

Economics 1: Introduction to Economics

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What We Do Today...

- Instructor reality check
- Administrivia
 - Problem set 4/sample midterm
 - Paper assignment
 - Lectures schedule
- Focus back: what is this “markets behaving badly” part of the course about?
- Economics of information

Taking a Breath...

- Two weeks out from the midterm...
- That means it is time for me to take a breath, and today do:
 - first, an instructor reality check;
 - second, a little administrivia;
 - third, a quick review of what we are doing in this “markets behaving badly” part of the course, and
 - fourth, launch into the economics of information...

Instructor Reality Check

February 24, 2016 8-9 AM
Wheeler Auditorium, U.C. Berkeley

To Your i>Clickers

- Demand for BART trips is given by:
 - $P = \$16 - 80Q$,
 - where Q is given in billions of trips per year and P is in dollars per trip.
- BART's operating costs are: \$4/trip.
- BART's amortized capital costs are \$1 billion/year.
- If you were advising BART, what would you suggest they charge?
 - A. \$0/trip
 - B. \$4/trip
 - C. \$8/trip
 - D. \$10/trip
 - E. There is no good price to charge: the problem blows up and produces complex roots



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- BART's operating costs are \$4/trip.
- Its amortized capital costs are \$1 billion/year.
- BART charges \$4/trip
- What would ridership be at that price?
 - A. 150 million trips/year
 - B. 1,280 million trips/year
 - C. 640 million trips/year
 - D. 300 million trips/year
 - E. None of the above



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- BART's operating costs are \$4/trip.
- Its amortized capital costs are \$1 billion/year.
- BART charges \$4/trip; 150 million trips/year
- What would BART's consumer surplus be?
 - A. $\$6 \times 150M = \$900M$
 - B. $\$16 \times 150M = \$2,400M$
 - C. $\$8 \times 150M = \$1,200M$
 - D. $\$12 \times 150M = \$1,800M$
 - E. None of the above



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- BART charges \$4/trip; 150 million trips/year
- BART's consumer surplus is \$900 million/year
- Does it look like building BART was a good idea?
 - A. Yes: \$900M of consumer surplus
 - B. No: \$900M of CS < \$1B of amortized fixed costs
 - C. Yes: you also have to take account of producer surplus
 - D. No, but if you let people ride for free it would be a good deal
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- **Each trip taken via BART reduces highway congestion costs by \$4/trip**
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- Does it look like building BART was a good idea?

- A. Yes: \$900M of consumer surplus plus \$600M of reduced externalities > \$1B of amortized fixed costs
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- If BART were to charge \$0/trip, what would ridership be?

- A. 50M trips/year
- B. 100M trips/year
- C. 150M trips/year
- D. 200M trips/year
- E. None of the above is correct



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- If BART were to charge \$0/trip and have \$200M riders/year, what would consumer surplus be?

- A. $200M \times \$4 = \$800M$
- B. $200M \times \$8 = \$1.6B$
- C. $200M \times \$0 = \0
- D. $200M \times \$16 = \$3.2B$
- E. None of the above is correct



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- If BART were to charge \$0/trip, have \$200M riders/year, and generate \$1.6B in consumer surplus, how good a deal would it be?

- A. $\$1.6B - \$0.8B + \$0.8B - \$1B = \$600M/\text{year}$
- B. $\$1.6B/\text{year}$
- C. $\$1.6B + 200M \times \$4 = \$2.4B/\text{year}$
- D. $200M \times \$4 = \$800M/\text{year}$
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- If BART were to charge \$0/trip, have 200M riders/year, and generate \$1.6B in consumer surplus, how good a deal would it be?



A. \$1.6B consumer surplus - \$0.8B uncovered variable costs + \$0.8B highly congestion-reduction benefit - \$1B fixed cost amortization = \$600M/year <<

B. \$1.6B/year

C. $\$1.6B + 200M \times \$4 = \$2.4B/\text{year}$

D. $200M \times \$4 = \$800M/\text{year}$

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Q: So Why Isn't BART Free?

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A. $\$1.6B - \$0.8B + \$0.8B - \$1B = \$600M/year \ll$

• **A: GOOD QUESTION!**

- Perhaps politically easier to maintain system with a smaller subsidy?
- You're "only" throwing away \$100M/year of surplus, after all—reducing net value from \$600M to \$500M/year



Administrivia

February 24, 2016 8-9 AM
Wheeler Auditorium, U.C. Berkeley

Webtools

- Problem Set 4 is now out: due Mar 2/3. Link off of:
 - <http://www.bradford-delong.com/course-syllabus-econ-1-spring-2016-uc-berkeley.html>
 - <https://bcourses.berkeley.edu/courses/1411451/assignments/syllabus>
 - Direct link at: <http://delong.typepad.com/files/2016-02-24-econ-1-s-2016-problem-set-4.pdf>
- Paper Assignment is now out: due first section after spring break. Link off of:
 - <http://www.bradford-delong.com/course-syllabus-econ-1-spring-2016-uc-berkeley.html>
 - <https://bcourses.berkeley.edu/courses/1411451/assignments/syllabus>
 - Direct Link at: <http://delong.typepad.com/files/2016-02-23-econ-1-essay-question.pdf>

Paper Assignment

- Due at the start of the first section after spring vacation
- Write a short (700-1000 words) essay answering one of the four following topics.
- Citations... Not a research paper... No need to use outside sources... Hard copies... Double spaced, reasonable margins... 12-point... word count at end... Page numbers... Stapled... Name on pages...
- Four options—well, seven options—Dasgupta, Friedman and Director Friedman, Snee, any two, or all three

Option 1: Dasgupta

- UCLA Law School Professor Stephen Bainbridge provides, on Amazon's website, one of the only two one-star reviews of Partha Dasgupta's *Economics: A Very Short Introduction*:
 - "If you're looking for a VSI to Econ 101 and 102, skip this book. The treatment of microeconomic basics consists of exactly 14 pages. Macroeconomic theory gets a whopping 4 pages. The rest consists mainly of a political tract on wealth and poverty. It's the first VSI whose title amounts to a misrepresentation."
- Do you agree with Bainbridge that the book is not or with Dasgupta (and the five-star reviewers) that the book is a proper very short introduction to economics?
- Why do you agree with the one you agree with?
- Why do you disagree with the one you disagree with?

Option 2: Friedman and Director Friedman

- In their *Free to Choose*, Milton and Rose Director Friedman spend substantial time and space arguing that the Great Depression was the result not of a failure of the market system but of a failure of a government agency—the Federal Reserve.
- Why is it so very, very important in the structure of their argument for the Friedmans to argue this?
- Do you find them convincing on this point?
- If you think it fails to convince, where and why does it fail to convince?

Option 3: Slee

- In chapter one of his *No One Makes You Shop at Wal-Mart*, Tom Slee writes:
 - “Somehow, individual choice has turned out to be on the side of the powerful. And somehow we have ended up making choices that make us worse off. What has gone wrong? Why is it that with more choices than any society in history, we do not get what we want?”
- In Slee’s view, the market system has failed to deliver on its promise to generate near-universal opportunity and prosperity.
- What does he think has gone wrong?
- Do you find his argument for what has gone wrong convincing, or do you think it fails to convince?
- If you think it fails to convince, where and why does it fail to convince?

Option 4: More than One of the Above

- Take any two—or take all three—of the books by Slee, by Dasgupta, and by Friedman and Director Friedman.
- Compare and contrast the frameworks they put forward into which they think you should place your understanding of economics and the economy.
- Which of the books you are analyzing seemed most convincing?
- Which did you find most disturbing?
- Which did you find most wrong-headed?
- Why?

Where We Are...

- Feb 22: We got through ch. 10
- There are substantial benefits to keeping in rough contact with the textbook
 - (with the exception of chapter 4 on elasticities, and the theory of the firm, which we got into only sideways via monopoly...
- But we won't get through all of micro before the midterm...
- Slipping the midterm a week right now would be a very bad idea. I am not going to do that.
- And I would rather have you thinking about the material in chapter 13 in the run-up to the midterm than the material in chapter 12.
- So for the midterm we are going to march through chapter 11 and then chapter 13
 - That will mean leaving 12 and 14 for the week between the midterm and spring break

Where We Are Going...

- Feb 24: ch. 11: Information/Asymmetries
- Feb 29: ch 11: Information/Asymmetries
- Mar 2: ch 13: Regulation and Cost Benefit Analysis

- Pre-Midterm Review Monday March 7
- Midterm Monday March 9

- After the Midterm
 - Ch. 12: Labor Markets and Income Distribution
 - Ch. 14: Public Goods and Political Economy

- After Spring break
 - Paper due...
 - Start macroeconomics
 - Somewhere down in Palo Alto, Enrico Moretti is laughing at me...

Meta-Announcement

- We are moving announcements and administrivia out of lecture time and onto the “announcements” bCourses page...
- That is all...

**One Last Piece to Our “Taking a
Breath...” Interregnum...**

Orientation


February 24, 2016 8-9 AM
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A Little Perspective...

- We are marching through the “how do markets go wrong?” part of the course...
- Out-of-equilibrium, rigidified by government, uncompetitive, non-rival (increasing returns to scale), externalities (in production and in consumption, positive and negative), information asymmetries, non-excludible (public goods etc.), maldistributions, miscalculations...
- That makes nine kinds of things to go wrong.

CHAPTER 10

Externalities and Property Rights



WHEN COSTS OR BENEFITS ACCRUE TO PEOPLE NOT DIRECTLY INVOLVED IN TRANSACTIONS, MARKET ALLOCATIONS ARE OFTEN INEFFICIENT

A drill television ad for a British brand of pipe tobacco opens with a distinguished-looking gentleman sitting quietly on a park bench, smoking his pipe and reading a book of poems. Before him lies a pond, overgrown except for a rather duck swimming peacefully with her ducklings. Suddenly a raucous group of teenage boys bursts onto the scene with a remote-controlled toy warship. Yelling and laughing, they launch their boat and maneuver it in aggressive pursuit of the terrified ducks. Interrupted from his relaxation, the gentleman looks up from his book and frowns calmly on his pipe as he surveys the scene before him. He then reaches into his bag, pulls out a remote control of his own, and begins manipulating the joystick. The scene shifts underwater, where a miniature submarine rises from the depths of the pond. Once the boys' boat is in the sub's sights, the gentleman pushes a button on his remote control. Seconds later, the boat is blown to smithereens by a torpedo. The scene fades to a close-up of the tobacco company's label.

EXTERNAL COSTS AND BENEFITS

External costs and external benefits—externalities, for short—are activities that generate costs or benefits that accrue to people not directly involved in those activities. These effects are generally unintended. From the pipe smoker's point of view, the noise generated by the

LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- LO1 Define negative and positive externalities and analyze their effect on resource allocation.
- LO2 Explain and discuss the Coase theorem.
- LO3 Explain how the effects of externalities can be remedied and discuss why the optimal amount of an externality is almost never zero.
- LO4 Evaluate the legitimacy of the commons, and show how private ownership is a way of governing it.
- LO5 Define positional externalities and their effects and show how they can be remedied.

And Remember: The Market Balance Sheet: Pro

- The competitive market in equilibrium, from the perspective of a utilitarian seeking to achieve the greatest-good-of-the-greatest-number:
 1. Allocates the roles of producers and sellers to those who can make and sell in a way least costly to society's resources, those with the lowest *opportunity cost*.
 2. Produces at a scale that exhausts all possible *win-win exchanges*
 3. Allocates the goods produced to those with the greatest *willingness-to-pay*—those who, by the money standard, need and want it the most

Questions?