Economic institutions:

Business:

- Private producing units in our society
- Responsible for 80% of production

Three primary forms of business:

- Sole proprietorship
- Partnership
- corporation

The relative importance of manufacturing:

- Percentage of production unchanged
- Percentage of jobs has fallen
- Reasons

1. More productive
2. Import more
3. Service jobs

Government:

1. State and local- employ over 14 million and spend all most one trillion dollars per year
   - Revenue from property and sales taxes
   - Largest expenditure is education

2. Federal
   - Revenue from income and social security taxes
   - Largest expenditure is income security

Roles of government:

1.Correcting for externalities

2. Providing public goods

3.Providing a fair distribution of income

4. Merit goods

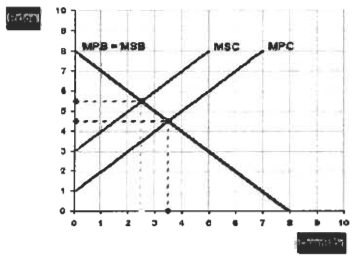
Externality:

A cost or benefit that is passed on to third parties outside the activity or transaction

1. Negative externality- cost are passed on to third parties

2. Positive externality- benefits are passed on to third parties

Negative externality:



Marginal Private Cost (MPC)

•The cost of just the people in the transaction.

•Does not include the cost passed on to third parties

Marginal Social Cost (MSC)

•The total cost to society of producing an additional unit of a good or service

•Includes the cost to third parties

Marginal Private Benefits (MPB)

•The benefits of just the people in the transaction.

•Does not include the benefits passed on to third parties.

Marginal Social Benefit (MSB)

•The total benefit to society of producing an additional unit of a good or service

•Includes the benefits to third parties

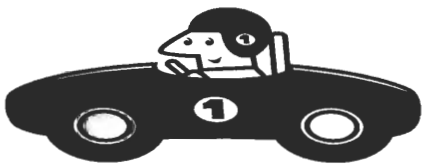
Public goods:

•Non rival in consumption- one person's enjoyment of the benefits of a public good does not interfere with anyone else

•Non-excludable- once the good is produced no one can be excluded from enjoying its benefits

Free rider problem:

•Because people can enjoy the benefits of public goods whether they pay for them or not, they are usually unwilling to pay



Fair income distribution:

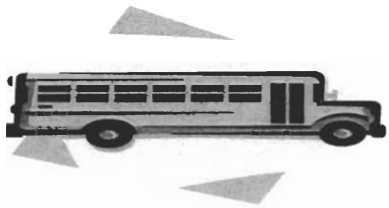
•Progressive tax- increase tax rate when income increases

•Proportional tax (flat)- tax rate constant at all income levels

•Regressive tax- tax rate decreases as income increases

Merit good:

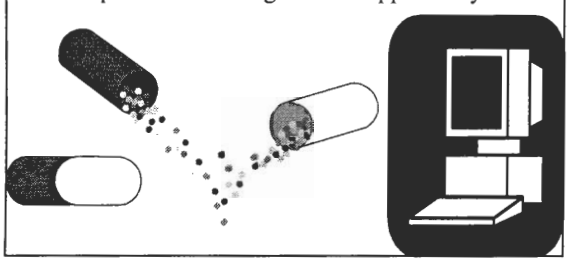
- Something society should not do without



International trade

Absolute vs Comparative:

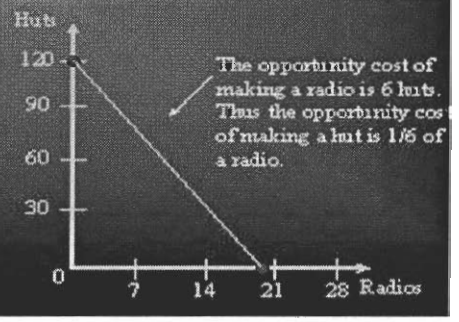
- Absolute Advantage- more productive
- Comparative advantage- lower opportunity cost



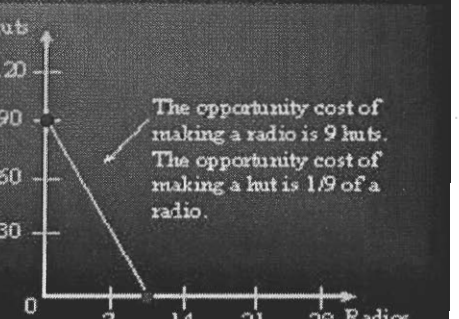
Example:

- Let's say that the crew on Gilligan's Island finds another nearby Island of native folk who also produ radios and huts
- Both the crew and the Islanders have 7 people and t same resources
- Linear PPC
- Allows us to calculate per-unit opportunity cost on once(since linear PPC's have constant opportunity cost)

The Crew's PPF



The Islander's PPF



Absolute advantage:

- Absolute advantage- an economy's ability to produce more of a good than another country can produce with the same resources
- In this case, the crew has an absolute advantage in radios and an absolute advantage in huts since they can make more of both (though it is possible to have an absolute advantage in only one good)

Comparative advantage:

- The crew's opportunity cost of making a radio is 6 huts, the islanders opportunity cost of making a radio is 9 huts, so the crew has the comparative advantage in radios.
- The crew's opportunity cost of making a hut is 1/6th of a radio. the islanders cost of making a hut is 1/9th. so the islanders have the comparative advantage in making huts

A note on Comparative Advantage:

- With two economies. it is not possible to have an comparative advantage in both goods

Trade:

- Now both islands are considering trade
- Each island will produce the good in which the have an comparative advantage

because they can produce it cheaper. It only costs the crew 6 huts to make a radio, while it costs the islanders 9 huts

Specialization:

•Each country will produce only the good in which it has a comparative advantage

•So, if the crew makes radios and the islanders make huts, how do they decide on the trading arrangement that is best for both of them?

The Islanders

•The **islanders will trade huts** for radios

•They want radios as cheaply as possible

•What is the most they will pay for a radio?

-9 huts. Because if a radio cast 10 huts, they would be better off making radios themselves and trading domestically

The Crew

•Since the crew is making radios, they are buying huts.

•They want to get as many huts a possible for one of their radios

•What is the least they would be willing to accept for a radio?

-6 huts. If they were offered 5 huts for a radio, they would be better of not making a radio and trading domestically

Specialization:

•Each country will produce only the good in which it has a comparative advantage

•So, if the crew makes radios and the islanders make huts, how do they decide on the trading arrangement that is best for both of them?

The Islanders

•The islanders will trade huts for radios

•They want radios as cheaply as possible

•What is the most they will pay for a radio?

-9 huts. Because if a radio cast 10 huts, they would be better off making radios themselves and trading domestically

The Crew

•Since the crew is making radios, they are buying huts.

•They want to get as many huts a possible for one of their radios

•What is the least they would be willing to accept for a radio?

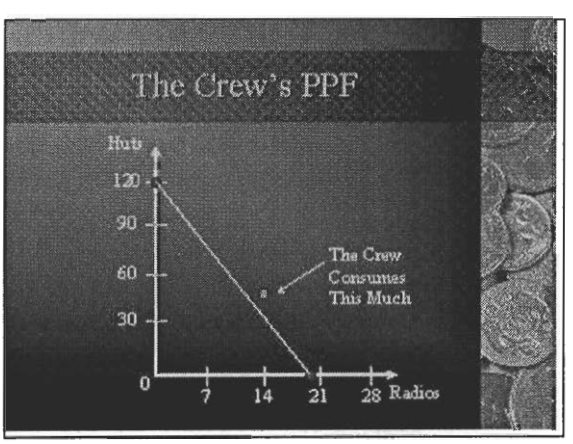
-6 huts. If they were offered 5 huts for a radio, they would be better of not making a radio and trading domestically

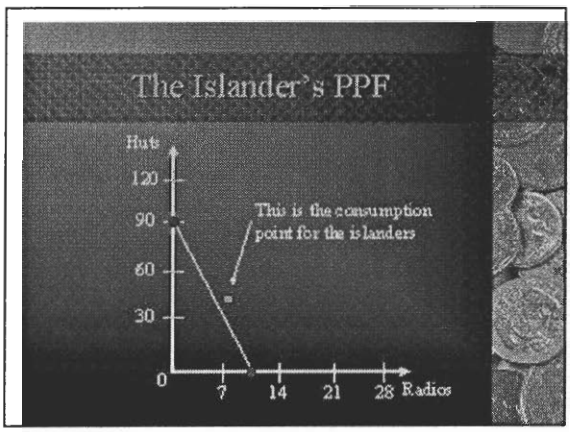
Terms of Trade:

- The islanders will pay anything less than 9 huts for a radio
- The crew will accept no less than 6 huts for a radio
- So anywhere between 6 and 9 huts per radio makes both islands happy

Why is it better to trade?

- Let's go back to the PPC's
- If the crew made all radios and traded 6 of them for 48, and islanders made all huts and traded 48 for 6 radios(a terms of trade of 8 huts per radio), we will see that such a trade will allow each island to consume outside of their PPC
- Both islands win through free trade



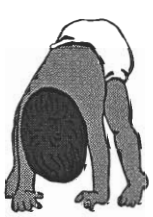


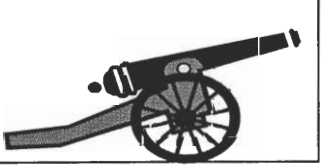
Barriers to trade:

•Quotas- limits how much can be shipped
•Tariffs- tax on imports
•Non-tariff barriers- ex: regulatory restrictions

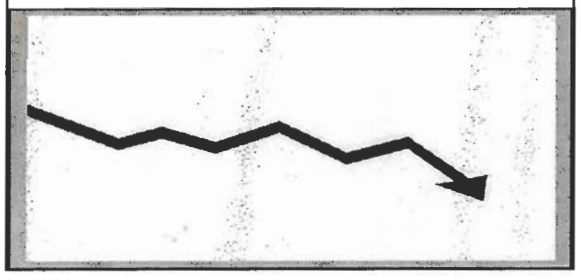
Arguments against free trade

•Nationalism- "Buy American" save American jobs
•The exploitation doctrine- trade is a zero sum game
•Infant industries
•National defense





Business cycles



Phases of the business cycle:

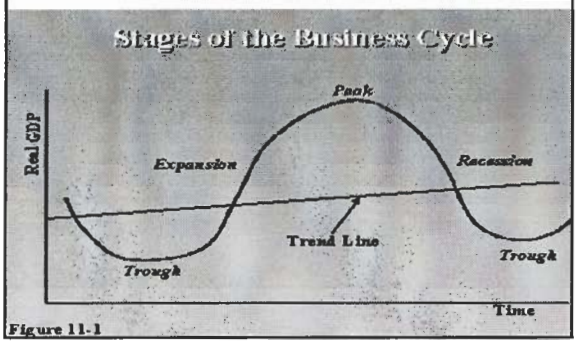


Figure 11-1

Leading indicators:

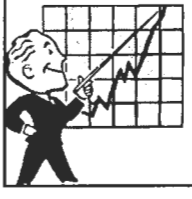
- New orders for consumer goods
- New business formation
- Orders for plant and equipment
- Building permits(housing starts)
- Change in inventories
- Price of raw materials
- Money supply

Goals for the economy:

1. Full employment
2. Stable prices
3. Growth

Causes of growth:

- Incentives
- Technological development
- availability of resources
- capital accumulation
- Entrepreneurship



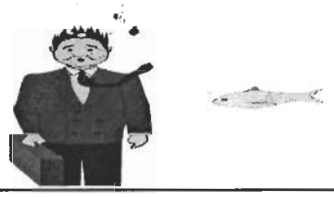
Unemployment rate:

U/LF

- U- # of people willing and able to work, but are unable to find work
- Labor Force- Employed + unemployed
- Target rate of unemployment- lowest sustainable rate 4%

Types of Unemployment:

- Cyclical- due to fluctuations in the economy
- Structural- mismatch of skills
- Frictional- due to job search

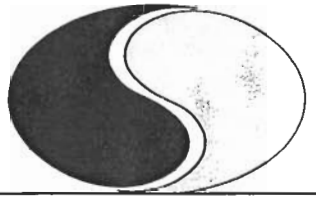


Okun's rule:

- If the unemployment rate increases by 1% output will fall by 2.5%
- If the unemployment rate decreases by 1% output will rise by 2.5%

Real vs Nominal

- Real output- adjusted for change in the price level(constant prices)
- Nominal output- in current prices



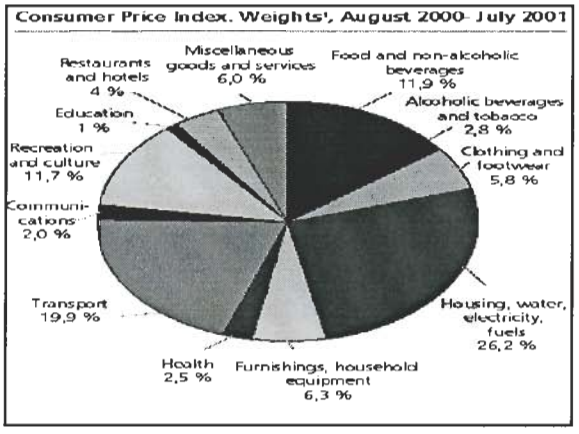
Inflation:

- Increase in the price level
- demand pull-increased demand
- cost push-decreased supply

Measuring inflation:

- Producer price index(PPI)- composite of prices of important raw materials
- Consumer price index(CPI)- Measures prices of a "basket" of goods

GDP deflator- (Nominal GDP / real GDP) x 100



National Income Accounting

Expenditure approach:

GDP=C + I + G + (X-M)

Consumption:

- Durable goods
- Non-durable goods
- services

Investment:

- Nonresidential
- Residential
- inventory

Government purchases:

- Expenditures by federal, state and local governments on final goods
- does not include transfer payments(social security, unemployment etc.)

Net Exports

- Exports- sales to foreigners of U.S. produced goods
- Imports- purchases by U.S. citizens of foreign produced goods
- Net exports- Exports - imports

GDP VS GNP

•GDP- output produced within an economy

•GNP- output produced by a country`s own citizens and firms

GDP= C + I + G + (X-M)

•GNP= GDP + net foreign factor income

•NDP= GDP - capital consumption allowances

•NNP= NDP + net foreign factor income

•NI= NNP - indirect business taxes or

•NI= wages + rents + interest + profits

•PI= NI - corporate income taxes-undistributed corporate profits- social security contributions + transfer payments

•DI= PI- personal taxes

The value-added technique:

•Merely summing all sales revenues entails double counting

•value added is computed by subtracting from final sales any purchases of intermediate products