Solutions and summary to chapter assignment

When here is an efficient allocation Of resources, all members are equal. In Parent some are better off. Property Rights and Exchange in a Market Economy Property Right: legally enforced right to select the uses of an economic good. Ownership: involves use rights and limitability rights, Gains from Trade People buy and sell to make themselves better off. Trade is when the buyer places a higher value on the item of the seller. Gains from trade make both parties better Off. Mutually advantageous. Gains form trade come form individual preferences, since people place different values on items according to their preferences.

Comparative advantages: specialization Of a good. A common misconception is that trade takes place because people have too much of some goods. Trade is an important form of value creation. , providing important incentives to move resources to more productive uses. BASICS OF SUPPLY AND DEMAND MARKET PRICE SYSTEM – THE PRICE MECHANISM Market includes all potential buyers of a certain product. Competitive market: many buyers and sellers and individual transactions are so small in relation to the market that the price is unaffected by any single sale or purchase. Demand curve depicts how many people are willing to buy a product at each rice. T slopes downward because people Will buy more if products have lower prices. Supply curve depicts how many producers are willing to sell at each price. At a higher price, sellers are willing to sell more products, upward slope. Two curves cross at the market clearing price, where the quantity of products demanded equals the quantity of products supplied, This is when a market is in equilibrium. Strong pressures push markets to equilibrium. Supply and

demand diagrams are snapshots at a pointing time. As time passes, both change, LINEAR SUPPLY AND DEMAND Supply function.

Sq involves market price of product supplied and wages paid to workers. Supply curves show the relation between price and quantity supplied holding all other factors constant. Demand function Q involves per capita income and price of the product. Equilibrium is when Q equals Sq PRICE AS A SOCIAL COORDINATORS Prices play crucial roles to coordinate consumption and production decisions Of individuals. If everyone trades n the marketplace and all mutually advantageous trades are completed, the price system results in Parent efficient resource allocation without any government intervention.

EXTERNALITIES AND THE CEASE THEOREM Externalities exist when the actions of one party affect the well being or production possibilities of another party outside and exchange relationship. They prevent a free market from being efficient. (investment in control of pollution) In this case government intervention seemed to enhance efficiency, Cease presented in 1960 a convincing argument: that exchange, in free market is more powerful in producing efficient results than had been thought previously. As long as property rights can be traded, there is an incentive to rearrange these rights to enhance economic efficiency. If firm doesn't control pollution there s an opportunity cost Of not receiving from its neighbors) The firm will pollute only if the pollution is more valuable to the firm than the cost it imposes on its neighbors. Coarsens arguments convinced most economists that externalities were less Of a problem than previously thought and implied a distribution of proper (legal) rights might have less of an effect on the

ultimate use of resources than it has on the distribution of income. So long as these rights can be exchanged.

Market exchange will not always solve the problem of externalities, due to contracting costs, as search and info costs, bargain and decision sots, drafting, logging and enforcement costs. Coarse Theorem: the ultimate resource allocation will be efficient, regardless to the initial assignment to property rights, as long as contracting costs are sufficiently low and the property rights are assigned clearly, are well enforced, and can be exchanged readily. It suggests also that contracting costs are central to the study of organizations.

MARKET VS. CENTRAL PLANNING History suggests that the price system is more efficient at controlling and coordinating production and consumption decisions in large economies than is central planning. The price system motivates better use Of knowledge ND information in economic decisions, and provides stronger incentives for individuals to make productive decisions. General vs. Specific Knowledge General knowledge is free to transfer. (prices and quantities) As the cost of information transfer increases, information is said to be more specific.

Factors that influence costs of transferring information: I. Characteristics of sender and receiver(people of same training culture and language communicate easier) 2. Technology available for communication (email lowers costs of transferring information) 3. Nature of the knowledge itself. (some knowledge is difficult to summarize, empowered and transfer in a timely fashion) Specific types of knowledge 1. Idiosyncratic knowledge of

particular circumstances: employees on the spot know if truck has left for specific products, using info immediately before it becomes useless.

He needs to load mores tuff instead of transferring this info to an authority or central planner 2. Scientific Knowledge: knowledge of recombinant DNA is not easily transferred to inconsistencies 3. Assembled Knowledge: years of experience operating a machine. This is not easily transferred to others. Specific knowledge is critical in properly allocating resources. Many economic opportunities are short lived and must be acted on quickly by the person on the spot or lost. KNOWLEDGE CREATION Knowledge is dynamic.

There are 2 factors that can motivate changes in the costs of transferring knowledge: technology (lowered costs) and actions individuals can make to convert specific knowledge to more general knowledge (manuals of operation) Technology: figuring out better ways to use existing resources (in services and manufacturing) using conversion of specific knowledge SPECIFIC KNOWLEDGE AND THE ECONOMIC SYSTEM Market economies are more likely than centrally planned economies to incorporate relevant specific knowledge in economic decision making.

Since specific knowledge is not given to a sole individual but decentralized, to INCENTIVES IN MARKETS Private property rights are critical tort making a market economy work because they provide strong incentives for decentralized decision makers to act on their specific information- the wealth effects of economic decisions are borne directly by the resource owners, who will profit on them, In centrally planned economies, decision makers have

limited incentives to make productive use of information resources even if they have them, since they do town these resources.

CONTRACTING COSTS AND EXISTENCE go FIRMS Hayes suggests that markets are better than central planning. Nevertheless, many firms use central planning, where decisions are all made by their managers. Resources are allocated by both markets and firms because economic transactions involve contracting costs, including search and info costs, bargaining and decision costs, and policing and enforcement costs. In some cases the method will be market exchange and in others it will involve firms.

Contracting Costs and Markets A primary setoffs costs of using markets for exchange involves the discovery and agitation of prices. Firms have, for example, two potential advantages: 1. Fewer transactions: for N customers and M factors of production, total transactions are N 4 M. If a customer hires the same 10 workers to assemble a PC it will cost him N* M 2. Informational Specialization: producers know better of how to assemble a PC than any customer Costs associated with specific assets are very motivating for the existence of firms.

Assets are specific when they are worth more in their current use than in alternative uses. Another potential advantage Of firms is that in some cases they can reduce interacting costs through established reputations. (longer lives) Government regulation helps firms in that avoiding taxes they can produce cheaper products, thing that doesn't happen in market transactions. Contracting Costs within Firms Resource allocation by firms also involves

contracting costs. The larger the firm, the more difficult to make efficient and timely decisions.

As a firm grows, important decisions must be delegated to non owners generating costs to motivate these non owners to work in the interests for the owners. Efficient Organization Individuals involved in trade and production have incentives to implement cost educing methods of organization because there are greater gains to be shared. (cost reduction gives more profits) Managerial Objectives Value minimization is the sole Objective Of managers. Chapter 3 Review Questions 3-11. In certain professional sports, team owners " own" their players.

Owners can sell or trade players in another team. However, players are not free to negotiate with other team owners on their own behalf. The team owners initially obtain the rights to players through and annual draft that is used to allocate new players among the teams in the league. They also can obtain the rights to players y purchasing them from another team, Players do not like this process and often argue that they should be free to negotiate with all teams in the sporting league, In this case, they would be free to play for the team that offers the most desirable contract.

Owners argue that his change in rights would have a negative effect on the distribution of talent across teams. In particular, they argue that all the good players would end up on rich, media center teams such as NY or LA (because the teams can pay higher salaries.) The inequity of players across teams would make the sport less interesting to fans and thus destroy the league.

Do you think the owner's argument is correct? Explain. Believe the owner's argument is correct.

If all good players were in the same team or distributed among the two richest teams, this or these teams would always win games, making the games predictable and losing their competitiveness' and amusement for consumers. 3-13. Q)cuts Hill Golf Club is a private count"/ club. It charges an initiation fee Of $23, 000. When members quit the club, they receive no refund on their initiation fees. They simply lose their membership. Salt Lake Country Club is also a private golf course. At this club, members join by buying a membership eradicate from a member who is leaving the club.

The price of the membership is determined by supply and demand. Suppose that both clubs are considering installing a watering system. In each case, the watering system is expected to enhance the quality of the golf course significantly. To finance these systems, members would pay a special assessment of $2, 000 per year for the next three years. The proposals will be voted on by the memberships. Do you think that the membership is more likely to vote in favor of the proposal at Locust Hill or for the one at Salt Lake country club? Explain.

Locust Hill Club members have a greater power of acquisition compared to the members of Salt lake Club, since membership at Salt Lake is determined by the market. Nevertheless, there are probably less members at Salt Lake than at Locust since Salt Lake members have to wait for a member to leave in order to enter the club while Locust Hill members just have to pay an initiation fee to enter. In this case, Salt Lake might be a more exclusive club,

but it really depends on the pressure exerted by supply and demand so it can't actually be determined.

Due to this probable exclusivity of members at Salt Lake, the membership would probably vote in favor of Salt lake Club, whose members are more involved in club activities and desire to hue a better club. Members at Locust Hill won't leave the club since they would lose $23, 000 on leaving and therefore if they don't have a watering system they would still be members. Members at Salt Lake without a watering system might consider selling their memberships and therefore the prices of these memberships would lower. 3-17.

Two men, Robinson Crusoe and Friday, have been marooned separately on the same deserted island. There are two activities each man can undertake to obtain food: fishing and gathering coconuts. Robinson Crusoe can catch 40 fish per hour or gather 10 coconuts per hour. Friday can catch 10 fish per hour or gather 8 coconuts per hour. Answer the following questions: a) Who is more efficient in each activity? Could either or both of them benefit from meeting and deciding to form a trading relationship? Explain intuitively.

Intuitively, Robinson is more efficient in both activities: fishing and gathering coconuts. Since Robinson can handle both activities allocating part of his time to fishing and other part of his time to gathering coconuts, he doesn't need help ND therefore will not benefit from a trading relationship. Friday needs the trading relationship because he is not as efficient in any of the activities as Robinson. In the case that Friday helped out Robinson and they formed a trading agreement, he would probably be assigned to gathering

coconuts part of his time and cooking the fish the other half.) Robinson and Friday have not yet met. Robinson is working 2 hours a day and producing (and consuming) 48 fish and 8 coconuts (note: the fish are very small.) Friday is also working 2 hours a day, but he is producing and consuming 5 fish and 4 coconuts. NOW assume that Robinson and Friday meet and develop a trading relationship. Come up with a production and trading scheme such that they can each work the same amount per day as before, but each is better off than before. Provide specific numbers to show how they are better off.

The way to obtain more fish and coconuts working together is for Robinson to solely fish during two hours per day and for Friday to solely gather coconuts for two hours a day, yielding B fish and 4 coconuts for each of them, 3-18. Suppose that annual demand in the IS, S, market for ice cream cones can be expressed as Q = 800 + 0, 21 – IPPP, where CO is the number of cones demanded in millions of cones, equals average monthly income in dollars, and P is the price in dollars per cone.

Supply can be expressed as SQ = 200+ SOP (with the same units for quantity and price,) a) Graph the demand and supply curves for ice cream cones, assuming that the average monthly income is $2, 000 and solve for equilibrium and quantity. The equilibrium of the market is given at a price of $4 per ice cream cone and a quantity supplied and demanded Of 800 ice cream cones. B) NOW assume that average monthly income drops to $750 and supply is unchanged. Draw the new demand curve on the same graph as used above and solve for the new equilibrium price and quantity.