

Economic institutions:



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Business:

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



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Three primary forms of business:

- Sole proprietorship
- Partnership
- corporation

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The relative importance of manufacturing:

- Percentage of production unchanged
  - Percentage of jobs has fallen
    - Reasons
      1. More productive
      2. Import more
      3. Service jobs

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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

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Roles of government:

1. Correcting for externalities
2. Providing public goods
3. Providing a fair distribution of income
4. Merit goods

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### 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

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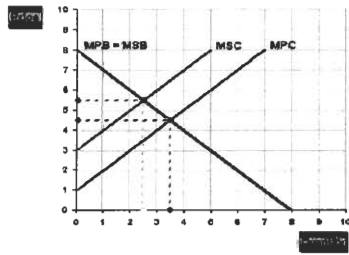
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### Negative externality:



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### Marginal Private Cost (MPC)

- The cost of just the people in the transaction.
- Does not include the cost passed on to third parties

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### 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



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### Marginal Private Benefits (MPB)

- The benefits of just the people in the transaction.
- Does not include the benefits passed on to third parties.

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### 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



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### 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

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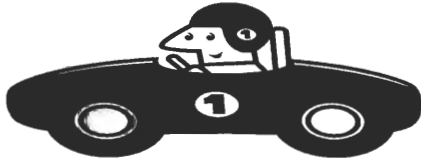
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### Free rider problem:

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



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### 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

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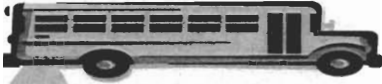
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Merit good:

- Something society should not do without



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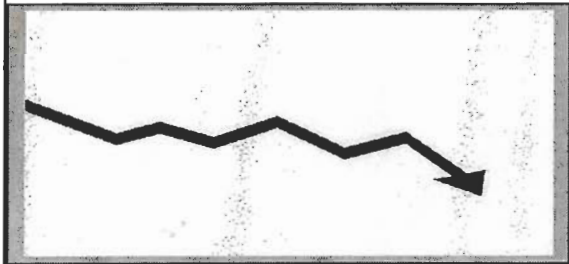
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# Business cycles



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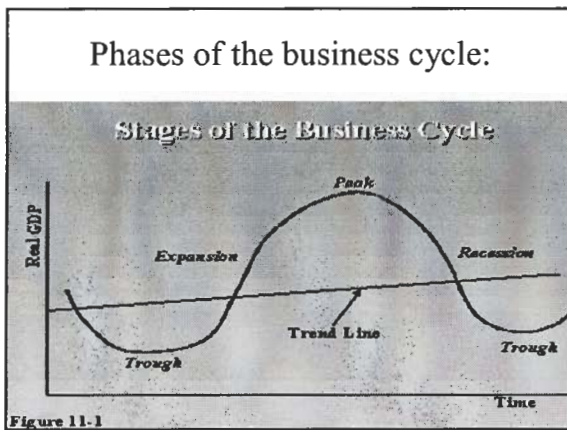
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## Phases of the business cycle:



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## 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



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### Goals for the economy:

1. Full employment
2. Stable prices
3. Growth



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### Causes of growth:

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



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### 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%

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### Types of Unemployment:

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



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### 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%



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### Real vs Nominal

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



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## Inflation:

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



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## 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-  $(\text{Nominal GDP} / \text{real GDP}) \times 100$

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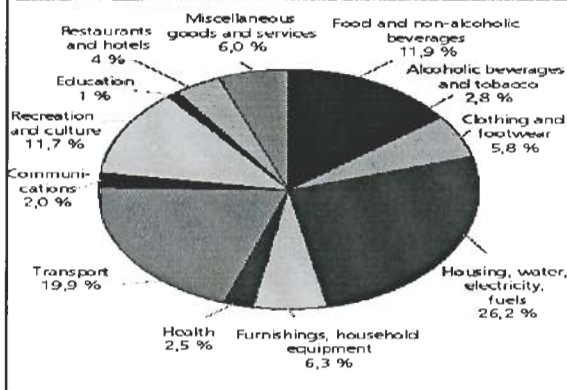
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Consumer Price Index. Weights, August 2000- July 2001



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National Income Accounting

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Expenditure approach:

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

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Consumption:

- Durable goods
  
- Non-durable goods
  
- services

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**Investment:**

- Nonresidential
- Residential
- inventory

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**Government purchases:**

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

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**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

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### GDP VS GNP

- GDP- output produced within an economy
- GNP- output produced by a country's own citizens and firms

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$$\text{GDP} = C + I + G + (X - M)$$

- 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

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### 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

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