Summing Up

The core building blocks behind the economist's definition of value.

Individuals face constraints on their ability to pursue their needs and wants.

The slope of the budget constraint communicates the **opportunity cost** of consuming more of some good or service.

Individuals can define their preferences across the various consumption opportunities they face.

They choose based on the interaction of preferences and budget constraints so that the marginal rate of substitution of X from Y equals the opportunity cost of X from Y.

In a market economy, opportunity cost is measured as the ratio of the price of X to the price of Y. As the price of X changes, we can define the individual demand for each consumer. Add up the quantities demand for all consumers yields the market demand.

Demand represents the maximum willingness to pay for each additional unit.

Supply represents the minimum amount sellers must receive to be willing to provide an additional unit.

In a market equilibrium, there exists a single price at which quantity demanded equals quantity supplied.

That price represents value

a) in the sense that it is the opportunity cost (in terms of foregone consumption of other goods and services) of the last unit of the good or service in question that can be produced without making some participant in the market worse off; and

b) in the sense that it is the signal by which society, in the absence of some political, communal, traditional, or violent intervention will allocate resources recognized as property by members of that society.

I want to focus on manipulating the supply-demand diagram as an analytical tool and consider what happens when the government intervenes in markets.

With

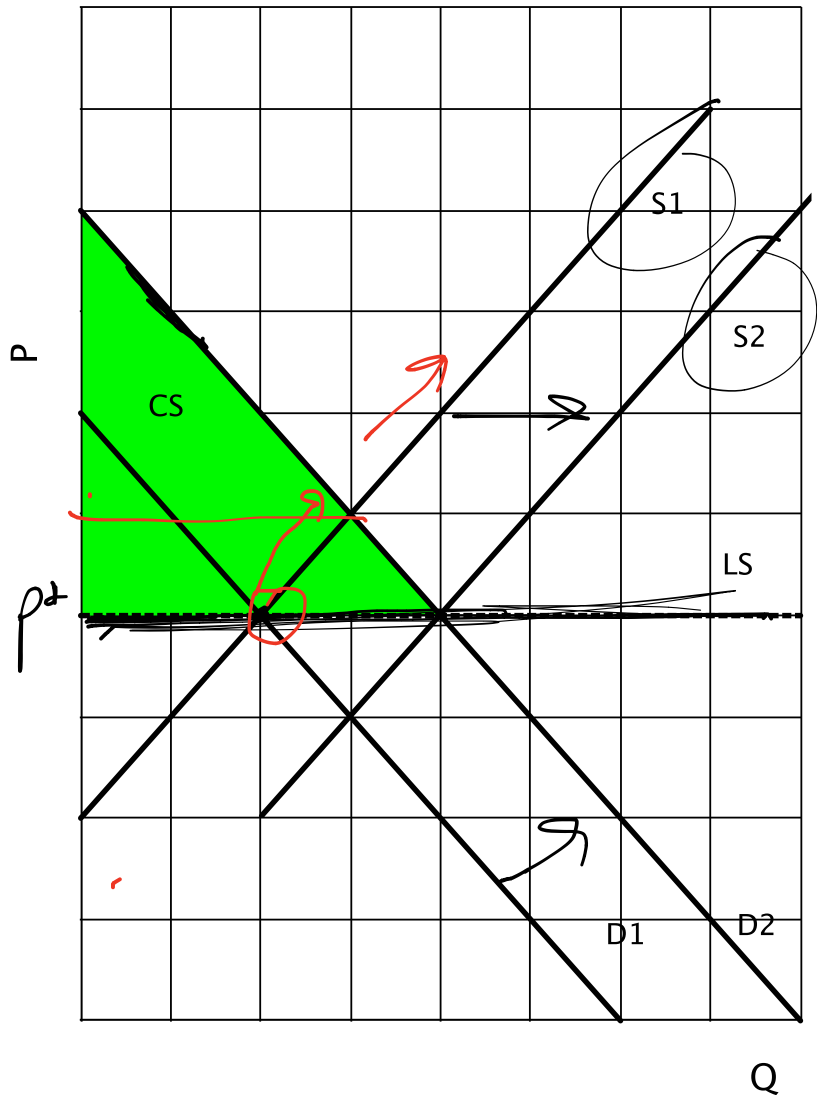
identical consumers
identical sellers and
free entry and exit

Economic profit = 0

Price is constant
Supply is horizontal

Consumer Surplus is maximized

Producer Surplus is zero

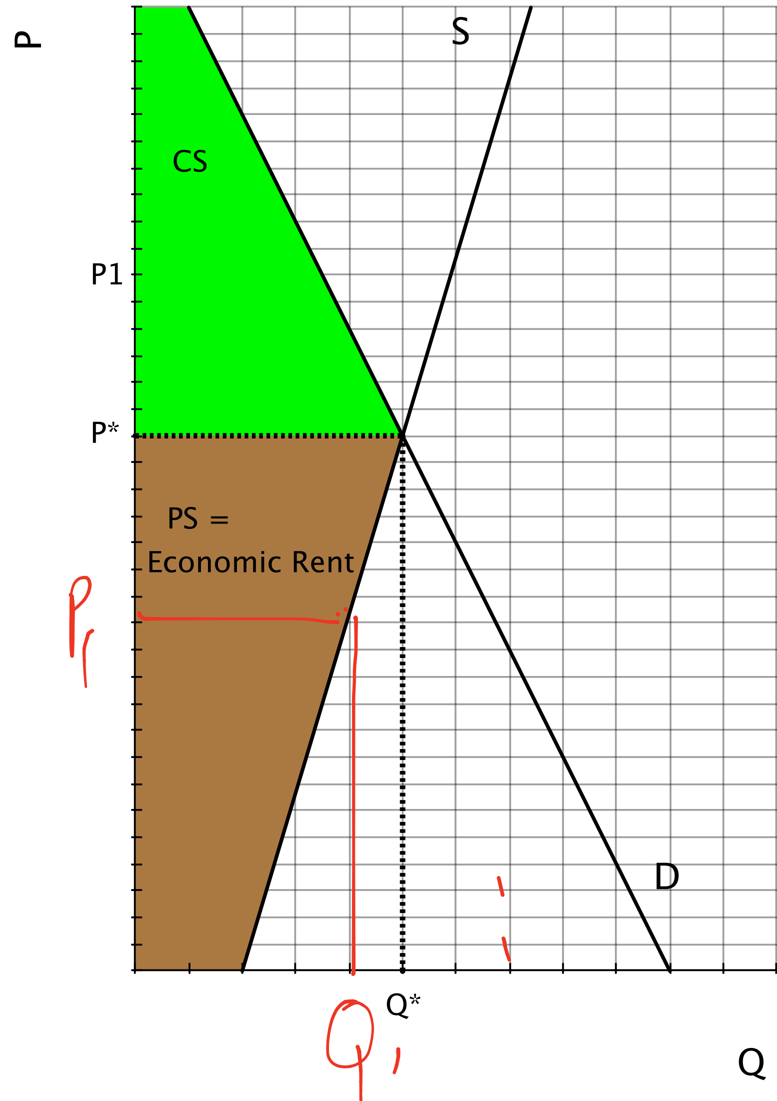


But, we know that long-run supply curves slope up! Why do they?

Quality differences

Increasing natural resource depletion costs

Claim: Rent, not profit, is the source of most of global inequality in wealth



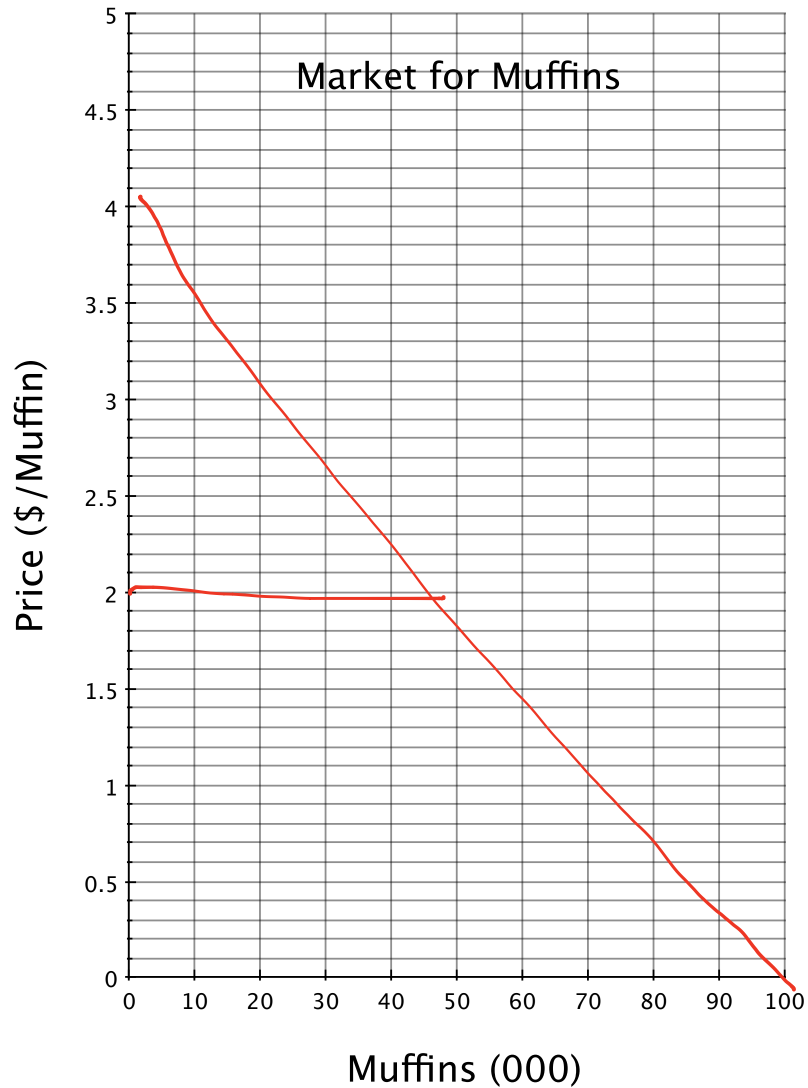
Intervening in Markets

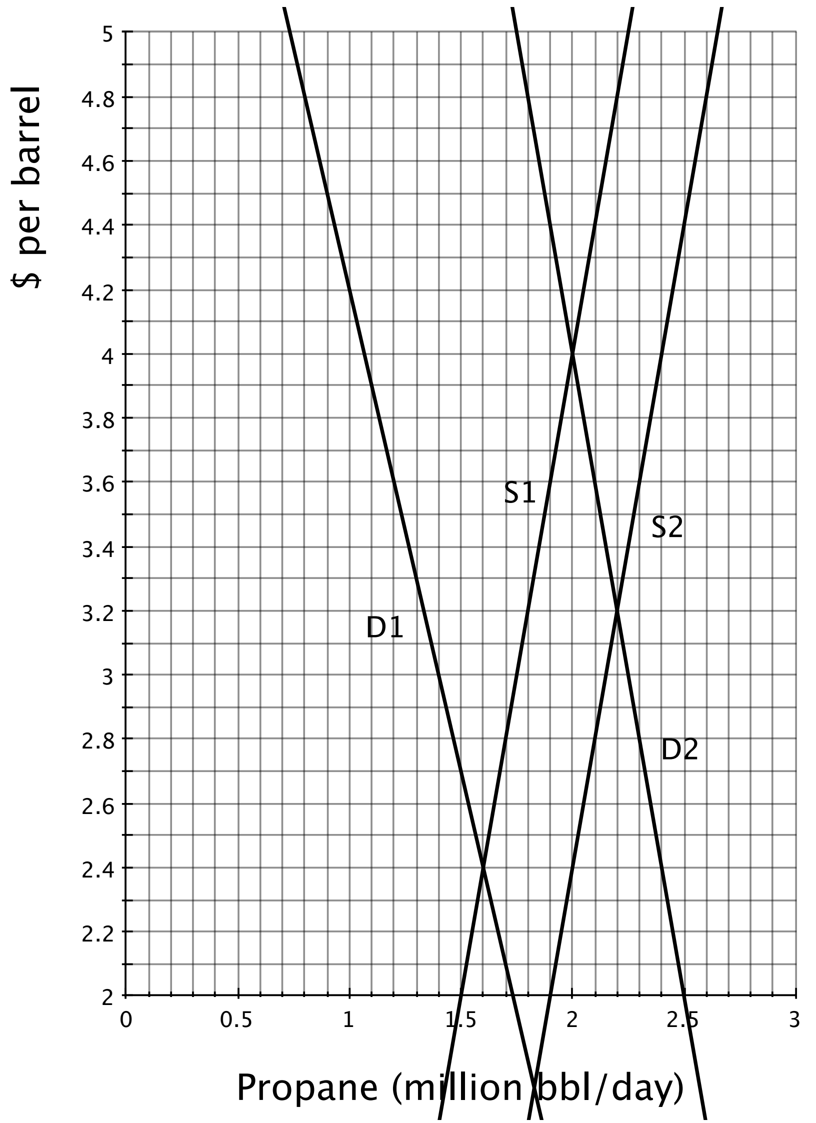
Government intervenes in markets

- To generate revenue to cover the costs of government programs
- Because the polity doesn’t like the market outcome

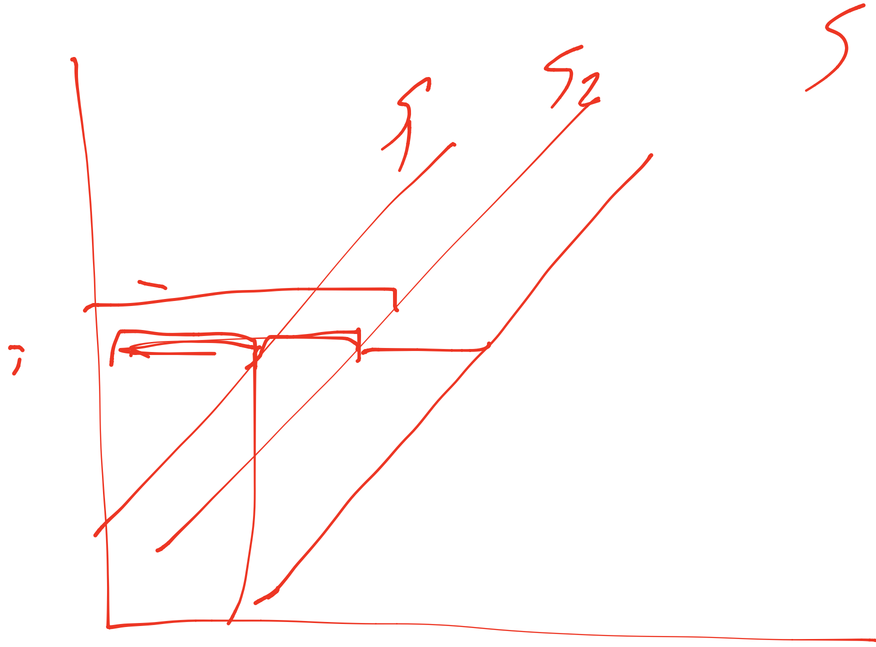
CS = $50,000

PS = 0




$ per barrel
5
4.8
4.6
4.4
4.2
4
3.8
3.6
3.4
3.2
3
2.8
2.6
2.4
2.2
2
0
0.5
1
1.5
2
2.5
3
S1
S2
D1
D2
Propane (million bbl/day)

1



q_1 q_2

$Q = q_1 + q_2$