

Economics 103
Microeconomic Principles
George Mason University
Spring 2006

Class info: W 7:20 – 10:00 PM, Enterprise Hall 80, course number 11093

Instructor: **Daniel Klein**, Professor of Economics
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office hours: Wednesday and Thursday 6:00 – 7:00 PM and by appt.

Teaching assistant: **Diana Weinert**, grad student in economics, dweinert@gmu.edu
Ms. Weinert will grade your exams and quizzes, and keep the grades.

office hours: Monday 5:30—7:00, Wednesday 2:00—3:30

place: at the table outside Klein's office (Enterprise 328)

The course is based on the lectures. There is no textbook. Outside of class, get together with classmates to go over the notes and study. During the first two weeks, make contact with at least one or two classmates. Early in the course, get into a practice of meeting to discuss the material.

Required materials:

1. Course packet, to be purchased from the campus bookstore.
2. Handout materials (free).
3. Henry Hazlitt, *Economics in One Lesson* (Crown Publishers).

Composition of course grade:

12 Quizzes: **35 percent** of grade

Midterm exam: **30 percent** of grade (date to be announced)

Final exam: **35 percent** of grade (Wednesday May 10, 7:30 – 10:15 PM)

Quiz questions:

Quizzes at the start of class will be based on material and readings through the previous week. Quiz questions will *not* ask you about the lecture (or associated readings) to be given that day.

Quiz and exam questions:

Questions will be multiple choice and short answer. The questions will be based on the

lecture material, the assigned readings, and the handouts. The assigned readings from Hazlitt, the packet, and the handouts are *fair game*. Questions may test your knowledge of those readings, *even on points that I did not cover in class*.

Missing exams will not be accommodated. You are being informed *now* of the exam dates, so I will not permit you to miss them for any kind of personal business.

When to do the readings assigned for lecture topics:

I encourage you to do the readings in advance of lecture. However, in lecture I will *not* assume that you have done the assigned readings in advance.

Getting help from me:

1. Come to my office hours (W and Th 6:00 – 7:00). Office hours are time devoted to you. When you come to my office, I will want to know what I can do for you. Office hours are an opportunity for you to talk to me about matters beyond the course. If you want to talk about economic issues in general, I will be happy to share my thoughts and information.
2. Emailing me (dklein@gmu.edu). I have email set up at home and check it frequently. For questions and clarifications, you may do best to email me.
3. Ask questions during class. Although I go into class with the intention of giving a full lecture, there is time for some questions. I especially encourage you to ask questions when you have difficulty following the material.
4. For quick questions, try me right after class.

Getting help from Ms. Weinert:

1. Come to her office hours.
2. Emailing her (dweinert@gmu.edu).

Course Outline

I. Introduction

The Art of Economics: Learning to see *the unseen* (Hazlitt: pp. 3-7)

The Broken Window (Hazlitt: pp. 11-12)

“Public Works Mean Taxes” (Hazlitt: pp. 19-24)

"The Blessing of Destruction" (Hazlitt: pp. 13-18)

World War II hurt the economy (Pkt: Robert Higgs on "War Prosperity")

II. Choice and Exchange

Crusoe and Friday

Individual preference, "utility"

The marginal unit, marginal utility: diamonds-water paradox

Scarcity

Opportunity cost

Mutual gains from trade

Barter and the problem of double coincidence of wants

Evolution of money

Characteristics that make a commodity a good money

The history from gold to green

Three kinds of government rules for society:

- 1) rules that enforce and protect voluntary exchange:
 - property rights, consent and contract (tort and contract law)
- 2) rules that restrict private activity and voluntary exchange (intervention, regulation)
- 3) rules that govern the use of government resources by private parties (for example, rules of the road)

III. The Market: Demand and Supply

Willingness to pay

Demand schedule, demand curve

Distinction between "change in quantity demanded" and
"change (or shift) in demand"

Things that affect the demand curve,

such as the prices of substitutes and complements (Pkt: Lee on Costs)

Demand curve as the marginal benefit curve

Consumer surplus

Willingness to be paid

Supply schedule, supply curve

Supply curve as the marginal cost curve

Producers surplus

IV. **The Free Enterprise System (FES)**

The Roller Rink

Spontaneous Order

Coincidence of interest

Local knowledge, or decentralized knowledge, or "the knowledge of time and place"

Blackboard supply & demand story (science fiction)

Excess demand, excess supply, and price adjustment

Market clearing price, or "equilibrium"

Superior Being: Victoria. She wants to maximize social surplus

The invisible hand (Pkt: Adam Smith on "invisible hand")

The FES as a spontaneous order (Pkt: Smith on Spontaneous Order and Woolen Coat;)

Friedrich Hayek (1899-1992) on the collapse of a tin mine

Adam's Smith's theory: The chief determinant of economic prosperity is freedom

(Pkt: Higgs on the Koreas; Gwartney and Lawson on Economic Freedom of the World)

Arbitrage

"The law of one price"

Deviations from the law of one price

Speculation

Doomsday? Resource depletion?

Can a nonrenewable resource last forever?

The Great Bet: Paul Ehrlich vs Julian Simon (Pkt: J. Tierney on "Betting the Planet"; McClintick and Emmett on "Betting on the Wealth of Nature")

"Substitutes are everywhere"

The betterment motive and the price system (Hazlitt: pp. 146-148; Pkt: Roberts on Profits)

The *Essential Dialectic* of FES:

current shortcoming → profit opportunity → entrepreneurship → remedy of the shortcoming. Hence, FES is self-improving!

V. **Economic Organization**: Amplifications of how the FES works.

Production possibilities, fish vs. coconuts

Division of labor, specialization

The pin factory (Pkt: Smith on pin factory)

Absolute advantage

Comparative advantage
Free trade vs. protectionism

Capital investment: machines, technology

Spear → fish → savings → net → fish

"The Curse of Machinery" (Hazlitt: pp. 35-46)

“Social Darwinism”: On voluntary choice (profit and loss) as a selection mechanism.

Increasing, constant, and decreasing returns to scale

Explanations for increasing returns

Explanations for decreasing returns

Economies of scope

The skateboard maker needs ball-bearings. Should he buy them or should he make them himself?

Integration within the firm vs. relying on the market

Transaction costs, Ronald Coase (Pkt: Klein on "Transaction Costs")

Owners as residual claimants

Principal-agent relationships: creating incentives for the people who work for you

Monitoring, promotion, firing employees

Commissions, piece-rates, bonuses, etc.

Moral support, recognition, esteem

Franchise chains (Handout: Peterson on Franchises)

Trust in the FES, or the problem of Quality and Safety:

The FES relies on the division of labor, but the division of labor implies a *division of knowledge*. That means people are ignorant of some things that others know. This raises the question of the *integrity* of promises.

Assurance of quality and safety. Repeat dealings and reputation.

Dealers, brokers, middlemen, brand names, knowers, “seals of approval”

(Pkt: Klein on “How Trust is Achieved”; Meineke President’s letter to D. Klein)

VI. **Genuine Applications of the Vocabulary to Current Issues**

Minimum wage laws (price floor) → surplus, or unemployment

(Hazlitt: pp. 118-123; Pkt: Gorman on “Minimum Wages”)

Rent control (price ceiling) → shortage

(Hazlitt: pp. 111-117; Pkt: Block on “Rent Control”)

Deadweight loss

Fixed exchange rates

Wage and price controls in the U.S. during WWII

The black market price of pork chops in New York City 1945

Prohibitions and black markets

Drug prohibition: Crime and health consequences (Pkt: Boaz on drug prohibition)

Prostitution prohibition: Crime and health consequences

Sugar policy (Pkt: Foldvary on sugar protectionism)

Price supports, "nonrecourse loan"

Protectionism

Sugar smuggling

Intervention dynamic

Some remarks on agricultural policy in general

Concentrated benefits vs. diffused costs of government intervention

Tax incidence: who bears the tax?

Excise tax

Ad valorem tax

Consumer vs. producer burden

Deadweight loss (Hazlitt: pp. 25-26)

Elasticity of Demand

Tax facts (Pkt: Higgs on “Carnival of Taxation”, Klein and Raish on “They Take More Than Half”)

VII. **FES Imperfection and Remedy by a Superior Being**

Simplification of FES theory:

- 1) one's own voluntary choice is advantageous to oneself
- 2) no systemic effects on bystanders or third parties
- 3) intense competition

Negative externalities: pollution

Transaction costs, the Coase Theorem (Pkt: Klein on "Transaction Costs")

Positive externalities: rabies shots

Corrective policies by an omniscient and omnipotent Victoria

Free rider problem in a FES setting

Public goods

Rivalry in consumption: whether my enjoyment impinges on yours

Excludability: the costliness of withholding enjoyment from nonpayers
technology changes whether these features are present

The free rider problem is a financing problem, not a production problem

Club goods

Tragedy of the commons (Pkt: Hardin on “Tragedy”; Anderson on “Capturing”)

Natural monopoly

Public utilities (best examples: water distribution, natural gas distribution)

What would Victoria do?

Equity concerns

Diminishing marginal utility of wealth (or dollars)

Victoria sees only dollars (willingness to pay or to be paid)

Victoria's mother, Joy, sees utility

Distribution of wealth; Welfare State policies (Pkt: Heyne et al on Distribution)

The myth of rationality

Do people always “choose in their best interest”?

Dr. Jekyll and Mr. Hyde

Weakness of will, “addiction”

Paternalism

VIII. **Government Imperfection**

Motives of government officials

Bifurcation of funding and service

Problems with government agencies

Problems with politicians

The not-worth-knowing-better problem (Pkt: Jeff Friedman on “Public Ignorance”)

Problems with regulations

IX. **Final Judgments: Choosing Between Imperfect Institutional Arrangements**

“Losing Touch”: Local knowledge and restatement of the art of economics

(Pkt: Donald Boudreaux on “Losing Touch”)