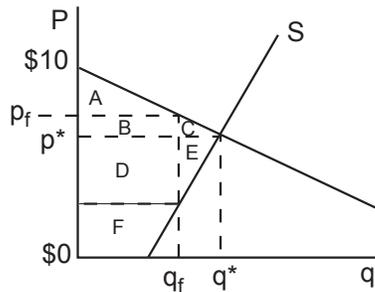


ECON 224, Professor Hogendorn

Problem Set 1 Answers

1. *JFK\_a.*

- (a) The equilibrium point must be on the upper half of the demand curve, and the supply curve must intercept the horizontal axis.



- (b) Demand must be the governing curve because it is not possible to sell more than people are willing to buy. CS is reduced by  $B + C$  and PS is reduced by  $E$  but increased by  $B$ .  $C + E$  is the deadweight loss.

- (c) First, note that we are talking about just your firm, while the curves represent all firms. *Some* firm(s) will lose customers under the price floor, since the quantity sold falls. If you are concerned that your firm will suffer a disproportionate share of this reduction, you might not favor the price control.

Also, these curves are probably short-run curves. In the long run, elasticity of demand is likely to rise, as consumers find new airports and new alternatives for shipping air freight. Thus the gains today may be smaller or even turn to losses in the future.

2. *Potatoes\_a*. The public interest argument is that tax breaks will help potato farmers to continue in business to preserve their way of life. Thus, the benefits of this policy go to the potato farmers and to a lesser degree those who are closely linked to them. As long as this industry is not very large relative to the Maine economy, these benefits go to a concentrated group.

The policy proposes tax breaks, so the main cost is lost tax revenue. Assuming this is made up for from broad-based taxes like income or property taxes, the cost is widely distributed.

Thus in the Wilson Matrix we have the case of Client Politics. The potato farmer lobby will work hard to get this policy enacted. Opposition will only come through “entrepreneurial” efforts by politicians that are aimed at the voters at large.

3. Suppose that the Maine potato farmers are lobbying the state legislature for special state tax breaks. The public interest argument is to preserve the potato farming way of life.

Use the Wilson Matrix to analyze what kind of political situation this creates. Remember to be specific about what are the benefits and what are the costs. It works best to assume the public interest justification, at least for the sake of argument, and make that the benefit. Then the costs are whatever would pay for the regulation.