Rationalizations /Justifications **CONCEPTS**	**CASES**
<u>PUBLIC GOOD:</u> A commodity or service which is supplied to one person is available to others at no extra cost. It may be contrasted with a private good where one person's consumption precludes the consumption of the same unit by another person. The public good is thus set to exhibit non rival consumption, one person's consumption of the good that no reduces its availability to anyone else's. A pure public good also has the characteristic of non excludibility that is, if the good is provided the producer is unable to prevent anyone from consuming it. This latter characteristic prevents private market from functioning since a seller could be unable to ensure that only those individuals who paid for the good could obtain it. Since the good could be obtained without payments no one could be willing to pay for it. If exclusion is possible the good is still a public good even though it can be provided in a private market. Where exclusion is possible or where consumption is no completely non rival we have an example of a mixed good (or impure public good), a phenomenon which is certainly more common than that of the extreme case. Where consumption of a good is non rival, the charging of a price for the good or service, is in terms of the Pareto principle, inefficient. This is so because adding an extra unit of consumption provides a benefit to the consumer without imposing any cost, while the charging of a price could prevent some consumption from taking place, thus, taking a net loss of satisfaction or utility. It follows that, even when it is possible, the provision of a public good through a private market will not enable the best or optimal level of output to be produced. As we have seen, in a case of non excludability a market	-SECOND BANK OF THE UNITED STATES - BANK OF AMERICA

cannot operate at all. The provision of a public good is a matter of collective choice. Generally, we expect to find public goods provided by government and paid for compulsory taxation. An alternative solution could be for all the members of the community to make a voluntary agreement to provide and pay for the good. The difficulty with this solution is that individuals may conceal their true valuation of the good in order to escape payment, i.e. they may seek to be free riders. The problem of providing public goods by voluntary agreement rather than compulsory taxation is analyzed in the voluntary exchange model. The total demand for a public good may be estimated by adding up the demands of the individuals composing the society. However, whereas with a private good we obtain the market demand curve by the horizontal addition of individual's demand curve (i.e. at each price we sum the amounts demanded by each person), with a public good the total demand curve is obtained through the vertical addition of individual's demand curves. The demand curves are added vertically because given non rivalness each unit of the good is available to both individuals. the problem is to find the total price the community is willing to pay for each unit of the good. The optimal level of output is where the vertically added demand curve meets the marginal cost curve. At that point the costs to the community of one more unit is just equal to the amount the community is willing to pay for that unit. It should be noted that demand curves are constructed under the unrealistic assumption that individuals reveal their preferences. Examples of public goods include national defense, street lightning, environmental protection.	
NATURAL MONOPOLY: when an entire demand within a relevant market can be satisfied at lowest cost by one firm rather than by two or more., it is a natural	- EL PASO NATURAL GAS COMPANY

monopoly whatever the actual number of firms is. (technical barriers to entry, economies of scale, efficiency pricing: price equals average costs; maximum efficiency average cost equals average revenue)	
<u>EXTERNALITIES</u> (Pollution) : Known as external effects, spillovers, external economies and diseconomies and neighborhood effects. They involved an interdependence of utility and/or production functions. For example the upstream pulp mill which discharges effluent in the river thus reducing the scope for efficient downstream is said to impose an externality on the fisherman. Some economists at the qualification that the interdependency must not have been taken account of through trade. A beneficial externality (external economy) is, where an externality generating activity raises the production or utility of the externally affected party (bee-keeper-pollination services). An external diseconomy is where the externality generating activity lowers the production or utility of the externally affected party (environmental pollution). Externalities arise because of the non-existence of markets. In fact there are non markets in clean air, etc. A major, although not the only source of this market failure is the inability to define an enforce property rights (coase theorem).	- NOVA PRODUCTS - PITTSBURGH CORNING - TYLER INSULATION PLANT
<u>CARTELS:</u> Formal agreement between firm in a oligopolistic market to cooperate with regard to a agreed procedures on such variables as price and output. The result is diminished competition and cooperation over objectives as for example, joint profit maximization or avoidance of new entry. In general side payments must be made between cartel members in order to induce adherence to this objective.	
<u>PRISONER'S DILEMMA:</u> This term arises from a consideration of the decision problem of arrested criminals who are the subject of separate interrogation. Each	- NOVA PRODUCTS - PITTSBURGH CORNING - TYLER INSULATION PLANT

criminal knows if no one confesses and informs on his co-partners in crime he will get off scot-free or at least with a modest sentence. However if one partner confesses and the others do not, he will go free while the others receive severe sentences. If all confess, then all will be sentenced but less severely if only one confesses. The incentive here for the rational actor, concern only with his own survivor is to confess and let the other suffer the consequences. But, as all will be motivated to act in this way, they end up with an outcome that is worse for all than if they have been able to make a binding agreement among themselves that no one confesses. This model shows how rational behavior at the micro level leads to an apparently irrational macro outcome.	
MERIT GOODS: a good the consumption of which is deemed to be intrinsically desirable. In the case of such goods it is argued that consumer sovereignty does not hold and that is consumers who are willing to purchase adequate quantities of such goods they should be compelled or encouraged to do so. This argument is sometime deployed in defense of compulsory education or free tax - financed health services. Many economists would reject this reasoning but in any case there is a difficulty in determining which goods are merit goods. A variant of this argument ids that individuals willingly delegate to government or professional agencies decisions on certain matters which they do not fell competent to asses (health care).	
PATERNALISM: some kind of regulation are partially justified on the grounds that the government has certain responsibility to protect individuals from their own irresponsibility. Examples: helmets for motorcycles, mandating of secondary school education, airbags.	
Complications **CONCEPTS**	**CASES**

<u>SECOND BEST:</u> If one of the conditions for Pareto optimality (Pareto optimum: when the economy's resources and output are allocated in such a way that no reallocation can make anyone better off without making at least one other person worse off) cannot be fulfilled then the best attainable situation (second best option) can only be achieved by departing from all the other Paretian conditions.	
<u>FREE RIDERS</u>: a phenomenon arising from the characteristics of public goods. Basically the fact that public goods are non rival (A's partaking in the consumption does not hurt B's consumption; the MC is zero, exclusion is inefficient, market is not efficient in the provision) means that the provision of the good to one person entails the provision to another person. If potential consumers are therefore faced by the issue of financing the provision of the good each one has the incentive to not to state his true wiliness to pay since he can gamble on the good being provided to others who will express some wiliness to pay. Where the good cannot be varied in size the good may be provided and those who falsely stated their preferences will nonetheless benefit from the existence of the good. If the size of the good can be varied then understatement of preferences will cause less of the good to be provided than would otherwise be the case. Those understating their preferences may still gain however since they will receive the amount of the good in question and will still not pay for it, those are free-riders. (they are not reveling preferences) . If this phenomenon is a big one public goods will be underprovided and it will be a strong case for the good to be provided through government action.	
<u>AVRECH JOHNSON EFFECT</u>: refer to the profit maximizing response of a regulated firms which in facing an allowance rate of return of capital have the incentive to choose input combinations which are more capital	

intensive that would have been employed in the absence of the a set rate of return.	
PRICE CAPS: It is a form of regulation used in Britain for privatized industries. Price caps are used for example by FCC to set so that AT&T is fee to raise its prices at the rate of inflation minus some amount selected to reflect expected productivity. Price caps regulation is view as providing incentives for the firm so regulated to be cost efficient. In a sense, it bills regulatory lags into the process in an non accidental way. And it is quite similar to the slightly scale plan described above inasmuch as consumers are permitted to share in productivity gains. Price caps regulation is probably most effective as a transitory step on the path to a total deregulation and full competition of an industry. .	
PRINCIPAL -AGENT / MOTIVATIONAL PROBLEMS: this refers to the situation in the theory of the firm where interest of managers and shareholders differ. The principal (i.e. the shareholders) has interest in the performance of the firm but appoints an agent (i.e. the manager) to act in his place. The principal cannot fully control what the agent does, this often leads to the above problem. Do regulations motivate an stimulate producers to be efficient?	- GENERAL TELEPHONE OF THE NORTHWEST -BAY STATE GAS CO.: STRATEGY FOR THE 1990s.
STATIC/ ASYMMETRIC INFORMATION: differentiation in information posses by the parties to a market transaction. Buyers and sellers have unequal knowledge of the relevant information. This absent of perfect (equal) information on the part of buyers and sellers precludes perfect competition. Perfect competitor requires symmetric information. Asymmetric information is frequently encountered in labor markets where firm and workers have unequal knowledge of the information necessary to set wages.	- PITTSBURGH TYLER INSULATION PLANT - NOVA PRODUCTS - PITTSBURGH CORNING - TYLER INSULATION PLANT
TECHNOLOGY /INNOVATION:	-TELECOMMUNICATIONS IN TRANSITION

<u>RATIONAL EXPECTATIONS</u>: the application of the principal maximizing behavior to the acquisition and processing of information for a purpose of forming a view about the firm. It suggests that individual does not make systematic forecasting errors; but that the guesses about the future are on average correct. Individuals use all the available and relevant information when taking a view about the future and at a minimum use of information up to the point at which the marginal costs of acquiring and processing information equal the marginal benefits from this activity. In the extreme where information is complete and there is no uncertainty this hypothesis reduces to one to one of perfect foresight.	
<u>MORAL HAZARD</u>: the effect of certain types of insurance systems in causing a divergence between the private Marginal Cost of some action and the Marginal Social Cost of that action thus resulting in an allocation of resources which is not optimal. For example, a person may be insured against illness in such a manner that the cost to him of consuming more medical care is less that the cost to society. Consequently he may increase his use of medical facilities beyond the socially optimal level. This in turn would lead insurance companies to recalculate premiums and increase the costs to all consumers. The problem of moral hazard leading to overuse of facilities arises in both private insurance systems and in state controlled agencies. Thus, is a situation in which the presence of insurance or the expectation of compensating policy weakens or distorts incentives to prudent behavior.	-METROPOLITAN BANK FOR SAVINGS - FINANCIAL INSTITUTIONS REFORM, RECOVERY AND ENFORCEMENT ACT OF 1989
<u>CONFLICT OF INTERESTS</u> :	
<u>BYPASS</u> : When there are potential customers of an existing natural monopoly within its operating territory, who construct a manage of their own facilities in searching an economically attractive way of getting the service.	-NORTHWEST TELEPHONE COMPANY

Technology is driving the cost of bypass down but those bypassed natural monopolies inmediately lose revenues but not cost. Boeing, Tektronics and the state of Washington itself established their own networks.	
Alternatives CONCEPTS	CASES
COASE'S THEOREM: Pareto optimum is possible in the presence of externatilities in the absence of State intervention if bargaining is possible between the producer and recipient of an external effect and if property rights are clearly specified. The theorem based upon the argument that externatlities do not give rise to a misallocation of resources provided there are no transaction costs and given property rights that are well defined and enforceable. Here the parties, the producer and the consumer of the externatilty, would have a market incentive to negotiate a mutually beneficial trade that is to internalize the externality. The neutrality theorem states that the outcome of this trading process would be the same in irrespective of whether it was the producer or consumer of the externatlity who held the property right of veto over the use of the resource.	- SOUTHERN CALIFORNIA EDISON -WEYERHAUSER COMPANY LONGVIEW -WAYERHOUSER COMPANY SPRINGFIELD
INCOMPLETE CONTRACTS:	
CONTESTABILITY: (Contestable markets) A market where there is freedom of entry an exit is costless. Potential entrants can enter such market whenever profits exceed the normal rate. Olygopolistic markets can , thus, be contestable. Costless exit means sunk costs are 0. Such markets are subject to hit-and-run entry and exit and firms will produce where price = marginal cost and marginal cost =average cost.	- NORTHWEST /REPUBLIC AIRLINES MERGER
DEREGULATION: The removal of Government laws and by laws which restrict entry to certain activities .	-FANNIE MAE-FREDDIE MAC

PRIVATIZATION: The policy of converting public ownership of an asset to private ownership or of permitting the performance of a certain activity, hitherto carried out by the public organization, by a private sector business. The major argument advanced for privatization is that of increase efficiency, but as many of the former nationalized industries are natural monopolies it has been necessary to establish regulatory agencies to supervise price setting and commercial policies.	-FANNIE MAE, FREDDIE MAC
CORPORATIZATION:	
ANTITRUST: This is a term for legislation to control the growth of market power exercised by firms. The term relates not only to anti-monopoly policies but also to restrictive practices operated by individual firms, groups of amalgamated companies (trust) and groups of corporating firms(cartels). In USA the intend to posses monopoly power by means of merger and acquisitions and its exercise through non normal business practices is declared illegal. Non normal business practices or restrictive practices include such behavior as price discrimination, price leadership and exclusive dealing.	
INDUSTRY ASSOCIATIONS/ COOPERATIVES:	-SANFORD MILLS -TRIS AND CHILDREN'S SLEEPWEAR - THE UPHOLSTERED FURNITURE FLAMMABILITY