OUTLINE — October 1, 2018

- Imperfect Competition, continued
  - Monopolistic Competition, continued
- Externalities
  - Definitions
- Guest Speaker, Prof. Trevon Logan (Ohio State)
- Externalities, continued
  - Coase Theorem
  - Taxes & Subsidies (and what is "optimal")

PS 2 is due Mon/Tues 15/16

Monopolistic Competition

- Lots of firms
- No barriers to entry/exit
- *Heterogeneous* product

Profit Maximization

- Max profit when choose q so that MR = MC

Entry erodes profit

Long-Run Equilibrium

Effect of increased variable cost?

Market Failure: Externalities

- Your activity affects someone else
- Negative externality
  - Cost borne by someone else
- Positive externality
  - Benefit received by someone else

Guest Speaker: Prof. Trevon Logan

Prof. Trevon Logan
BS, Univ of Wisconsin-Madison
MA, MA, and PhD, UC Berkeley
Title: Hazel C. Youngberg Distinguished Professor of Economics, at The Ohio State University
Research specialties
Economic history, health economics and economic demography
Today's paper, "Do Black Politicians Matter?"
NBER Working Paper # 24190 (google "NBER 24190")

Positive Externality

- Benefits accrue to people who are neither the buyer nor the seller
  - *Education !*
- Private Marginal Benefit
- External Benefit (or, marginal external benefit)
- Social Marginal Benefit (or, marginal social benefit)

Positive Externality

Negative Externality

- Marginal Private Cost (or, private marginal cost)
- Marginal Damage Cost (or, external cost)
- Marginal Social Cost (or, social marginal cost)

Negative Externality

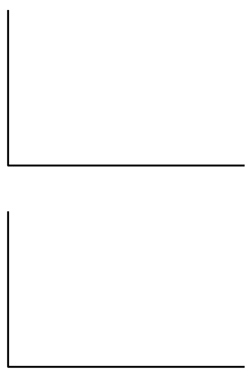
Coase Theorem

- Solution without government possible
- Requires
  - Well-defined property rights
  - No costs to bargaining
  - Only a few people
- Otherwise: government intervention

Encourage behavior with subsidy

- Private market produces too little when there are positive externalities
- Encourage with subsidies
- Example: Prof. Olney buys $48 Bart ticket each month, paid through pre-tax payroll deduction
  - $3 paid by Bart
  - $10 paid by UC Berkeley
  - $10 paid by federal government
  - $3 paid by state government
  - Which means just $22 is paid by Prof. Olney

Negative Externality: A Tax



Externalities & Taxes or Subsidies

- The challenge: what is the ***right (or, optimal) size*** of tax or subsidy?
  - It's positive (not normative) analysis
  - "Right" or "optimal" means generating socially optimal quantity
- Taxes discourage activity generating negative externalities
  - If Tax > MDC, then
  - If Tax < MDC, then
  - Only if tax = MDC, then
- What should the tax revenue be used for?
  - Offset (or, cover) costs represented by MDC