

Key Terms & Examples

Chapter 5

1. Consumer Surplus-

- a. The excess of the benefit received from a good over the amount paid for it. It's is calculated as the marginal benefit (or value) of a good minus it's price, summed over the quantity bought.
- b. Example:
 - i. You are shopping for a new sweater. You know exactly what you want and are willing to pay \$75 to get it. You then walk into a shop that has the precise item on sale for \$50. You buy the sweater and enjoy a consumer surplus of \$25.

2. Deadweight Loss-

- a. A measure of inefficiency. It is equal to the decrease in total surplus that results from an inefficient level of production.
- b. Example:
 - i. A firm develops a diet drug and sells it for \$1 a pill. Its marginal cost of production is 10 cents a pill. The firm could increase production almost without limit and its marginal cost would remain close to 10 cents a pill. But more people would buy the drug at 10 cents a pill. The underproduction of the drug brings a deadweight loss.

3. Market Failure-

- a. A situation in which a market delivers an inefficient outcome.
- b. Example:
 - i. The presence of pollution tells us that the market for electricity experiences market failure.

4. Producer Surplus-

- a. The excess of the amount received from the sale of a good or service over the cost of producing it. It is calculated as the price of a good minus the marginal cost (or minimum supply price), summed over the quantity sold.
- b. Example:
 - i. Suppose Microsoft sells Windows 7 for \$100 a copy and its opportunity cost of production is \$5 a copy. Then Microsoft enjoys a producer surplus of \$95.

5. Transaction Costs-

- a. The opportunity costs of making trades in a market. The costs that arise from finding someone with whom to do business, of reaching an agreement about the price and other aspects of the exchange, and of ensuring that the terms of the agreement are fulfilled.
- b. Example:
 - i. I am buying a house. I pay a realtor to help me find the best

place and a financial planner to help me get the best loan. These costs are my transaction costs of buying the house.

Chapter 6

1. Minimum Wage-

- a. A regulation that makes the hiring of labor below a specified wage rate illegal. The lowest wage at which a firm may legally hire labor.
- b. Example:
 - i. Suppose that the government passes a minimum wage law that requires all employers to pay workers at least \$5.15 an hour. The wage \$5.15 an hour is a minimum wage.

2. Price Ceiling-

- a. A regulation that makes it illegal to charge a price higher than a specified level.
- b. Example:
 - i. Suppose the government passes legislation governing the maximum price that natural gas distributors can charge households for natural gas. As long as the maximum price is above the equilibrium price, no shortage of natural gas occurs. If in colder weather, the demand for natural gas increases and the equilibrium price rises above the maximum price allowed, a shortage of natural gas will occur. The country is facing the effects of a natural gas price ceiling.

3. Price Floor-

- a. A regulation that makes it illegal to charge a price lower than a specified level.
- b. Example:
 - i. A minimum wage of \$5.15 an hour is the lowest wage rate that workers can get paid. The minimum wage rate is a price floor.

4. Production Quota-

- a. An upper limit to a quantity of a good that may be produced in a specified period.
- b. Example:
 - i. The United States imposes production quotas on the quantities of tobacco and sugar grown.

5. Rent Ceiling-

- a. A regulation that makes it illegal to charge a rent higher than a specified level.
- b. Example:
 - i. In NYC, rent ceilings have been used since WWII.

6. Subsidy-

- a. A payment made by the government to a product.
- b. Example:
 - i. In remote parts of the third world, the quantity of communications equipment is less than the efficient level.

By paying a subsidy, local governments can encourage private suppliers to consider external benefits and increase production.

7. Tax Incidence-

- a. The division of the burden of the tax between the buyer and the seller
- b. Example:
 - i. Suppose that the government of California levies a \$500 tax on sale of an SUV. The tax incidence is the share of the tax paid by the buyer and by the seller of the SUV.

Chapter 8

1. Budget Line-

- a. The limit to a household's consumption choices. It makes the boundary between those combinations of goods and services that a household can afford to buy and those that it cannot afford.
- b. Example:
 - i. Jim has \$10 a day to spend on gas and coffee. The line that joins all possible combinations of gas and coffee that Jim can afford with \$10 in his budget line.

2. Consumer Equilibrium-

- a. A situation in which a consumer has allocated all his or her available income in the way that, given the price of goods and services, maximizes his or her total utility.
- b. Example:
 - i. Imagine that you have \$100 to spend on various goods and services. If you have spent all your \$100 and in such a way that your total utility is maximized you are at a consumer equilibrium. That is, no reallocation of the \$100 between the goods and services can increase your total utility.

3. Diminishing Marginal Utility-

- a. The tendency for marginal utility to decrease as the quantity consumed of a good increases.
- b. Example:
 - i. Your 1st cup of coffee is amazing. Your 2nd cup is OK. Your 3rd cup is getting boring. And you can't bear to drink a 4th cup. You are experiencing diminishing marginal utility of coffee.

4. Marginal Utility-

- a. The *change* in total utility resulting from a one-unit increase in the quantity of a good consumed.
- b. Example:
 - i. Your marginal utility from OJ is the increase in the total utility you get from drinking an additional glass of OJ.

5. Marginal Utility Per Dollar-

- a. The marginal utility from a good that results from spending one more dollar on it. It is calculated as the marginal utility from the