Principles of Economics Review Session

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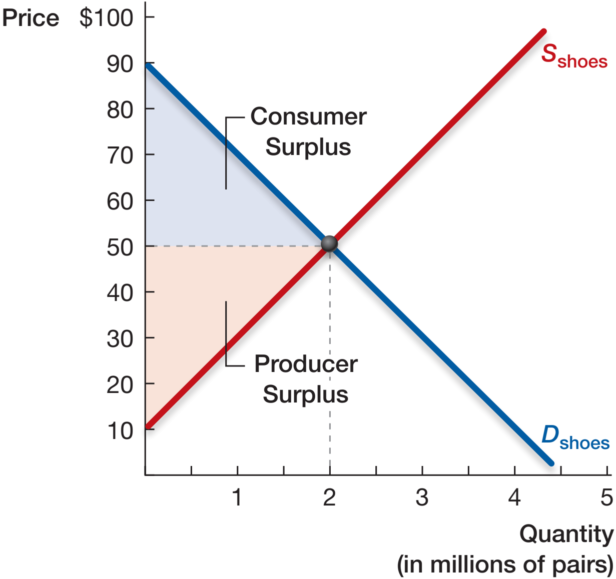
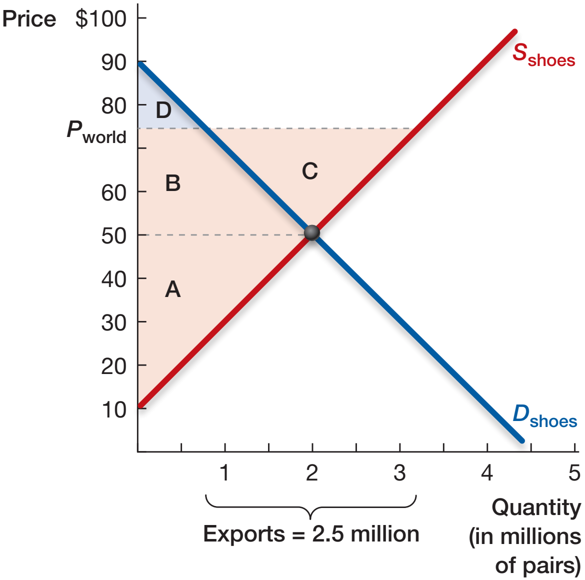
Chapter 8: Trade

- Everyone has at least one comparative advantage
- By specializing your comparative advantage and exchange make the trade unit as a whole better off
- Here we assume "small country" for simplicity, that is, countries take world price as given, hence the horizontal world price
- Redistributions between sectors may occur
- Tariffs make the society as a whole worse off

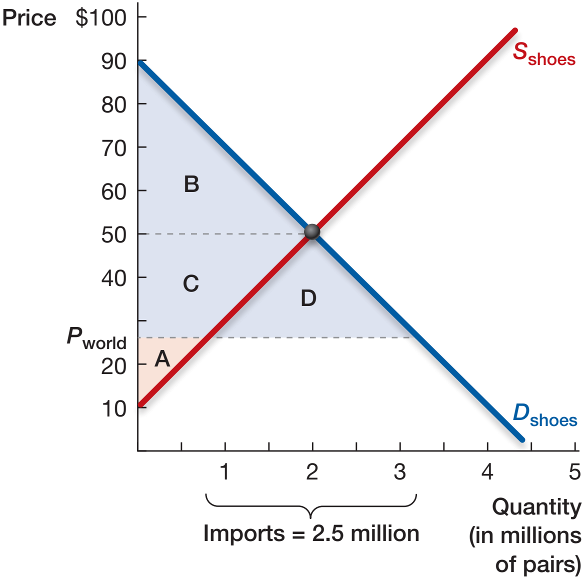
Pre-Trade: Autarky



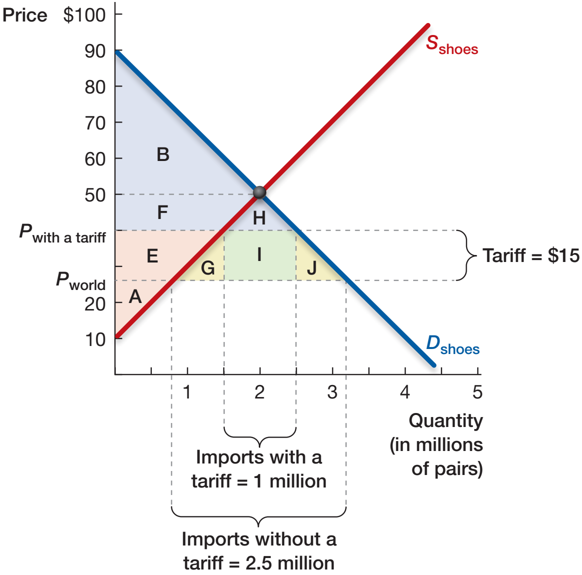
Export Benefits Producers



Import Benefits Consumers



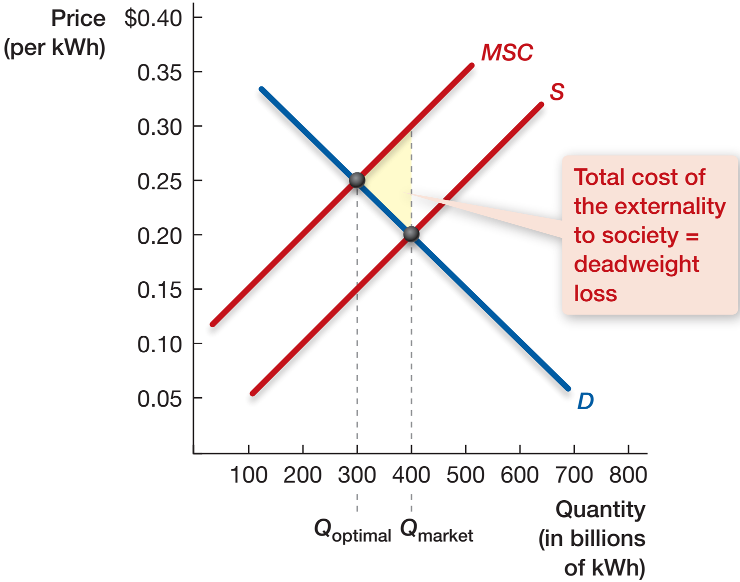
Tariffs: Over-Produce and Under-Consume



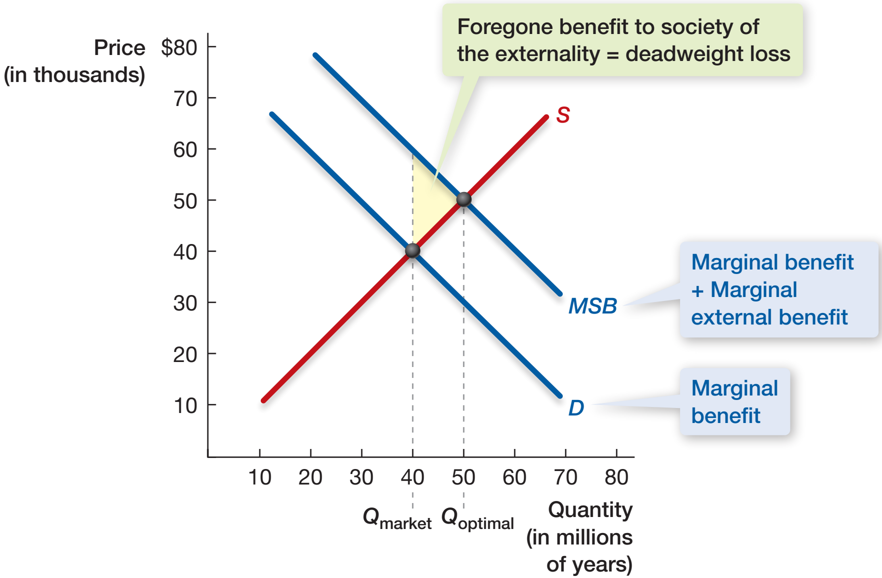
§9.1–9.3: Externalities

- Externalities are some costs or benefits not recognized by the buyers and sellers
- This often creates over-produce or under-produce of goods, relative to the optimal quantity, so is inefficient
- Possible solutions:
  - Pigou: Internalizing the externalities, usually through tax
  - Coase: Define property rights and let people bargain
- Coase Theorem: When property rights are clearly defined and if there is no transaction cost, private bargaining always achieves the efficient outcome. So the initial allocation of property rights do not matter.

Negative Production Externality



Positive Consumption Externality



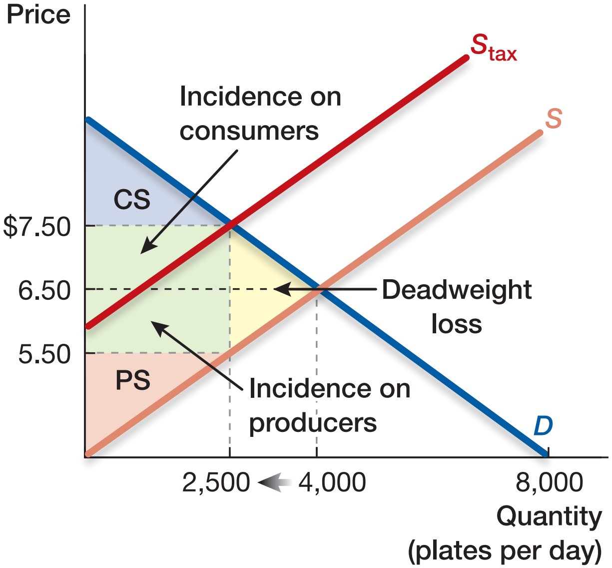
§9.4–9.5: Public Goods and Common Resources

- Public goods and common resources are both hard to exclude other people's usage
- But common resources are rival in consumption, public goods are not
- So we often see over-consumption of common resources (tragedy of commons)
- And under-production of public goods (free-rider problem)

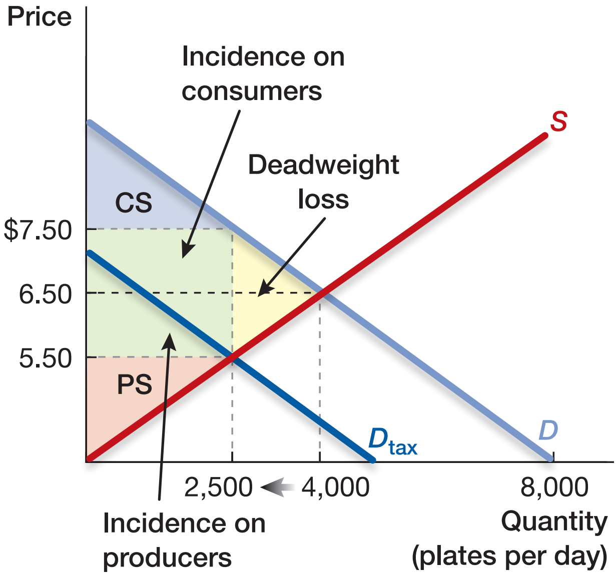
Chapter 10: Tax

- Since quantity is no longer at the efficient level, taxtation usually creates deadweight loss
- Tax incidence and equilibrium price and quantity after tax is independent of whom the tax is levied on
- The more inelastic one is, the more tax burden one gets
- Taxing inelastic goods will have fewer deadweight loss

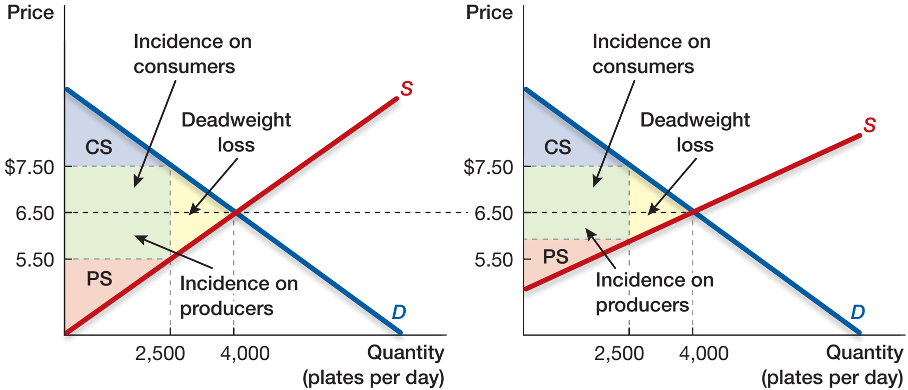
Tax on Producers



Tax on Consumers



More Elastic, Less Tax Burden



Tax, Deadweight Loss, and Elasticity

Midterm 2008 Multiple Choice Q8. Suppose that policymakers are considering placing a tax on either of two markets. In Market A, the tax will have a significant effect on the price consumers pay, but it will not affect equilibrium quantity very much. In Market B, the same tax will have only a small effect on the price consumers pay, but it will have a large effect on the equilibrium quantity. Other factors are held constant. In which market will the tax have a larger deadweight loss?

A. Market A
B. Market B
C. The deadweight loss will be the same in both markets.
D. There is not enough information to answer the question.

Tax, Deadweight Loss, and Elasticity

Midterm 2009 Multiple Choice Q15. Which of the following combinations will minimize the deadweight loss from a tax?