

Microeconomics, Module 18, “Externalities – Transaction Costs” (chapter 13)

*Micro module 18: Readings for eighth edition*

(The attached PDF file has better formatting.)

Updated: October 19, 2010

{The Landsburg textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

Read section 13.3, transaction costs, on pages 436-443. Understand (i) how transaction costs affect the Coase analysis and (ii) the types of transaction costs.

Read section 13.4, “Law and Economics,” on pages 443-449. Casualty insurance depends on the legal rights of policyholders vs claimants. Many of the principles in this section are repeated on CAS exams.

Read the summary from the second paragraph on page 449 through the end.

Review questions R2, R3, and R4 on page 450. Question R4 is the historical event that led to much of the theory. Early trains caused sparks that could ignite crops on farmland adjacent to the tracks. The best solution was for farmers not to plant crops close to the tracks, and perhaps the railroad company should compensate the farmers for the (minor) loss of crops. Letting farmers plant right up to the tracks and then charging the railroad for fire losses to the farms is a poor solution.

Problem 1 on page 451 is the classic example of a positive externality. Most externalities are negative; most good things are not free, but pollution is widespread.

Review problem 12 on page 453. Know whether the tariff increases or decrease social welfare.

Review problems 16 and 17 on page 454. Focus on the difference between social gain and individual gain.

Review problems 18 and 19 on pages 454-456. Focus on the effect of transaction costs on optimal social relations.

Review problem 22 on page 457. Insurers have conflicting incentives. They want to reduce traffic accidents to minimize their loss payments, but without traffic accidents, drivers would have no incentive to buy insurance. Auto insurance is required by law, but for other lines of business, insurers have clearer conflicts.