Chapter 6
Efficiency and Fairness of Markets

6.1 Resource Allocation Methods

1) What allocation method is the primary method used in the United States?

Answer: While all the different allocation methods—first-come, first-serve, majority rule, contest, force, and so forth—are used in various instances, the primary method used in the United States is allocation using market prices. In the United States, for most goods and services, if someone is willing and able to pay the market price for a good or service, the person can acquire the good or service.

Topic: Allocation methods
Skill: Level 2: Using definitions
Objective: Checkpoint 6.1
Author: MR

6.2 Value, Price, and Consumer Surplus

1) Is the marginal benefit someone places on a good or service the same as the price he or she pays? Explain your answer.

Answer: Generally the marginal benefit of a good or service is different than the price that is paid. The marginal benefit is the maximum amount a consumer is willing to pay for a good or service. Typically the consumer can buy the good or service for a price less than the maximum. Indeed, the difference between the marginal benefit (the maximum price the consumer is willing to pay) and the price actually paid is the consumer surplus.) However, it might be the case that the price precisely equals the marginal benefit, that is, equals the maximum the consumer is willing to pay. In this case alone, the marginal benefit equals the price. And in this case, the amount of the consumer surplus equals zero.

Topic: Marginal benefit
Skill: Level 2: Using definitions
Objective: Checkpoint 6.2
Author: WM
2) Why is the demand curve the same as the marginal benefit curve?

Answer: The demand curve for a good tells us for any quantity of the good, the dollar’s worth of other goods and services that we are willing to forgo in order to get one more unit of the good in question. The marginal benefit of a good is the additional benefit from each unit of a good consumed. The additional benefit is measured by the amount of other goods and services we are willing to forgo to get one more unit of the good in question. Hence the demand curve is the same as the marginal benefit curve because the demand curve shows precisely what the marginal benefit curve measures.

Topic: Demand curve and the marginal benefit curve
Skill: Level 2: Using definitions
Objective: Checkpoint 6.2
Author: JC

3) The demand curve is the same as another curve. Which curve is the same as the demand curve? Why are the curves the same?

Answer: The demand curve is the same as the marginal benefit curve. For any quantity, the demand curve shows the dollar value of other goods and services the consumer is willing to forgo to get another unit of the good. (This amount is the maximum price the consumer is willing to pay and equals the price from the demand curve vertically above each quantity.) But the amount of other goods and services the consumer is willing to forgo is the marginal benefit of the good. Hence along the demand curve the price associated with each quantity of the good is the same as the marginal benefit of that quantity. (So that, for instance, the price associated with the 3rd quantity is the same as the marginal benefit of the 3rd unit.) Therefore the demand curve is the same as the marginal benefit curve.

Topic: Demand curve and the marginal benefit curve
Skill: Level 2: Using definitions
Objective: Checkpoint 6.2
Author: SA

4) What are the two ways demand curves can be interpreted?

Answer: Demand curves can be used to find either:

1) the quantity demanded at a given price. In this view, the curve is a demand curve;
2) the maximum price people are willing to pay for a given quantity. In this view the curve is a marginal benefit curve.

Topic: Demand curve and the marginal benefit curve
Skill: Level 2: Using definitions
Objective: Checkpoint 6.2
Author: SB
5) "A demand curve is the same as a marginal cost curve." Is this statement correct or incorrect? Explain your answer.

Answer: The statement is incorrect. A demand curve is a marginal benefit curve not a marginal cost curve. A demand curve is a marginal benefit curve because it can be used to find the maximum price people are willing to pay for a given quantity, that is, the marginal benefit of the given quantity.

Topic: Demand curve and the marginal benefit curve
Skill: Level 2: Using definitions
Objective: Checkpoint 6.2
Author: MR

6) What is consumer surplus?

Answer: Consumer surplus equals the difference between the marginal benefit of the good and the price paid for it summed over the quantity consumed. The total consumer surplus in a market equals the area under the demand curve and above the price.

Topic: Consumer surplus
Skill: Level 1: Definition
Objective: Checkpoint 6.2
Author: MR

7) What must be true for a consumer to enjoy a consumer surplus from a unit of a good?

Answer: The marginal benefit to the consumer of the unit of the good must be greater than the price of the good.

Topic: Consumer surplus
Skill: Level 1: Definition
Objective: Checkpoint 6.2
Author: TS

8) If the demand for a good does not change, how will an increase in the price of that good affect the consumer surplus from it?

Answer: The consumer surplus equals the difference between the marginal benefit of the good and its price summed over the quantity consumed. If the demand for a good does not change, then the marginal benefit of that good does not change. Hence an increase in the price decreases the consumer surplus from that good because 1) it decreases the quantity purchased, and 2) it decreases the consumer surplus on each particular unit that is purchased.

Topic: Consumer surplus
Skill: Level 3: Using models
Objective: Checkpoint 6.2
Author: SA
9) The figure shows the demand curve for hotel rooms at a local resort.
   a. If the hotel charges $120 per night, how many rooms will they rent?
   b. If there are only 40 rooms available, how much are customers willing to pay for a room?
   c. If 60 rooms are available, how much are customers willing to pay?
   d. What do the dollars in your answer to part (c) represent?

   Answer: a. At $120 a night, the hotel will rent 20 rooms.
   b. If 40 rooms are available, customers are willing to pay $90 per room.
   c. If 60 rooms are available, customers are willing to pay $60 per room.
   d. The $60 represents the dollars worth of other goods and services that customers are willing to forgo to get one more night in a hotel room.

   Topic: Demand curve and the marginal benefit curve
   Skill: Level 4: Applying models
   Objective: Checkpoint 6.2
   Author: SB

10) Jenn is willing to pay $75 for a purse and the purse’s price is $60. What is Jenn’s consumer surplus on this purse?

   Answer: The consumer surplus equals the difference between the marginal benefit of the good and the price actually paid. Jenn is willing to pay $75 for the purse, so its marginal benefit to her is $75. However, she only must pay $60, so Jenn has a consumer surplus of $75 - $60 = $15.

   Topic: Consumer surplus
   Skill: Level 3: Using models
   Objective: Checkpoint 6.2
   Author: JC
11) Jason needs help getting ready for the next test in his economics course and would like to hire Maria, an economics tutor to help him. Jason is willing to pay $30 for the first hour of tutoring, $25 for the second, $20 for the third, $15 for the fourth, and $10 for the fifth. The equilibrium price for tutoring is $15 per hour. For how many hours of tutoring will Jason hire Maria? Why this amount of hours? What is Jason's consumer surplus, if any, from the tutoring? What is Maria's consumer surplus from the tutoring?

Answer: Jason will hire Maria for 4 hours of tutoring. At $15 per hour, the marginal benefit to Jason of the first 4 hours exceeds the price. But the marginal benefit from the fifth hour is less than the price and so Jason will not hire Maria for 5 hours. Jason's total consumer surplus is $30, the sum of $15 from the first hour plus $10 from the second plus $5 from the third plus $0 from the fourth. Maria has no consumer surplus in this market because she is the producer not the consumer.

*Topic: Consumer surplus*

*Skill: Level 3: Using models*

*Objective: Checkpoint 6.2*

*Author: TS*
12) The figure above shows the demand curve for pizza.
   a. What is the marginal benefit of the 20th pizza?
   b. What is the maximum price the consumer is willing to pay for the 20th pizza?
   c. If the price of a pizza is $6, what is the consumer surplus of the 20th pizza?
   d. If the price of a pizza is $10, what is the consumer surplus on all the pizzas consumed?
   e. If the price of a pizza is $6, what is the consumer surplus on all the pizzas consumed?

Answer: a. The marginal benefit of the 20th pizza is $10.
   b. The maximum price the consumer is willing to pay for the 20th pizza is $10.
   c. If the price of a pizza is $6, the consumer surplus of the 20th pizza is $4.
   d. If the price of a pizza is $10, the consumer surplus is $40.
   e. If the price of a pizza is $6, the consumer surplus is $160.

*Topic: Consumer surplus*

*Skill: Level 4: Applying models*

*Objective: Checkpoint 6.2*

*Author: SB*
13) The figure above shows Cindy's demand for CDs per year.

a. What is Cindy’s consumer surplus on all the CDs consumed if the price of a CD is $12?
b. What is Cindy’s consumer surplus on all the CDs consumed if the price of a CD is $9?
c. What happens to Cindy’s consumer surplus when the price of a CD falls?

Answer: a. Her consumer surplus when the price of a CD is $12 equals $15, the area of the triangle under the demand curve and above the price.
b. Her consumer surplus when the price of a CD is $9 equals $60, the area of the triangle under the demand curve and above the price.
c. As the price of a CD falls, Cindy’s consumer surplus increases. This result reflects the observation that consumers are better off when prices are lower.

*Topic: Consumer surplus*

*Skill: Level 4: Applying models*

*Objective: Checkpoint 6.2*

*Author: SA*
14) The diagram above depicts the demand for, and market price of, buckets of raw oysters in Orlando.

a. What is the consumer surplus of the person who buys the 100th bucket of oysters?
b. What is the consumer surplus of the person who buys the 200th bucket of oysters?
c. What is the consumer surplus of the person who buys the 300th bucket of oysters?
d. What is the total consumer surplus from all the oysters consumed in the market?

Answer: 

a. The consumer surplus of the person who buys the 100th bucket of oysters is $6.
b. The consumer surplus of the person who buys the 200th bucket of oysters is $3.
c. The consumer surplus of the person who buys the 300th bucket of oysters is $0.
d. The total consumer surplus in the market is $1,350.

Topic: Consumer surplus
Skill: Level 3: Using models
Objective: Checkpoint 6.2
Author: JC
6.3 Cost, Price, and Producer Surplus

1) Explain the difference between the words "value," "price," and "cost."

Answer: Value refers to the marginal benefit of consuming one more unit of a good and is illustrated by the demand curve.

Price is determined in the market by the forces of supply and demand. Price is what the supplier receives for selling a good and is what the buyer pays when purchasing a good.

Cost refers to what must be given up to produce a good. The marginal cost of producing one more unit of a good is illustrated by the supply curve.

2) The supply curve is the same as another curve. What other curve is the same as the supply curve? Why are the curves the same?

Answer: The supply curve is the same as the marginal cost curve. The marginal cost is the cost of producing one more unit of a good. For any quantity, the supply curve shows the minimum price for which a producer is willing to produce another unit of the good. (This price is equal to the price on the supply curve vertically above each quantity.) A producer is willing to produce a unit of the good if the price covers all costs of the producing that unit, that is, if the price equals the cost of producing the unit. The cost of producing the unit is the marginal cost. Hence along the supply curve, the price associated with each quantity is equal to the marginal cost of each quantity. Therefore the supply curve is the same as the marginal cost curve.

3) What is producer surplus?

Answer: Producer surplus equals the difference between the price of the good and the marginal cost of producing it, summed over the quantity produced.
4) What must be true for a producer to obtain a producer surplus from the sale of a unit of a good?

Answer: The price must be greater than the marginal cost of producing the good.

Topic: Producer surplus
Skill: Level 1: Definition
Objective: Checkpoint 6.3
Author: TS

5) If the price of a visit to Sea World exceeds the marginal cost of the visit by $13, a producer surplus exists for Sea World.” Is this statement true or false?

Answer: The statement is true. Anytime the price exceeds the marginal cost, there is a producer surplus. In this case, the producer surplus is $13 dollars.

Topic: Producer surplus
Skill: Level 2: Using definitions
Objective: Checkpoint 6.3
Author: JC

6) Maria helps tutor students taking economics. The equilibrium price for tutoring is $15 per hour. Maria has determined her opportunity cost per hour to be $6 for the first, $9 for the second, $12 for the third, $15 for the fourth, and $18 for the fifth. How many hours will Maria tutor? Why this amount of hours? What, if any, is Maria’s producer surplus?

Answer: Maria will tutor for 4 hours. For all of the first 4 hours of tutoring, Maria’s marginal cost of tutoring is less than or equal to the price she receives from tutoring. Maria will not tutor the fifth hour because for this hour her marginal cost exceeds the price. Maria makes a producer of surplus of $18, the sum of $9 on the first hour plus $6 on the second hour plus $3 on the third hour plus $0 on the fourth hour.

Topic: Producer surplus
Skill: Level 3: Using models
Objective: Checkpoint 6.3
Author: TS
7) The figure above shows the supply curve for pizzas.
   a. What is the marginal cost of the 20th pizza?
   b. What is the minimum supply price of the 20th pizza?
   c. If the price is $6 per pizza, what is the producer surplus on the 20th pizza?
   d. If the price is $6 per pizza, what is the producer surplus for the total quantity of pizzas produced?
   e. If the price is $8 per pizza, what is the producer surplus for the total quantity of pizzas produced?
   f. If the price is $10 per pizza, what is the producer surplus for the total quantity of pizzas produced?

Answer: a. The marginal cost of the 20th pizza is $6.
   b. The minimum supply price of the 20th pizza is $6.
   c. If the price is $6 per pizza, the producer surplus on the 20th pizza is zero.
   d. If the price is $6 per pizza, the producer surplus is $20.
   e. If the price is $8 per pizza, the producer surplus is $80.
   f. If the price is $10 per pizza, the producer surplus is $180.

*Topic: Producer surplus*
*Skill: Level 3: Using models*
*Objective: Checkpoint 6.3*
*Author: SB*
6.4 Are Markets Efficient?

1) When less than the efficient amount of a good is produced, how does the marginal benefit of the last unit produced compare to its marginal cost?

Answer: When less than the efficient amount of a good is produced, the marginal benefit of the last unit produced exceeds its marginal cost. The fact that the marginal benefit exceeds the marginal cost indicates that producing additional units of the good will move the amount of production closer to the efficient quantity.

Topic: Efficiency of a competitive market
Skill: Level 2: Using definitions
Objective: Checkpoint 6.4
Author: SA

2) Why is a competitive market efficient?

Answer: Efficiency is attained when production is such that the marginal benefit equals the marginal cost. When a competitive market is at equilibrium, the quantity demanded equals the quantity supplied, that is, the demand and supply curves cross. But the marginal benefit curve is the same as the demand curve and the marginal cost curve is the same as the supply curve. Thus equilibrium occurs at the point where the marginal benefit curve crosses the marginal cost curve. As a result, so the marginal benefit equals the marginal cost and hence the market is efficient.

Topic: Efficiency of a competitive market
Skill: Level 3: Using models
Objective: Checkpoint 6.4
Author: SA

3) Briefly describe the concept of the “invisible hand.”

Answer: The invisible hand suggests that a competitive market attains allocative efficiency simply by the forces of supply and demand, with no government involvement needed to organize the resources, or set the efficient price and quantity.

Topic: Invisible hand
Skill: Level 2: Using definitions
Objective: Checkpoint 6.4
Author: PH

4) Explain how the invisible hand delivers an efficient market outcome.

Answer: The invisible hand concepts claims that people, acting in their own self interest, send resources to be used at their highest value. As a result, resources are efficiently used to produce the output of goods and services that people most highly value. With this outcome, producer and consumer surplus are maximized.

Topic: Invisible hand
Skill: Level 2: Using definitions
Objective: Checkpoint 6.4
Author: CD
5) What is the "invisible hand"?

Answer: The invisible hand is a concept articulated by Adam Smith that suggests that competitive markets are efficient. Smith discussed how self-interested buyers and sellers, without government involvement, interact with one another to bring about market efficiency. In Smith's words, market participants are "led by an invisible hand to promote an end (efficiency) which was no part of his intention."

Topic: Invisible hand
Skill: Level 2: Using definitions
Objective: Checkpoint 6.4
Author: JC

6) When economists refer to "the invisible hand," what do they mean?

Answer: In his book, Wealth of Nations, Adam Smith wrote that a participant in a competitive market is "led by an invisible hand to promote an end which was no part of his intention." Market participants act in their own self-interest, attempting to maximize their own well-being, yet, in the process, the result is an efficient use of resources. This result occurs because the market forces of supply and demand invisibly guide resources to their highest valued uses.

Topic: Invisible hand
Skill: Level 2: Using definitions
Objective: Checkpoint 6.4
Author: JC

7) "If there is an inefficient level of nursing care in South America, a deadweight loss exists." Is this statement true or false?

Answer: The statement is true. Anytime there is an inefficient level of production, a deadweight loss exists.

Topic: Deadweight loss
Skill: Level 2: Using definitions
Objective: Checkpoint 6.4
Author: JC
8) What are some of the potential obstacles that can prevent a market from reaching the efficient outcome? Briefly define each obstacle.

Answer: The obstacles basically fall into two camps: Obstacles that occur because the government does not intervene in the market and obstacles that occur because the government does intervene in the market. In the first group are the issues of externalities, public goods and common resources, and monopoly. An externality occurs when a cost or benefit from production falls upon someone other than the producer or when a cost or benefit from consumption falls upon someone other than the demander. A public good is a good or service that can be consumed simultaneously by everyone even if they didn’t pay for the good or service. Public goods create the free rider problem, in which people consume the good without paying for it. A common resource is a resource that no one owns but everyone can use. A common resource is over-used. Finally, a monopoly occurs when a single producer controls the market by being the only producer. In the case of an externality, public good, or monopoly, government intervention has the possibility of increasing the market’s efficiency.

The second set of obstacles occur when a market is otherwise efficient but nonetheless the government intervenes in the market. The second group is comprised of price and quantity regulations, as well as taxes and subsidies. Some price regulations make prices higher than a certain price illegal; others make prices lower than a certain price illegal. Both prevent the market from reaching its (efficient) equilibrium. Taxes increase the price paid by the buyer and decrease the price received by the seller. Subsidies have the opposite effect, decreasing the price paid by the buyer and increasing the price received by the seller.

One last reason for a market to be inefficient that does not involve the government is high transactions costs. In this case it might be too expensive to operate a market.

*Topic: Obstacles to efficiency*
*Skill: Level 3: Using models*
*Objective: Checkpoint 6.4*
*Author: WM*
9) Jason hires Maria to tutor him in economics. Jason is willing to pay $30 for the first hour of tutoring, $25 for the second, $20 for the third, $15 for the fourth, and $10 for the fifth. Maria has an opportunity cost per hour of $6 for the first, $9 for the second, $12 for the third, $15 for the fourth, and $18 for the fifth. What will be the equilibrium quantity of hours tutored and the equilibrium price? Explain why this quantity and price is the equilibrium. What is Jason's consumer surplus and what is Maria's producer surplus?

Answer: The equilibrium quantity will be 4 hours of tutoring and the equilibrium price will be $15 per hour. The equilibrium quantity will be 4 hours of tutoring because for any of these first 4 hours, the marginal benefit (to Jason) exceeds or is equal to the marginal cost (to Maria). The price will be $15 per hour because that is the maximum price Jason is willing to pay for the fourth hour of tutoring and $15 is the minimum price Maria will accept for the fourth hour of tutoring. Jason's total consumer surplus is $30, the sum of $15 from the first hour plus $10 from the second plus $5 from the third plus $0 from the fourth. Maria makes a producer surplus of $18, the sum of $9 on the first hour plus $6 on the second hour plus $3 on the third hour plus $0 on the fourth hour.

*Topic: Efficiency of a competitive market*
*Skill: Level 3: Using models*
*Objective: Checkpoint 6.4*
*Author: TS*
10) The figure above shows the market for pizza.

a. If the price of a slice of pizza is $3, what is the consumer surplus of the 50th slice?

b. If the price of a slice of pizza is $3, what is the producer surplus of the 50th slice?

c. What is the efficient quantity? What is the equilibrium quantity? What is the deadweight loss when the equilibrium quantity is produced?

Answer: a. Consumer surplus is the distance between the demand curve and the price of $3 when 50 slices are consumed. That difference is $4, the marginal benefit, minus $3 or $1.

b. Producer surplus is the distance between the supply curve and the market price when 50 slices are produced. That difference is $3 minus $2, the marginal cost, or $1.

c. The efficient quantity is 100 slices because that is the quantity for which the marginal benefit equals the marginal cost. The equilibrium quantity is 100 slices, because that is the quantity for which the quantity demanded equals the quantity supplied. There is no deadweight loss at the equilibrium quantity because it is the same as the efficient quantity.

Topic: Efficiency of a competitive market
Skill: Level 4: Applying models
Objective: Checkpoint 6.4
Author: CD
11) Jason wants to hire Maria to tutor him in economics. Jason is willing to pay $30 for the first hour of tutoring, $25 for the second, $20 for the third, $15 for the fourth, and $10 for the fifth. Maria has an opportunity cost per hour of $6 for the first, $9 for the second, $12 for the third, $15 for the fourth, and $18 for the fifth. The initial equilibrium price for tutoring is $15 an hour and hence Maria tutors Jason for 4 hours. Now, Maria realizes that she is the only economics tutor because all the other tutors have graduated. Because she is the only tutor, she has a monopoly and, as a monopolist, Maria decides to charge a price of $25 instead of $15 an hour.

a. At the price of $25 an hour, how many hours will Maria tutor Jason?

b. At the initial equilibrium price of $15 an hour, what was Jason's total consumer surplus and Maria's total producer surplus?

c. At the price of $25 an hour, how many hours will Jason hire Maria to tutor him? What is Jason's total consumer surplus and Maria's total producer surplus?

d. How does the sum of Jason's consumer surplus plus Maria’s producer surplus compare at the initial equilibrium price of $15 an hour (part b) and at the new price of $25 an hour (part c)? Comment on any difference.

Answer: a. Maria will tutor Jason for 2 hours.

b. At the initial price of $15, Jason's total consumer surplus was $30, the sum of $15 from the first hour plus $10 from the second plus $5 from the third plus $0 from the fourth. Maria made a producer surplus of $18, the sum of $9 on the first hour plus $6 on the second hour plus $3 on the third hour plus $0 on the fourth hour.

c. At the new price of $25 an hour, Jason will hire Maria for 1 hour. Jason's total consumer surplus is $5, the consumer surplus from the first hour. Maria makes a producer surplus of $35, the sum of $19 on the first hour plus $16 on the second hour.

d. When the price was $15 an hour, the sum of the consumer and producer surpluses was $48. When the price is $25, the sum of the consumer and producer surpluses is $40. The $8 difference between the initial situation and the situation in which Maria is a monopolist is the deadweight loss.

Topic: Deadweight loss
Skill: Level 4: Applying models
Objective: Checkpoint 6.4
Author: TS
12) The figure above shows the market for hot dogs.
   a. What is the maximum price consumers are willing to pay for the 25th hot dog?
   b. What is the efficient quantity?
   c. Suppose that the production was limited to 25 hot dogs. In the figure, indicate the amount of the deadweight loss.
Answer: a. Consumers are willing to pay a maximum of $4 for the 25th hot dog.
b. The efficient quantity of hot dogs is 75 hot dogs because that is the quantity for which the marginal benefit equals the marginal cost.
c. The deadweight loss is indicated in the figure above.

*Topic: Deadweight loss*
*Skill: Level 4: Applying models*
*Objective: Checkpoint 6.4*
*Author: WM*
13) The figure above shows the supply and demand curves for pizza. If the market is at its competitive equilibrium, what area in the graph above represents:

a. consumer surplus?

b. producer surplus?

Answer: 

a. $\text{AFB}$
b. $\text{BFC}$

*Topic: Efficiency of a competitive market*

*Skill: Level 4: Applying models*

*Objective: Checkpoint 6.4*

*Author: SB*
14) The figure above shows the supply and demand for pizza.
   a. What is the efficient level of output?
   b. If 70,000 pizzas are produced, what area represents the deadweight loss?
   c. Why does the deadweight loss in part (b) occur?
   d. If 20,000 pizzas are produced, what area represents the deadweight loss?
   e. Why does the deadweight loss in part (d) occur?

   Answer: a. 40,000 pizzas is the efficient quantity.
   b. If 70,000 pizzas are produced, the deadweight loss is area C.
   c. The deadweight loss occurs because we are producing some pizzas, specifically pizzas 40,001 through 70,000, for which the marginal cost is greater than the marginal benefit.
   d. If 20,000 pizzas are produced, the deadweight loss is area B.
   e. The deadweight loss occurs because we are not producing some pizzas, namely pizzas 20,001 through 40,000, for which the marginal benefit is greater than the marginal cost.

   Topic: Deadweight loss
   Skill: Level 4: Applying models
   Objective: Checkpoint 6.4
   Author: SB
6.5 Are Markets Fair?

1) What is Utilitarianism?

Answer: Utilitarianism is the principle that we should strive to achieve "the greatest happiness for the greatest number of people."

Topic: Utilitarianism
Skill: Level 1: Definition
Objective: Checkpoint 6.5
Author: SA

2) What are the two views of fairness? How does each view redistribution of income from the rich to the poor?

Answer: One view is that "it's not fair if the result isn't fair." This view requires that income should be redistributed from the rich to the poor in order to create a fair result. Another view is that "it's not fair if the rules aren't fair." This view requires that private property may be transferred only under voluntary exchange, so redistribution of income is not fair unless it is voluntary.

Topic: Fairness
Skill: Level 2: Using definitions
Objective: Checkpoint 6.5
Author: CD

3) How can a person argue that health care services in America are provided efficiently, but not fairly?

Answer: The assertion that the health market is efficient implies that competitive market forces determines the level and quality of health care. Where the demand for and supply of health care intersects, the marginal benefit and marginal cost of health care are equal. This equality means that the people who are demanding health care are willing and able to pay the price, which is equal to the marginal cost of providing health care.

However, at that market price there are many people who cannot afford health care. These people, probably the poor and uninsured, are left to go to clinics, crowd emergency rooms, or else do without basic health care needs because of their lack of ability to pay the market price. This outcome could easily violate the "it's not fair if the result isn't fair" view of fairness. Thus observers who assert that the U.S. health care system might be efficient but isn't fair are using the "results" view of fairness.

Topic: Fair results
Skill: Level 4: Applying models
Objective: Checkpoint 6.5
Author: JC
4) Often politicians assert that a price, such as the price of gasoline or the rent for an apartment, is too high and that it is unfair for these prices to be so high. If these products are traded in competitive markets, what fairness rule are politicians using? Why?

Answer: The fairness rule is one of "It's not fair if the results aren't fair." The claim that the prices are too high to be fair is a claim that buyers are being unfairly harmed by having to pay such high prices. The assertion that people are harmed because the price is too high is looking at the results of the process because if the price had been lower, the assertion of unfairness would not have been made.

Topic: Fair results
Skill: Level 4: Applying models
Objective: Checkpoint 6.5
Author: JC

5) What approach to fairness argues in favor of government policies that redistribute income so that there is more equality of income?

Answer: The general approach to fairness that argues in favor of government redistribution is a "fair results approach," that is, an approach that argues "it isn't fair unless the results are fair." Utilitarianism is the principle that states that a society should strive for "the greatest happiness for the greatest number of people." Utilitarians argued that complete equality of income was the only income distribution that met their requirement so Utilitarians asserted that government policies to redistribute income are necessary for fairness.

Topic: Utilitarianism
Skill: Level 2: Using definitions
Objective: Checkpoint 6.5
Author: MR

6) What is the "big tradeoff"?

Answer: The "big tradeoff" is the tradeoff between efficiency and fairness. The idea is that if the government redistributes income so that it is more equally shared, output decreases so that it is less than the efficient amount. Output shrinks because such redistribution blunts people's incentives to work. Hence redistributing income so that everyone has the same amount of income might end up insuring that everyone's incomes are smaller than if less redistribution is pursued.

Topic: The big tradeoff
Skill: Level 1: Definition
Objective: Checkpoint 6.5
Author: MR
7) Why do societies face a tradeoff between the size of the economic pie and the degree of equality with which it is shared?

Answer: A person’s share of the economic pie is determined by his or her income. To increase the degree of equality, income must be redistributed away from richer people and towards poorer people. Income is transferred from the rich to the poor by means of taxes. Taxes discourage work and saving. Because people work less, the nation’s output decreases. When saving decreases, so does investment in capital, which also decreases the nation’s output. Thus taxes that redistribute income in order to make for a more equal income distribution decrease the nation’s output, that is, shrink the economic pie.

Topic: The big tradeoff
Skill: Level 4: Applying models
Objective: Checkpoint 6.5
Author: SB

8) Why does the problem of the big tradeoff arise when the government engages in the process of redistributing income using taxes and transfers?

Answer: There are two reasons why the big tradeoff problem arises. First, in the process of transferring income from the people who have to those who do not have, an administrative cost is incurred by society. The result is that $1 taxed is not $1 transferred. Hence the effort to make incomes more equal decreases the average income. Second, taxing people's income is a disincentive to work, while taxing people’s savings is a disincentive to accumulate capital. As a result, people work less and save less, both of which decrease the amount of goods and services produced and decrease people's income. Hence once again the effort to make incomes more equal decreases the average income.

Topic: The big tradeoff
Skill: Level 3: Using models
Objective: Checkpoint 6.5
Author: PH

9) Explain the modified version of utilitarianism proposed in the book entitled “A Theory of Justice,” by the philosopher John Rawls and its relationship to the “big tradeoff.”

Answer: Rawls was aware that extensive redistribution of income could decrease the average income, which is the tradeoff captured by the “big tradeoff.” Thus perfect equality of income might result in everyone having lower income than would otherwise be the case. To overcome this issue, according to John Rawls, the fairest distribution of the economic pie is the one that provides the poorest person the largest income possible. Hence less redistribution will take place than if perfect equality was the goal. As a result, average income will decrease less and the poorest person would be better off.

Topic: John Rawls
Skill: Level 2: Using definitions
Objective: Checkpoint 6.5
Author: PH
10) Bill Gates is a founder of Microsoft and the world’s richest individual. Suppose Microsoft sells more software and Mr. Gates acquires another billion dollars in wealth. Simultaneously, suppose a burglar whose income is well below average broke into Bill Gates’ house and stole a million dollars worth of antiques. Using the “it’s not fair if the rules aren’t fair” approach to fairness, is Mr. Gates’ acquisition of additional wealth fair? Is the (poor) thief’s acquisition fair?

Answer: In order for Mr. Gates to become richer, Microsoft had to convince consumers to buy their products. The consumers’ choices were voluntary. That is, the consumer engaged in a voluntary transaction with Microsoft and, as a result, Mr. Gates gained wealth. (And the consumers gained the software.) Because the exchange was voluntary, it is a fair exchange according to the “it’s not fair if the rules aren’t fair” approach. The burglar, however, did not engage in a voluntary transaction with Mr. Gates. Mr. Gates suffered an involuntary transaction with the burglar. Involuntary transactions violate the symmetry principle and hence the thievery is not fair according to the “rules” approach. Notice that the fairness has nothing to do with the incomes of Mr. Gates and the burglar; instead, fairness hinges on whether the transaction was voluntary.

Topic: Fair rules
Skill: Level 4: Applying models
Objective: Checkpoint 6.5
Author: JC

11) According to the ”fair rules” view of fairness, are taxes fair? Explain.

Answer: Taxes are unfair according to the fair rules view because they are an involuntary transfer of private property. While most economists and most people support fair taxation, there is little agreement on what constitutes a fair tax.

Topic: Fair rules
Skill: Level 3: Using models
Objective: Checkpoint 6.5
Author: PH