

Microeconomics, Module 9, "Welfare Economics and the Gains from Trade"

Micro module 9: Reading for tenth edition

(The attached PDF file has better formatting.)

{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 skipped sections are fascinating but are not tested.}

This module covers consumers' surplus and producers' surplus. Chapter 8 of Landsburg's text has other items as well, not all of which are not tested on the final exam. We specify here what you must know.

Read the introduction, which is excellent. A statement that a certain policy is good or bad is incomplete: almost every policy is good for some people and bad for others. Landsburg shows how to analyze policies.

Read section 8.1. Focus on the relation between demand, marginal value, and total value; exhibit 8-2 relates these concepts graphically. You use this relation on final exam problems dealing with consumers' surplus. The final exam problems give the market demand curve, the cost curves, and require you to compute various figures including consumers' surplus, producers' surplus, and social gain. Exhibits 8-3, 8-4, 8-5, 8-6, and 8-7 show the procedures. The final exam problems use simple curves, requiring geometry, not integration.

- ! The *consumers' surplus* is the area under the demand curve down to the price paid and out to the quantity demanded.
- ! The *producers' surplus* is the area above the supply curve up to the price paid and out to the quantity supplied.

Landsburg calculates consumers' surplus and producers' surplus from discrete supply and demand *schedules*. The homework assignments and final exam problems also use linear supply and demand *curves*. The areas representing consumers' surplus and producers' surplus are *right triangles*, whose area is $\frac{1}{2} \times \text{height} \times \text{width}$. The concepts and overview postings for Modules 11 and 12 show the procedure to calculate the surplus for various scenarios. Both the discrete schedules and the areas of triangles are shown in the practice problems, and the same procedures are used on the final exam.

Exhibit 8.2 shows the value as an area on a graph. To avoid calculus, Landsburg works out the figures by summing schedules. Using calculus, we integrate under a curve and above a straight line. Most final exam questions use linear demand curves and marginal cost curves and simple geometry to find the area of a right triangle. The final exam does not test your mathematical abilities, so it does not use more complex cost curves and demand curves.

Read Section 8.2 ("The efficiency criterion"). You will use the efficiency criterion, but you need not evaluate it. This is a course on economics, not on politics. Landsburg is a free-market economist (as are most actuaries), but even a century of socialist failures have not eliminated communist utopian dreams.

Focus on section 8.2.1, "consumers' surplus and the efficiency criterion," "the effect of a sales tax," and "understanding deadweight loss (several sub-sections)." The textbook uses graphics with letters for various regions. Final exam problems give similar graphics and ask you to identify various areas, such as the effect of a sales tax or an excise tax on consumers' surplus and producers' surplus.

Read the material on dead weight loss. The final exam problems test sales taxes, excise taxes, and subsidies. In each case, you determine the change in consumers' surplus, producers' surplus, and the dead weight loss.

You may skip the section on Hidden Assumptions and the section on "other normative criteria." They are worth reading, but these assumptions are not tested on the final exam.

Read Section 8.3 Examples and Applications. Focus on exhibit 8-11, especially bullet point #3. The final exam problems on price discrimination calculate separate consumers' surplus and producers' surplus for each class of consumers.

Skip section 8.4. This is all theoretical; Landsburg says that economists have proved the results, but no final exam questions are taken from this section.

Landsburg says that capitalism works well; it might be the best economic system around. Western thinkers have wondered how we can know if we are prejudiced; after all, Marxist economists said that communism was the best economic system around. Max Weber conjectured that scientists and scholars in an open university are relatively free of prejudice. This sounds good, but most academics have views that are at odds with those of simple economics. We believe in the invisible hand theory, but the final exam doesn't test this section.

Question: Communism has collapsed; are there still politicians and intellectuals who don't believe in free markets and the invisible hand theory?

Answer: Look at the European Union. In the twenty years since Communism has collapsed, leaders of various European countries (France, Germany, Belgium) has built up a system that is the opposite of Landsburg's textbook. Even now, with the poverty of the European Union compared to the vitality of India, China, Singapore, and other Asian nations, the leaders of France and some other European countries continue to espouse its ideas. Even Britain has succumbed to the European social welfare ideal, and it is only now trying to rescue itself. In recent decades, the U.S. has reversed its support of individualism and private business, and it is moving toward the European system.

Question: Are you saying that the goals of the European Union are not good?

Answer: We say nothing about the goals. The goal of a peaceful continent is wonderful; but the attempt to suppress free markets will cause that continent to sink. The ideal would be free markets along with political freedom and peace.

The material on macroeconomic theory is covered better in Barro's textbook. Many candidates are taking both micro and macro on-line courses; we cover this material in macro, where it is more relevant, not in micro. Landsburg and Barro have the same perspective, and we avoid duplicating material in these courses.

Question: Brealey and Myers, Landsburg, and Barro all have the same perspective. Is this expected?

Answer: Until thirty years ago, Western intellectuals argued about the best economic and financial systems. The Communist world seemed to be getting stronger; the Europeans (France, Germany) and Asians (Japan, South Korea, Singapore, Taiwan, Hong Kong) seemed to be over-taking the United States. The free market perspective in these three textbooks seemed a poor match for the central planning of Communist countries, the social model of the Europeans, or the directed economies of the Asians. But few now believe that the alternatives out-perform free markets. Even countries who oppose free markets speak of other objectives (justice, equity, equality), not pure economic or financial reasons for alternative systems. Economic and financial theory has converged; Brealey and Myers, Landsburg, and Barro reflect the current consensus.

But politics trumps economics. High taxes on labor ruin economies (see the modules on labor economics in microeconomics and macroeconomics courses), but western countries continue raising taxes.

Review end of chapter problems R2, R3, R4, R5, R6. "Analyze" means show the change in the graphic. For R3, explain how to calculate the size of each surplus.

Review end of chapter problem N1.

Review end of chapter problems 1, 2, 3, 4, 16, 17, 18.