

# Economics 1000

## Essentials of Economics

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**SPRING 2011**  
**T-TH 12:30-1:45**  
**CLAS 108**

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# Who is in charge?

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Who is in charge of making sure that enough bread gets produced to keep store shelves constantly stocked?

- A. The U. S. Department of Agriculture.
- B. The U. S. Commerce Department.
- C. The U. S. Treasury Department.
- D. The state-level Department of Consumer Affairs.
- E. Nobody.

# Nobody is in charge.

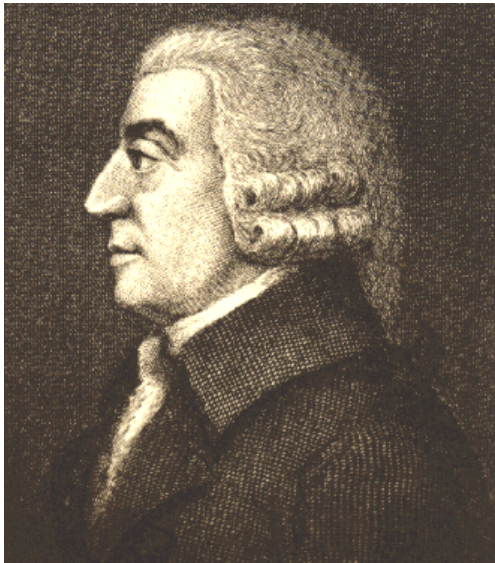
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After the break-up of the Soviet Union I was in discussion with a Russian official whose job it was to direct the production of bread in St Petersburg. “Please understand that we are keen to move towards a market system,” he told me. “But we need to understand the fundamental details of how such a system works. Tell me, for example: who is in charge of the supply of bread to London?” There was nothing naive about his question, because the answer (“nobody is in charge”), when one thinks carefully about it, is astonishingly hard to believe. Only in the industrialised West have we forgotten just how strange it is.

-- Paul Seabright, *The Company of Strangers*, Princeton University Press, 2004.

# The Invisible Hand.

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Adam Smith (1723-1790).

Image courtesy of the Warren J. Samuels  
Portrait Collection at Duke University.

- Under the right institutional arrangements, the pursuit of individual goals can lead to orderly and socially beneficial outcomes.
- Individuals are led as if by an invisible hand to promote outcomes they never intended.
- Taking advantage of dispersed local knowledge and specialized skills.

# Rules of the game

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- Efficacy of decentralized processes depends on nature of **property rights**.
- Clearly defined and enforced property rights:
  - encourage the effective use of already existing scarce resources.
  - spark efforts to discover new resources.
  - innovate new cost-cutting technologies.
  - develop new talents and skills.

# Property rights.

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- **Example: fisheries.**
  - If a resource is **unowned**, use rights depend on first capture.
  - Incentive to overuse the resource: tragedy of the commons.
- **Externalities and public goods.**
- **Markets don't fail; institutions fail.**

# “The Market.”

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Thomas Sowell,  
*Knowledge and  
Decisions*, New  
York: Basic Books,  
1980, p. 41.

There is too often a tendency to “refer to ‘the market’ as if it were an institution parallel with, and alternative to, the government as an institution. The government is indeed an institution, but ‘the market’ is nothing more than an *option* for each individual to choose among numerous existing institutions, or to fashion new arrangements suited to his own situation and taste.”

# Social cooperation.

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- Focus is on *actions, interactions, and consequences*
- Economic agents “economize”: they seek to do the best they can to achieve their goals (whatever those goals are) with whatever resources they have available.
  - results from *scarcity*
  - involves *trade-offs*

# Scarcity and plenty.

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Can scarcity be abolished?



# People face trade-offs.

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**All decisions involve tradeoffs. Examples:**

- Going to a party the night before your midterm leaves less time for studying.
- Having more money to buy stuff requires working longer hours, which leaves less time for leisure.
- Protecting the environment requires resources that might otherwise be used to produce consumer goods.

**There's no such thing as a free lunch.**

## Opportunity cost.

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The **opportunity cost** of any activity is the highest valued alternative that must be given up to engage in that activity.

# Opportunity cost.

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Robert Frost (1874–1963)



TWO roads diverged in a yellow wood,  
And sorry I could not travel both  
And be one traveler, long I stood  
And looked down one as far as I could  
To where it bent in the undergrowth;

Then took the other, as just as fair,  
And having perhaps the better claim,  
Because it was grassy and wanted wear;  
Though as for that the passing there  
Had worn them really about the same,

And both that morning equally lay  
In leaves no step had trodden black.  
Oh, I kept the first for another day!  
Yet knowing how way leads on to way,  
I doubted if I should ever come back.

I shall be telling this with a sigh  
Somewhere ages and ages hence:  
Two roads diverged in a wood, and I—  
I took the one less traveled by,  
And that has made all the difference.

# Opportunity cost.

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# Economic decision-making as greed.

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# Economic decision-making as rationality.

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- A person is **rational** if she does the best she can to achieve her objectives given what she has to work with.
  - More like Captain Kirk than Mr. Spock.

# Thinking at the margin.

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- Many decisions are not “all or nothing,” but involve **marginal changes** – incremental adjustments to an existing plan.
- Evaluating the costs and benefits of marginal changes is an important part of decision making.



# Should we finish the bridge?

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- Government has spent \$20 million on a bridge.
- Having a bridge is worth \$30 million to society.
- It would cost \$15 million to finish the bridge.



- A. Yes
- B. No

# *No theory means poor theory.*

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- Theory has explanatory power: discovery of causal relationships depends upon theory.
- You are using a theory even when you think you aren't.
- Some failures of “intuitive” theory:
  - Fallacy of composition.
  - Correlation versus causality.