AGENDA Tues 12/8

• QOD #40: Your future life
• Turn in QOD 31-40; Finish CH 13 P #4-5
• Final Exam Review Plan
  • Tues 12/8 after school (Partner practice in class)
  • Thurs 12/10 before school (Practice Exam Review in class)
  • Tues 12/15 after school (Practice Exam Review in class)
    • Peer Assessments EC DUE 12/15 in class
• Rents & Interest
• HW: Complete Partner Practice Quiz; Study for Final
QOD 40: Your future life

You are currently a worker earning $60,000 per year but are considering becoming an entrepreneur. You will not switch unless you earn an accounting profit that is on average at least as great as your current salary. You look into opening a small grocery store. Suppose that the store has annual costs of $150,000 for labor, $40,000 for rent, and $30,000 for equipment. There is a one-half probability that revenues will be $200,000 and a one-half probability that revenues will be $400,000.

a. In the low-revenue situation, what will your accounting profit or loss be? In the high-revenue situation?

b. On average, how much do you expect your revenue to be? Your accounting profit? Your economic profit? Will you quit your job and try your hand at being an entrepreneur?

c. Suppose the government imposes a 25-percent tax on accounting profits. This tax is only levied if a firm is earning positive accounting profits. What will your after-tax accounting profit be in the low-revenue case? In the high-revenue case? What will your average after-tax accounting profit be? What about your average after-tax economic profit? Will you now want to quit your job and try your hand at being an entrepreneur?

d. Other things equal, does the imposition of the 25-percent profit tax increase or decrease the supply of entrepreneurship in the economy?
QOD 40: Your future life

(a) The store’s accounting costs are $220,000 (= $150,000 + $40,000 + $30,000). In the low-revenue situation, the firm’s accounting loss is $20,000 (= $200,000 − $220,000). In the high-revenue situation, the firm’s accounting profit is $180,000 (= $400,000 − $220,000).

(b) On average, the expected revenue would be $300,000 (= $600,000 / 2), the accounting profit would be $80,000 (= $300,000 − $220,000), and the economic profit would be $20,000 (= $80,000 − $60,000). Yes, you would become an entrepreneur.

(c) In the low-revenue case, the accounting profit would be − $20,000 (a loss). In the high-revenue case, the accounting profit would be $135,000 (= $180,000 − $45,000). The average after-tax accounting profit would be $60,000 (= $80,000 − $20,000). The average after-tax economic profit would be $0 (= $60,000 − $60,000). Yes, you would still become an entrepreneur because the accounting profit, on average, was still as great as your current salary, even after the tax.

(d) Other things equal, the imposition of the profit tax would decrease the supply of entrepreneurship in the economy. With lower returns available for entrepreneurs, some will choose to remain in their current occupations, rather than taking the risk of opening a new business.
Economic Rent

- Price paid for land and other natural resources
- Perfectly inelasticity supply (you can’t grow the earth)
- Demand for land is derived from the demand for the products that land helps to produce.
- Changes in demand-Las Vegas, La Jolla, the middle of the desert
- A surplus payment
Economic Rent

![Graph showing the relationship between acres of land and land rent in dollars. The graph includes supply and demand curves, labeled as D1, D2, D3, and D4, and intersects at points S, a, b, and L0.]
Economic Rent

- Land ownership: fairness vs. allocative efficiency

- If land is a gift of nature, costs nothing to produce, and would be available without rental payments, why should rent be paid to those who just happen to be land owners?

- Land owners provide no value by simply renting out their land.

- Socialists—nationalize all lands for the good of the whole.

- If land were nationalized, could gov. planners assign each piece of land to its best possible use?

- Capitalists—private ownership allows for the allocation of scarce land resources to their best possible uses. Especially if rents are being paid.
Henry George

• Although land is a free gift, rents are considered to be surplus payments because they have no effect on the SUPPLY of land.
• However, individuals must pay rents because rents DETERMINE how society’s fixed supply of land is allocated among competing uses.
• Application: a single tax on land
  • Henry George’s proposal (late 1800s)
  • Single tax movement-economic rents could be HEAVILY taxed without diminishing the avail. supply of land or reducing the efficiency with which it is allocated.
  • Land owners during this time were enjoying larger and larger rents, but doing nothing for it.
  • Land rents-only tax gov. collects.
  • Criticisms-lots-current spending, capital gains, new buyers
Interest

- Price paid for use of money
- Stated as a percentage
- Money is not a resource
- Interest rates and interest income
- Range of interest rates
  - Risk
  - Maturity
  - Loan size
  - Taxability
Loanable Funds Theory

- Extending the model
- Financial institutions
- Changes in supply
  - Household thrift: higher rate = more incentive to save, lower rate = more incentive to spend.
- Changes in demand
  - Rate of return on investment vs. rate of interest
- Households are borrowers and savers.
- Fed steps in with the buying and selling of bonds. Sales = higher rates, Purchases = lower rates
Loanable Funds Theory

The equilibrium interest rate

The interest rate at which the quantity demanded of loanable funds equals the quantity supplied is the equilibrium interest rate. In the diagram, the equilibrium interest rate is 8%.
Time-Value of Money

• Money is more valuable the sooner it is obtained
  • Ability to earn interest
  • Compound interest—see p.301
• Future value
• Present value
Role of Interest Rates

- Relationship to:
  - Total output
  - Allocation of capital
  - R&D spending
- Nominal and real rates - inflation
- Application: Usury laws
  - Nonmarket rationing
  - Gainers and losers
  - Inefficiency
Economic Profit

- Explicit costs
- Implicit costs
- Pure profit
- Total revenue less explicit and implicit costs
- Role of the entrepreneur
  - Decide firm strategy for combining resources.
  - R&D
  - PERSONALLY bear the financial risks.
- Normal profit
Economic Profit

• Insurable risks - buy insurance policy
• Uninsurable risks
  • Changes in economic environment (recession)
  • Structure of economy - consumer tastes change, technology
  • Government policy - new regulation, removal of a tariff or quota
  • New products of production methods
Economic Profit

- Profit is compensation for bearing uninsurable risks
- Sources of economic profit
  - Create new products
  - Reduce production costs
  - Create and maintain a profitable monopoly
Economic Profit

• Profit rations entrepreneurship-entrepreneurs decide the best use of their talents
• Profit aids in resource allocation
• Profit and corporate stockholders-share in the success and risk of the business.
Distribution of U.S. Income

- **Wages and Salaries**: $7792 (70%)
- **Rents**: $268 (2%)
- **Interest**: $788 (7%)
- **Corporate Profits**: $1309 (12%)
- **Proprietors’ Income**: $1041 (9%)
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Key for Partner Review Wage/Labor/Rent/Interest