

**Economics 11**  
**MARKETS AND PRICES**  
**Santa Clara University**  
**Fall 2002**

**General Information:**

Instructor: Daniel B. Klein, Associate Professor of Economics  
Class place/time: Kenna 308, Tuesdays and Thursdays at either 11:50 or 3:40  
Class Sect. Number: the 11:50 class is 26650, the 3:40 class is 26652  
Prof. Klein's office: Kenna 300-H  
Office hours: 2:45-3:30 on Tuesdays, Wednesdays, and Thursdays  
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**Colloquium leaders:** Marisa Balch (mbalch@scu.edu)  
Leah Verhoeven (lverhoeven@scu.edu)  
office hours: To be announced.  
evening  
colloquia: Tuesdays and Wednesdays, 7:15 - 8:30 pm (not every wk!). The meeting place is to be announced.

**The Chief Sources: Me, Marisa, Leah, You, and Your Classmates**

This course will be based primarily on the lectures. There is no textbook. Make every effort to attend every lecture. Get together with classmates to go over the notes and to work together on homeworks.

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. I don't ask you to read a boring textbook, but I do ask you to sit down with each other and talk about what the class material means, how the diagrams work, and so on.

**Required Materials:**

1. Course packet, to be purchased from Copy-Craft, 341 Lafayette St., ph 247-4692.
2. Henry Hazlitt, *Economics in One Lesson* (Crown Publishers).

### **Composition of Course Grade:**

Midterm exam, Thursday Oct. 24, counts for **35 percent** of grade.

Final exam: For the 11:50 class it will take place on Tuesday Dec. 10 at 1:30, for the 3:40 class, day and time are to be announced. Counts for **40 percent** of grade.

Regular Homeworks count for **15 percent** of grade.

Reflection Homeworks count for **10 percent** of grade.

### **Exams:**

Exam questions will be similar in kind to the questions asked on the homeworks. Exams will be based on both the lecture material and the assigned readings. Emphasis will be placed on lecture material. The assigned readings from Hazlitt and the packet are *fair game* for exam questions. Exam questions may test your knowledge of those readings, *even on points that I did not cover in class*.

Missing exams will be severely frowned upon -- you will need a *substantiated*, truly dramatic cause. You are being informed now of the exam dates, so I will not permit you to miss them for any kind of personal business.

### **Regular Homeworks:**

Most weeks you will have a homework assignment. Homeworks will be passed out either on a Thursday, and will always be due one week later *at the beginning of class*. *Late homeworks will not be accepted*. You are encouraged to work together on the homeworks, but you must turn in individual homework papers. In computing your regular homework average, your lowest homework grade will be dropped.

### **Reflection Homeworks:**

The colloquium schedule is as follows:

Tues.&Wed. Oct. 1 & 2: Black Markets in America During World War II and Today

Tues.&Wed.Oct. 8 & 9: Trade Between Americans and People of Other Countries

Tues.&Wed. Oct. 15 & 16: Resource Conservation and Recycling

(Tues & Wed. Oct. 22 & 23: review sessions)

Tues.&Wed. Oct. 29 & 30: Legalize It? Drug Policy

Tues.&Wed. Nov. 5 & 6: The School Voucher Proposal

Tues.&Wed. Nov. 12 & 13: Automobile Emissions

Tues.&Wed. Nov. 19 & 20: Dilemmas of the Welfare State

(Tues. & Wed. Nov. 26 & 2: Thanksgiving holiday week)

(Tues. & Wed. Dec. 3 & 4: review sessions)

You will be expected to attend four colloquia. These colloquia, led by Marisa on Tuesdays and Leah on Wednesdays from 7:15-8:30 PM will be an all-student discussion of the topic, based on assigned readings (found in the packet) and class lecture. (For a listing of the assigned colloquium readings, *see the last page* of this course description.) You will be expected to have read the readings carefully; no presentation will be made. A good opportunity to discuss whether I'm full of crap.

For each colloquium that you attend, write a two-page reflection based on the assigned readings, the questions, and the colloquium discussion. Make your piece between 500 and 700 words (two pages). Turn in the reflections homework on the Tuesday of the following week, *at the beginning of class*. I will read and mark the reflections homeworks. You are required to turn in **four** reflections homeworks. The grade on a reflection assignment will a check plus (90), check (70), check minus (50), or zero.

**Extra-credit opportunities:** There will be four special lecture events outside of class that you can write a reflection assignment on. These events will take place as follows:

- C Wednesday Oct. 2, 7:30-9:00 (“Why My Thinking Changed”)
- C Thursday Oct. 24, 7:00-9:00 (Debate on Free Trade)
- C Thursday Oct. 31, 5:30-7:00 (“Economic Freedom Raises All Boats”)
- C Thursday Nov. 14, 5:30-7:00 (“For a Harmonious Globalization”)

If you attend an event and write a worthy reflection (two pages), you will get three points added to your midterm exam score. You may take advantage of this opportunity up to **three** times. (So if you go to three of these events and turn in three worthy reflections, your midterm exam score will go up by nine points.)

### **When to Do the Readings Assigned for Class Lecture:**

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. (Note: For colloquia you *are* to have done the reading and answered the questions in advance.)

### **Getting Help from me:**

There are four ways to get help from me:

(1) Come to my office hours. My office hours (Tues, Wed, Thursdays 2:45-3:30) represent 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@scu.edu). I have email set up at home and check it frequently. For urgent 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 usually some time for questions. I especially encourage you to ask questions when you have difficulty following the material. Clarifying questions are a good signal to me that I may be going too fast or skipping over some important points. More substantive questions about digressions from the main path of the lecture will sometimes go unpursued because time is scarce; please don't be offended if I can't pursue your question -- we can pursue it during office hours -- so don't hesitate to ask!

(4) For quick questions, try me right after class finishes.

## *Course Outline*

### I. **Introduction**

The Art of Economics: Learning to see *the unseen* (Hazlitt: pp. 15-19)

The Broken Window (Hazlitt: pp. 23-24)

"The Blessing of Destruction" (Hazlitt: pp. 25-30)

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 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

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

The *Essential Dialectic* of FES:

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

Market competition

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 function of profits and the price system (Hazlitt: pp. 161-163)

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; Johnson and Sheehy on Economic Development)

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")

"Substitutes are everywhere"

#### 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. 49-60)

Increasing, constant, and decreasing returns to scale

Explanations for increasing returns

Explanations for decreasing returns

Economies of scope

Should the skateboard maker buy or make the ball-bearings he needs?

Integration within the firm vs. relying on the market

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

Owners as residual claimants (Pkt: Thomas Hazlett on "Hostage Rescue")

Principal-agent relationships

Creating incentives

Monitoring, promotion, firing employees

Commissions, piece-rates, bonuses, etc.

Moral support, recognition, esteem

Franchise chains (Pkt: 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)

Discovery of opportunity in the FES:

Search, Epiphany, and Serendipity (Pkt: Klein on "Discovery")

"Social Darwinism": On profit as a survival mechanism

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

Minimum wage laws (price floor) --> surplus, or unemployment

(Hazlitt: pp. 134-139; Pkt: Gorman on "Minimum Wages")

Rent control (price ceiling) --> shortage

(Hazlitt: pp. 127-133; 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

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

Sugar policy

Price supports, "nonrecourse loan"

Protectionism

Sugar smuggling

Intervention dynamic

Some remarks on agricultural policy in general

Concentrated benefits vs. diffused costs of government intervention

Occupational licensing

Imperfect consumer information

Protecting the consumer?

or, protecting the practitioner?

(Pkt: Young on "Occ. Licensing", Postrel on "Hair Raising," Kelly Barron on "New Plague,")

Tax incidence: who bears the tax?

Excise tax

Dd valorem tax

Consumer vs. producer burden

Deadweight loss (Hazlitt: pp. 37-39)

Tax facts (Pkt: Higgs on "Carnival of Taxation")

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

Review: three building blocks of simplified FES theory:

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

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 public officials

Bifurcation of funding and service

Potshots at public agencies

Potshots at 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")

### **ASSIGNED READINGS (in packet) FOR THE COLLOQUIA:**

Tues.&Wed. Oct. 1 & 2: Black Markets in America During World War II and Today: **Higgs** on “War Prosperity” **and Tucker** on “Notes from the Underground”

Tues.&Wed.Oct. 8 & 9: Tues.&Wed.Oct. 8 & 9: Trade Between Americans and People of Other Countries: **Hazlitt**: pp. 74-89

Tues.&Wed. Oct. 15 & 16: Resource Conservation and Recycling: **Tierney** on “Betting the Planet” **and Tierney** on “What a Waste: Recycling is Garbage”

Tues.&Wed. Oct. 29 & 30: Legalize It? Drug Policy: **Boaz** on “Consequences”

Tues.&Wed. Nov. 5 & 6: The School Voucher Proposal: **Friedmans** on “A Voucher Plan,” **NCPA** on “Hidden Demand for School Choice,” **and ABCNews** on “Supreme Court OKs Vouchers”

Tues.&Wed. Nov. 12 & 13: Automobile Emissions: **Klein** on “Fencing the Airshed”

Tues.&Wed. Nov. 19 & 20: Dilemmas of the Welfare State: **Heyne, Boettke and Prychitko** on “TheDistribution of Income”