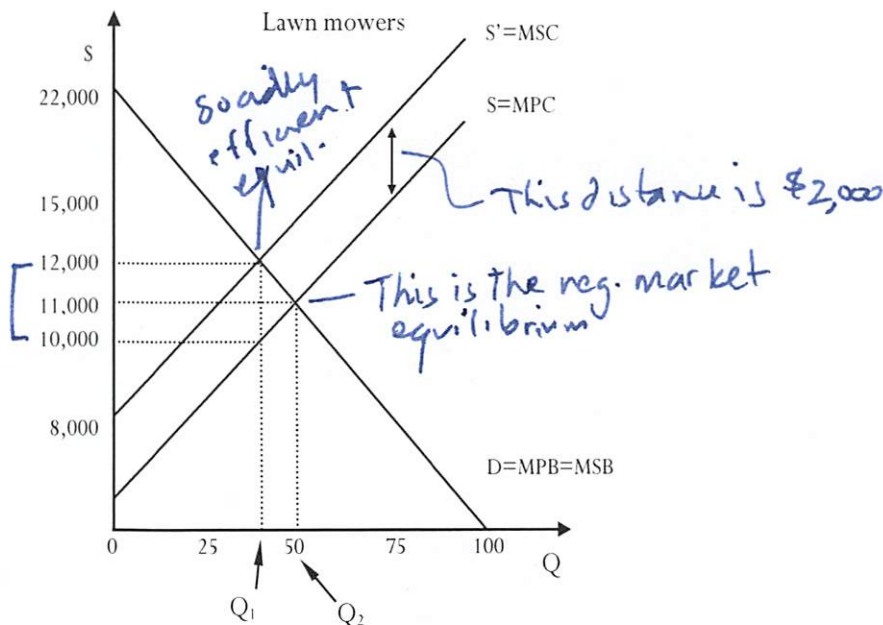


key

The graph to the right illustrates an externality situation. Use the graph to answer questions 1-5.



1. An externality is evident in the graph because there are two different quantities shown. Which is the socially efficient output in the market shown?

- a. Q1 (40)
- b. Q2 (50)
- c. Any quantity between 40 and 50.
- d. Any quantity between 0 and 39.

tax + neg. ext.

2. What is the amount of the Pigouvian tax (per unit) that would be required to bring about the socially efficient level of output?

- a. \$1,000
- b. \$2,000
- c. \$4,000
- d. \$5,000

3. What does MPC include?

- a. only the cost to build the lawn mowers
- b. only the cost of pollution damage to the neighbors
- c. both the cost to produce mowers plus the pollution damage

4. What does the fact that $MPB = MSB$ imply about externalities on the demand-side?

Since those are equal, there is no externality on the consumption side. (I could've made this a neg. consumption externality - the mower annoys neighbors - in that case, $MPB > MSB$)

5. What dollar amount represents the vertical distance between MPC and MSC? How did you find it? What does this dollar value represent?

\$2,000. This represents the marginal damage (or the monetary value of the neg. ext.). It represents the costs to correct the damage to the neighbors.

6. Explain the two key characteristics of "public goods." Give two examples for each characteristic.

Non-rival: one person's consumption does not affect or reduce another person's consumption. radio waves; fireworks display

Non-excludable: it's difficult, very costly, or impossible to exclude people from consumption.

7. What is the fundamental point of the "Coase theorem"?

Property rights are extremely important, and solve lots of problems.

(Any examples from class, esp. national defense)