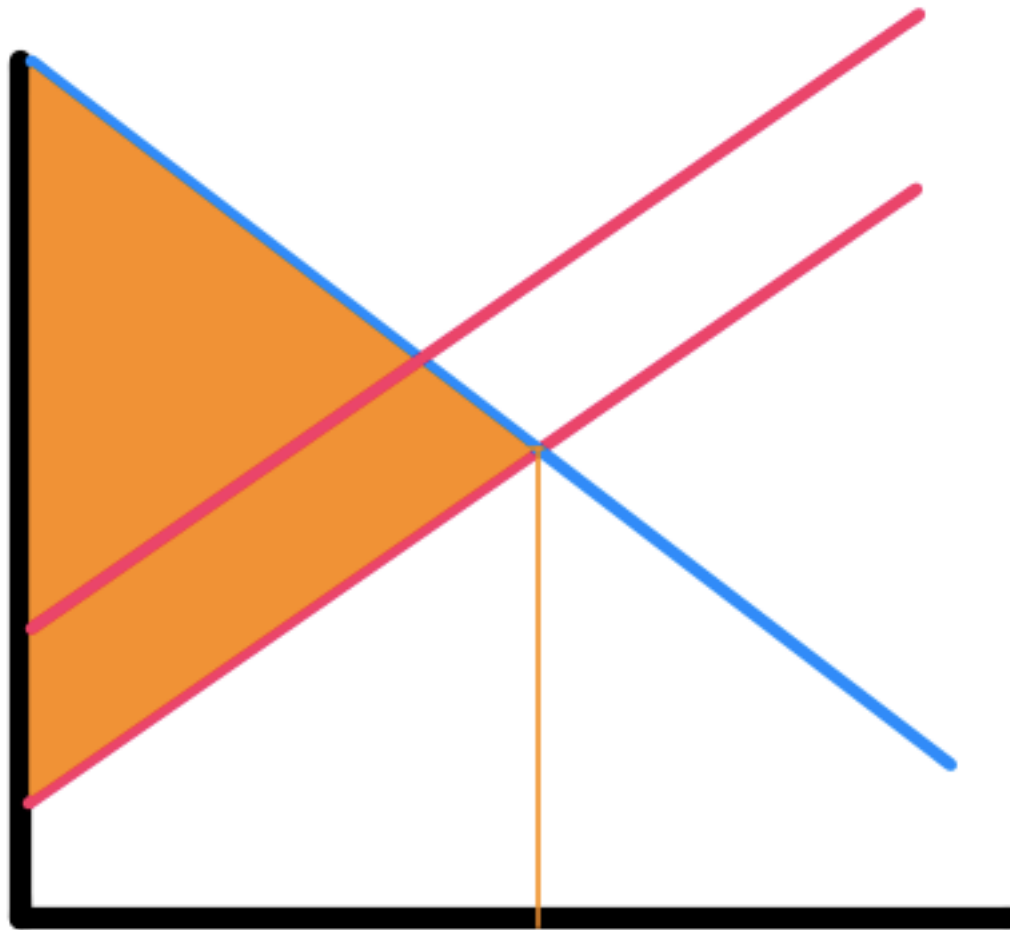
The Mechanics of Correcting Markets



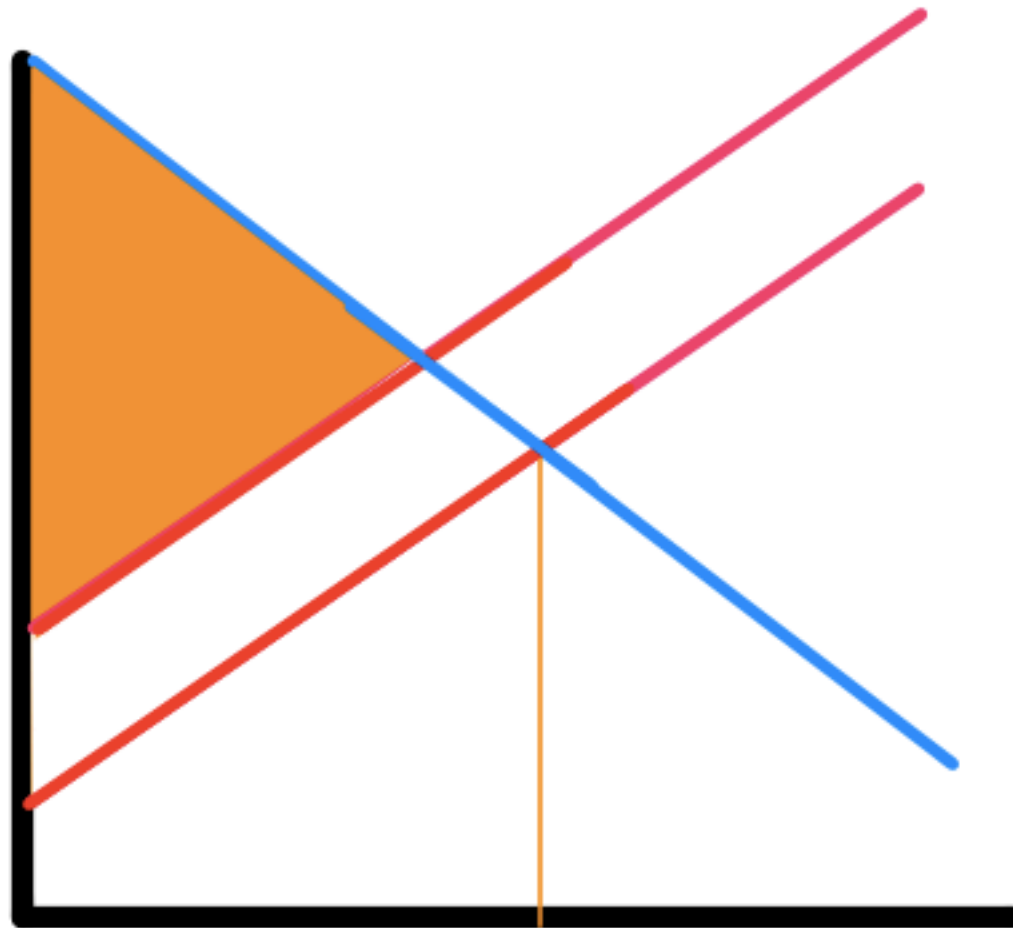
The Mechanics of Correcting Markets



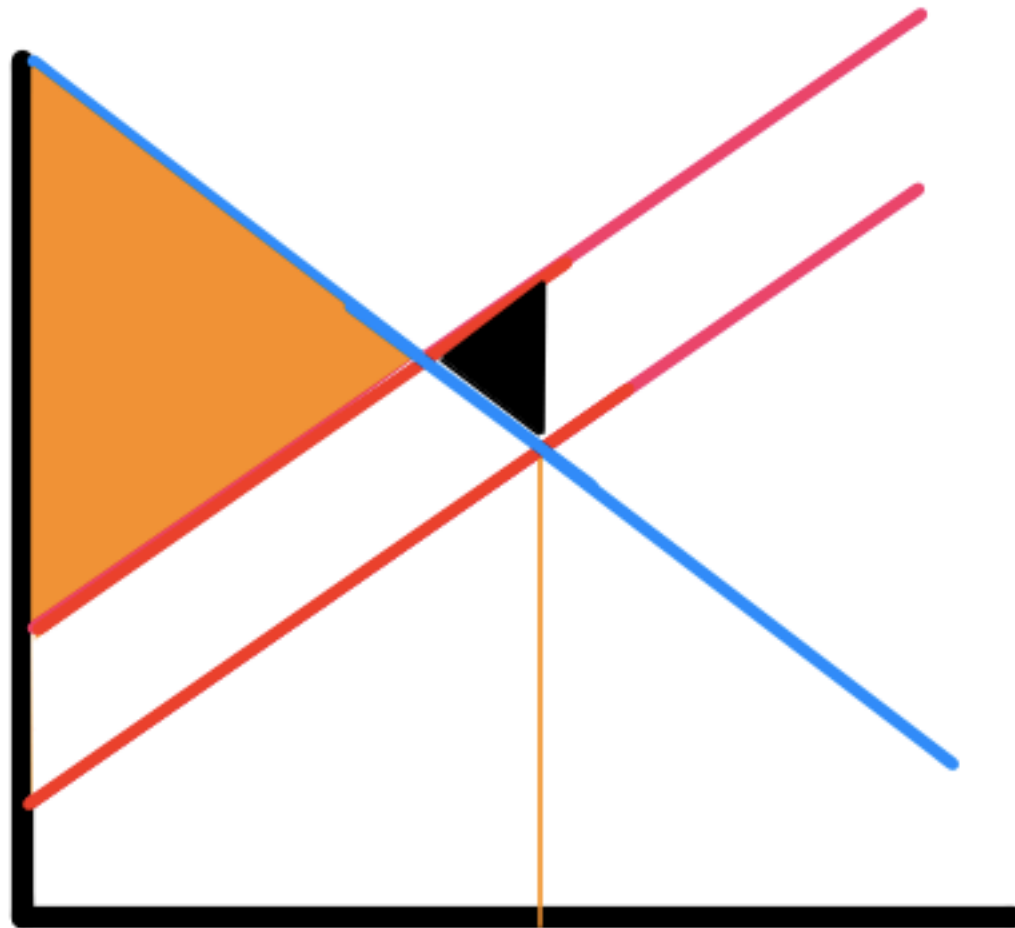
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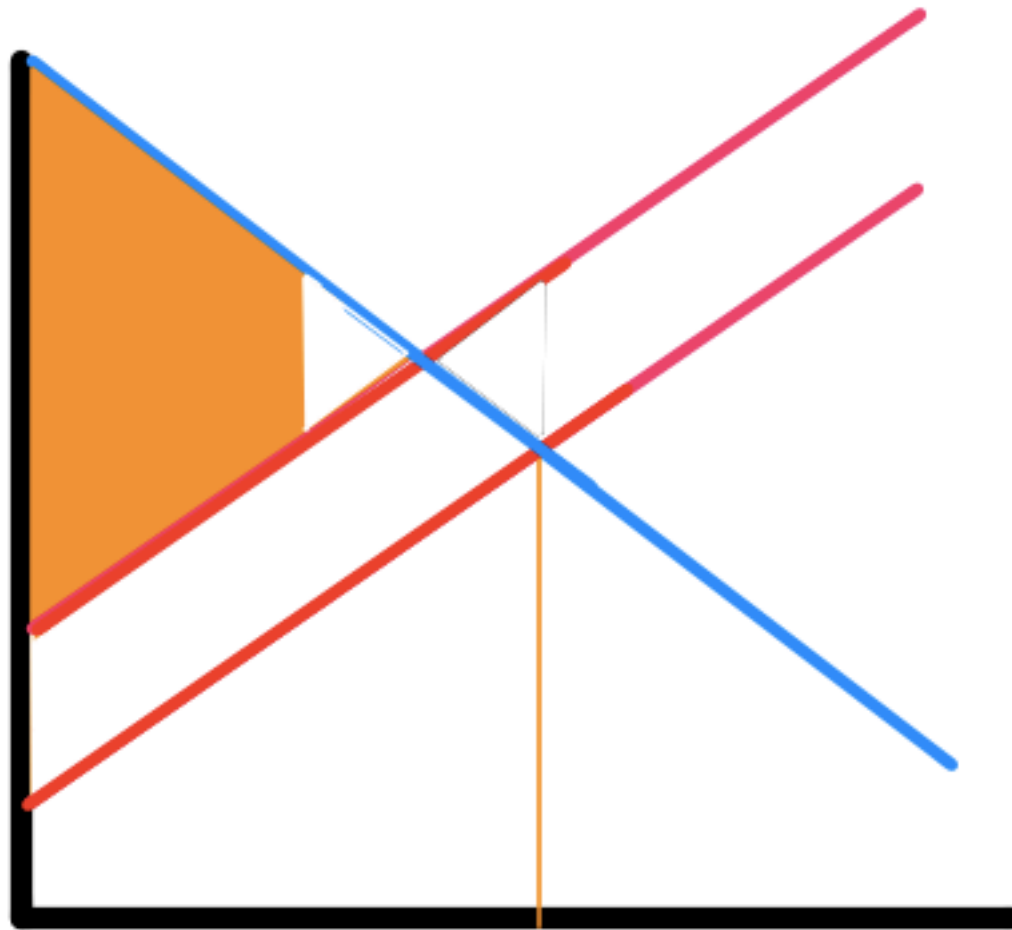
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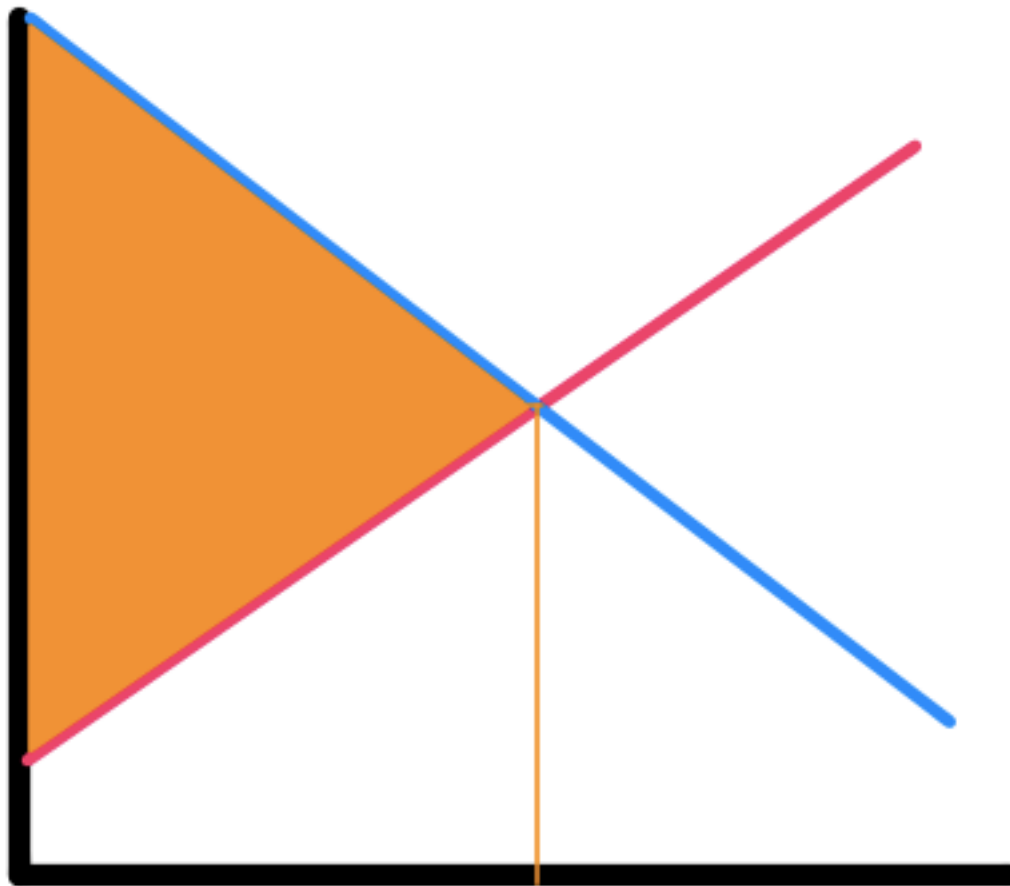
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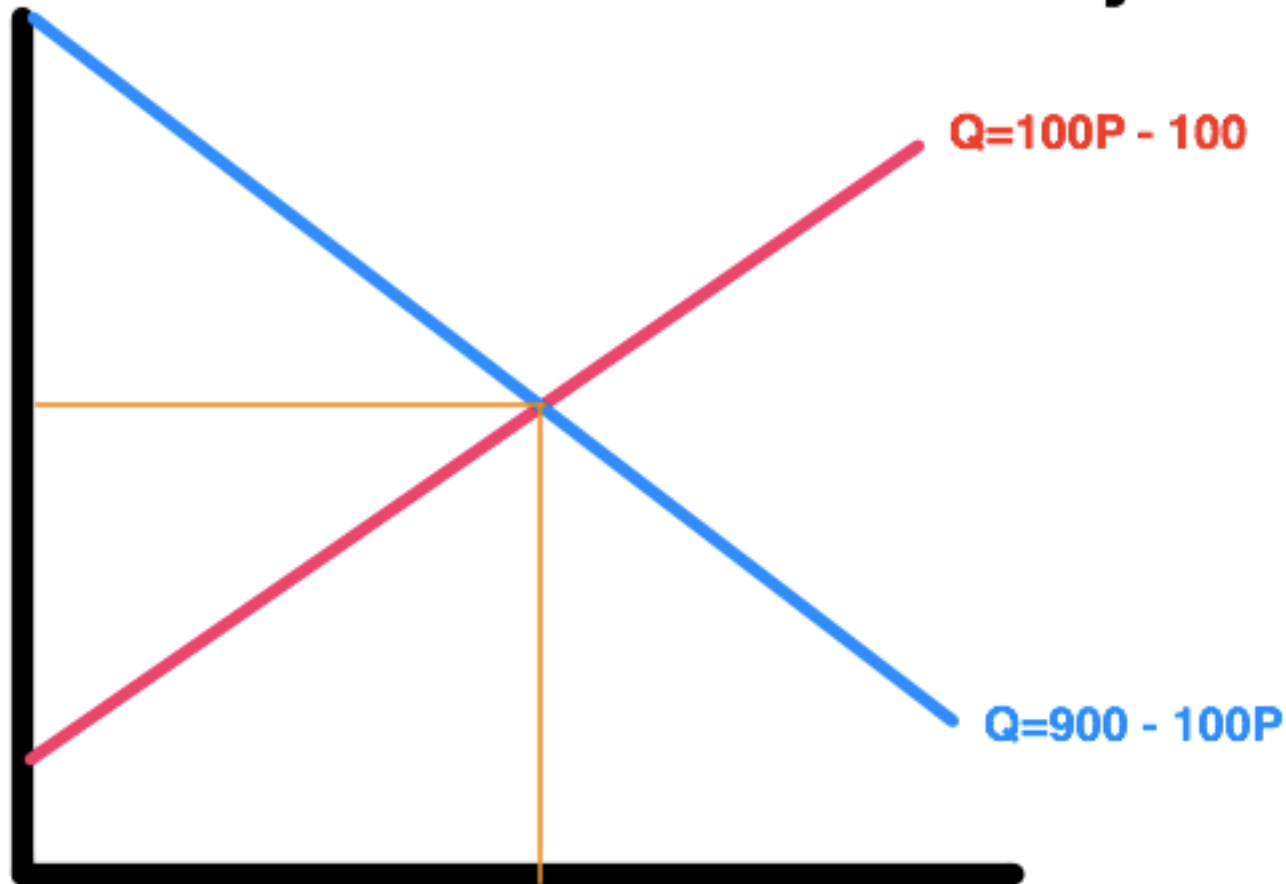
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The Right Solution to Externalities Is Very Simple...

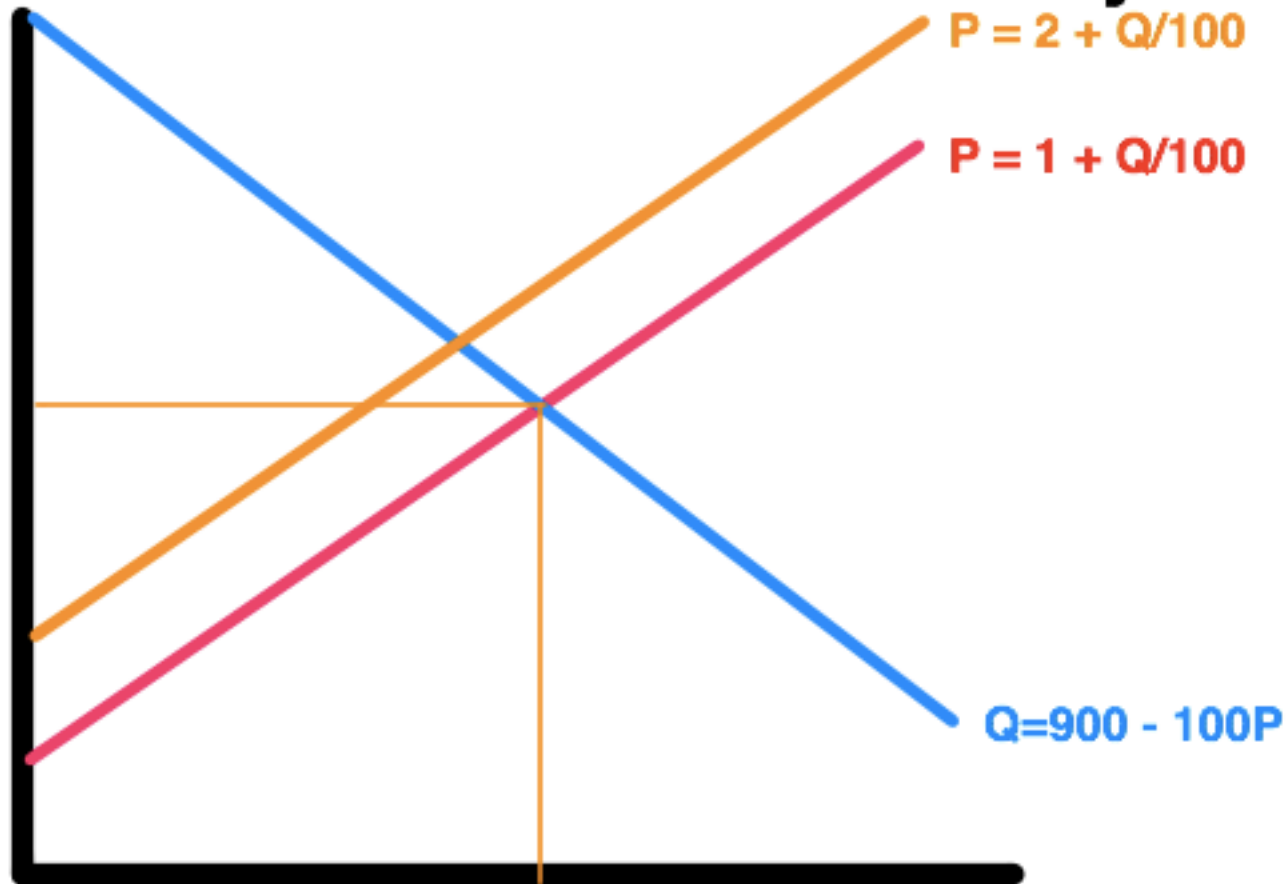
- Make the supply curve that demanders see the supply curve that corresponds not to the costs felt by producers but the costs felt by society as a whole
- Taxes (and subsidies)
- Q: Doesn't this let people buy their way out of doing what is right?
 - A: As long as customers' willingness to pay is greater than private costs of production plus the cost of making externality victims whole, producing is doing what is right.
- Q: Doesn't this mean that there is then one set of rules for the rich and another one for the poor?
 - A: Throwing real net economic surplus away doesn't fix that: "The law, in its majestic equality, forbids the rich as well as the poor to sleep under bridges, to beg in the streets, and to steal bread..."
 - Anatole France, *The Red Lily*, 1894, chapter 7

Now Let's Put Some Numbers on
This...
The Market for Lattes in Sunnydale



Add an External Cost: \$1 Per Latte

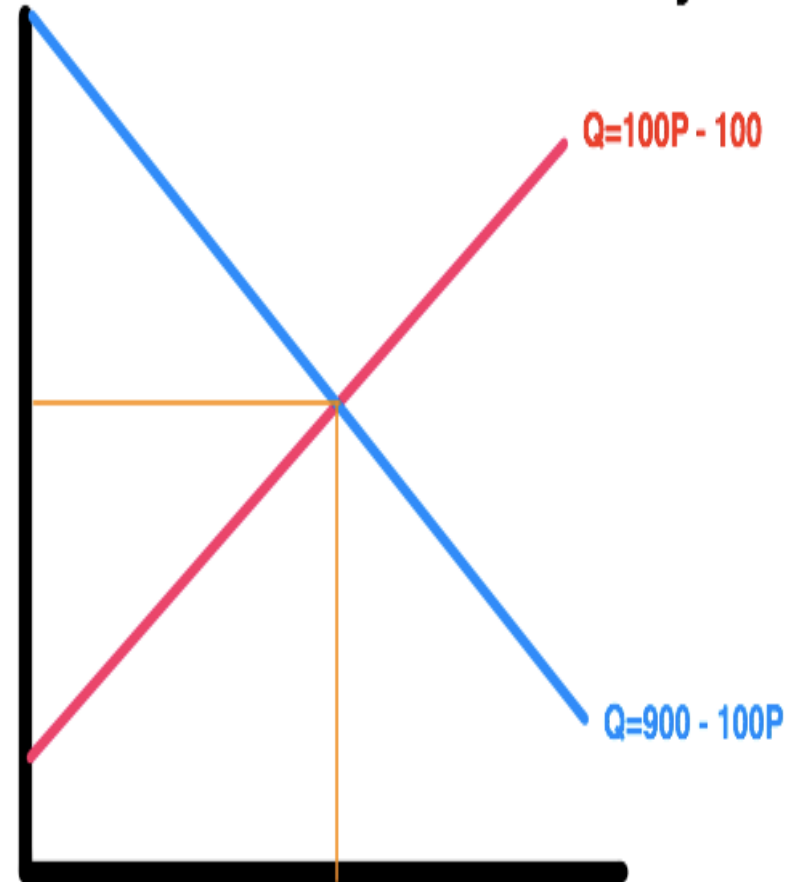
The Market for Lattes in Sunnydale



Ladies and Gentlemen, to Your i>Clickers

- The normal analysis:
 - $P=\$5$, $Q=400$. Demand hits the x-axis at $\$9$. Supply hits the x-axis at $\$1$.
- How much producer and consumer surplus?
 - A. $\$3600$
 - B. $\$1600$
 - C. $\$2000$
 - D. $\$800$
 - E. None of the above

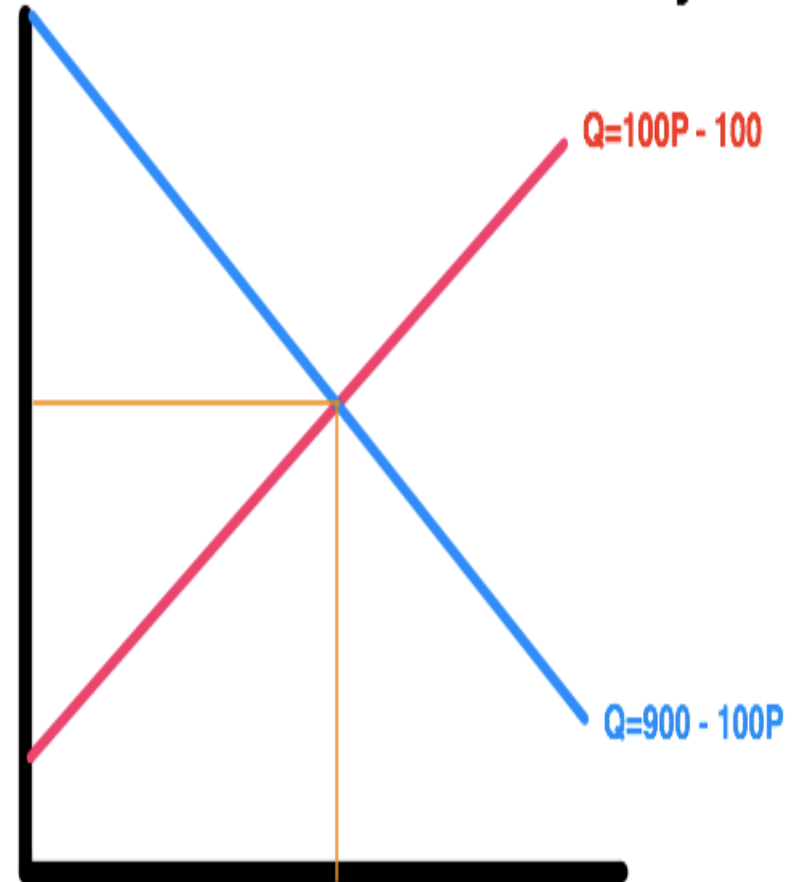
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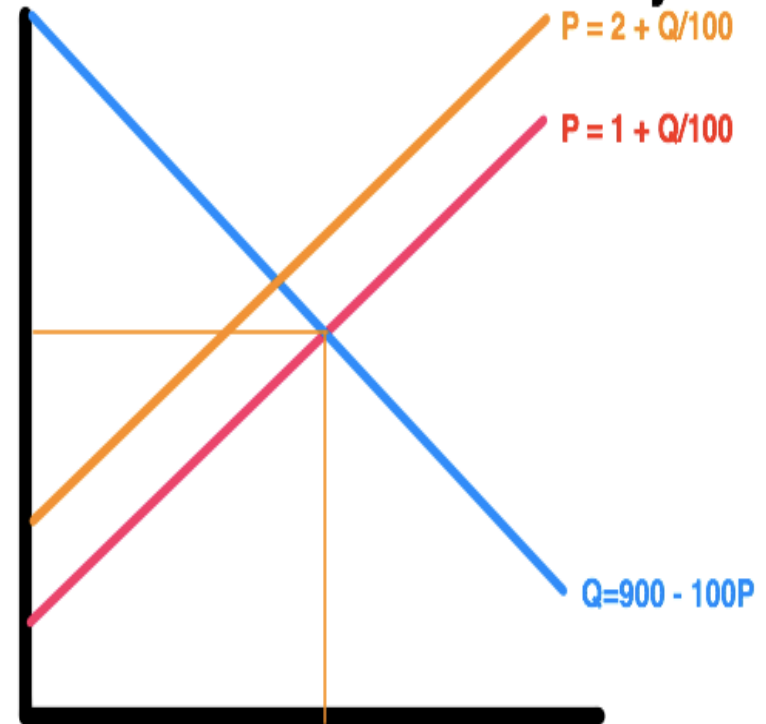
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- The normal analysis:
 - $P=\$5$, $Q=400$. Demand hits the x-axis at $\$9$. Supply hits the x-axis at $\$1$.
- Shift the supply curve up by $\$1$ via a tax...
- What is the new equilibrium price?
 - A. $\$5.50$
 - B. $\$5$
 - C. $\$6$
 - D. $\$4$
 - E. None of the above

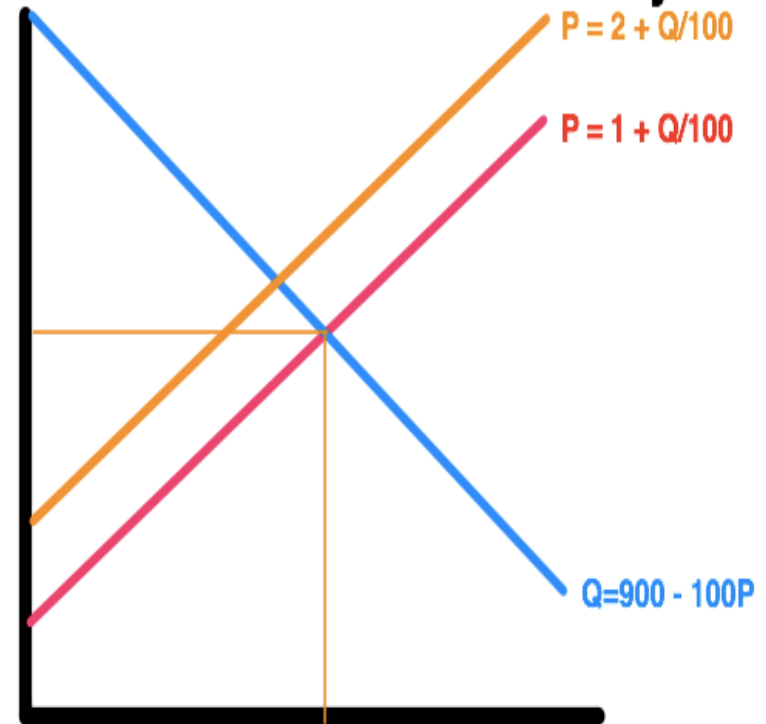
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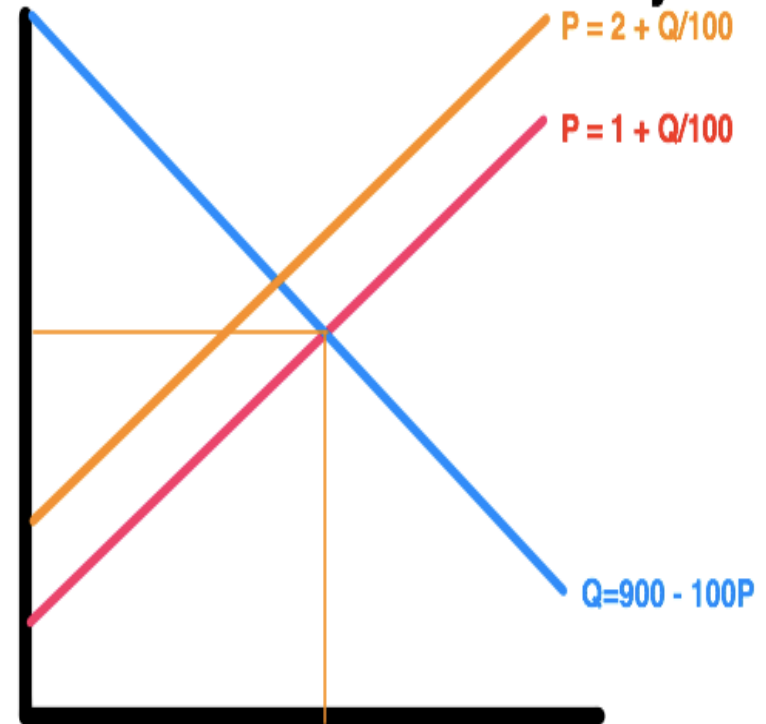
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- What is the new equilibrium quantity?
 - A. 600
 - B. 450
 - C. 400
 - D. 350
 - E. None of the above

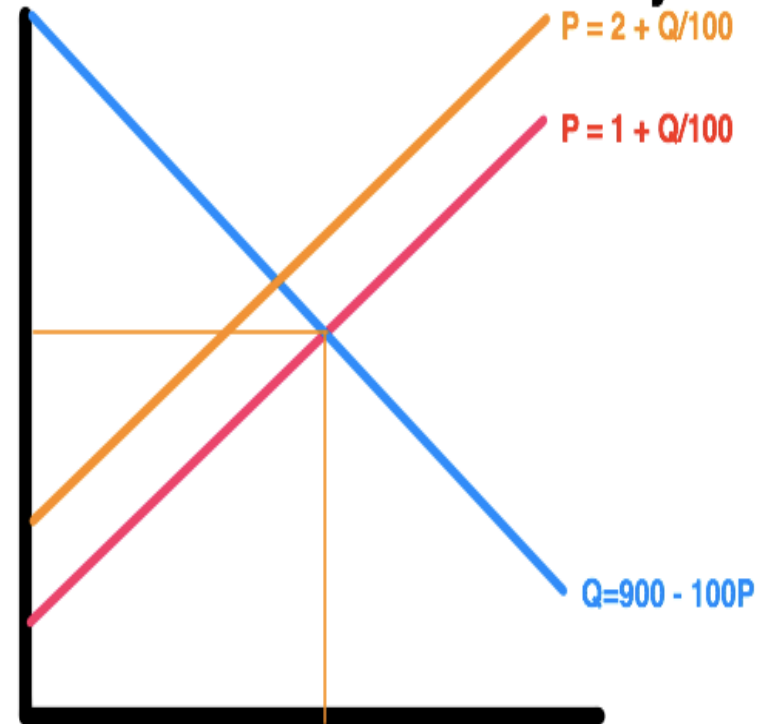
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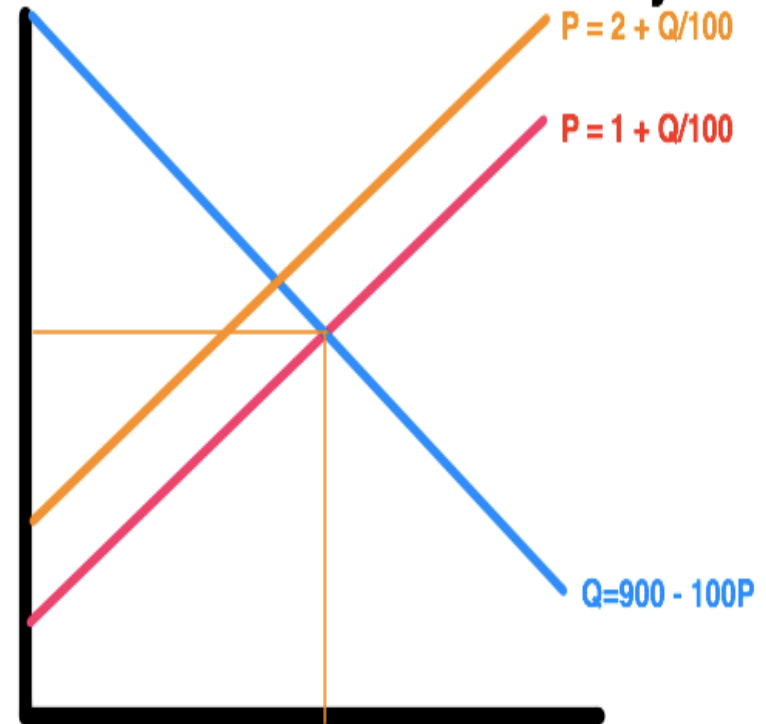
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- What is the social surplus?
 - A. $\$4000$
 - B. $\$3600$
 - C. $\$1600$
 - D. $\$1225$
 - E. None of the above

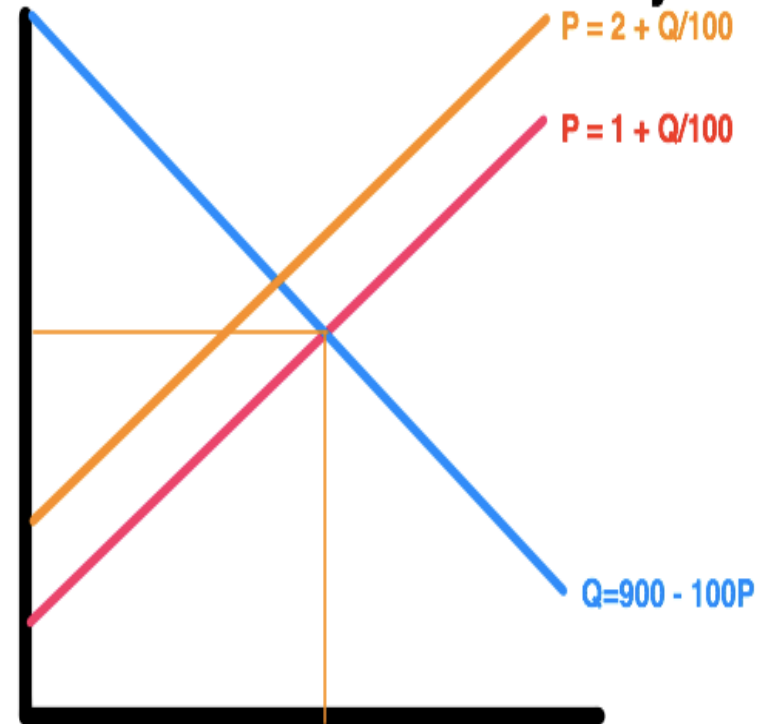
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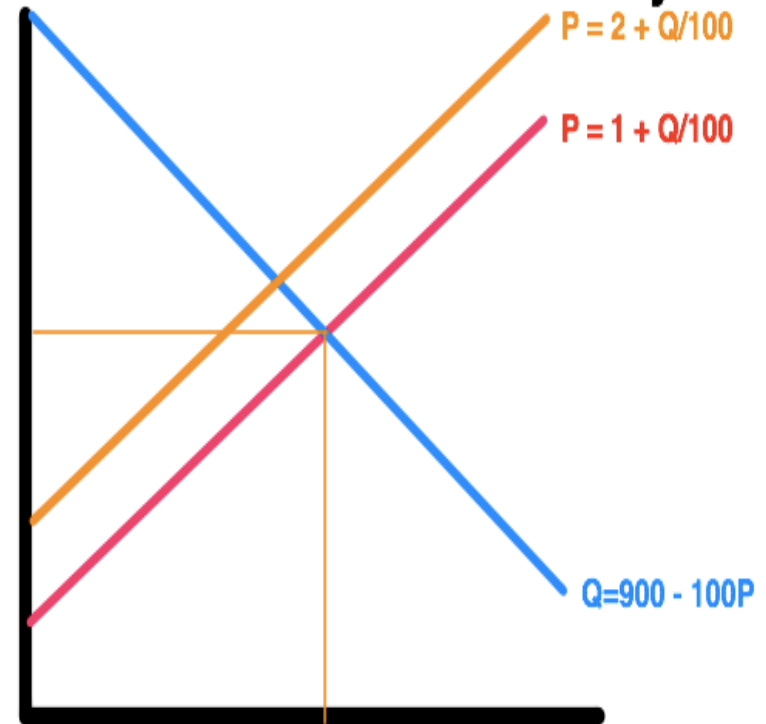
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- The normal analysis:
 - $P=\$5$, $Q=400$. Demand hits the x-axis at $\$9$. Supply hits the x-axis at $\$1$.
- \$1 externality
- Our basic analysis said: surplus of \$1600
- What was the real social surplus?
 - A. \$1600
 - B. \$1200
 - C. \$800
 - D. \$400
 - E. None of the above

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