Thinking Like an Economist

Course Information
Three Principles of Decision Making
  The Scarcity Principle
  The Cost-Benefit Principle
  The Incentive Principle
Examples

Today’s News Article Is Puzzling

The New York Times

Unpaid Work, but They Pay for Privilege

By GERRY SHEIN

With paying jobs so hard to get in this weak market, a lot of college graduates would gladly settle for a nonpaying internship. But even then, they are competing with laid-off employees with far more experience.

So growing numbers of new graduates — or, more often, their parents — are paying thousands of dollars to services that help them land internships.

Call these unpaid internships that you pay for.

Course Information

Copies of the syllabus, course calendars, Power Point slides, and assignments are available on the course web page: www.unc.edu/~salemi

Graded work with the clickers begins today. If you have not yet done so, register your clicker.

Make sure your eInstruction student ID is your UNC PID. No hyphen please.

Recitations Have Begun

Most of you have already attended your first recitation.

Your recitation assignment for next week is to read the excerpt from The Wealth of Nations which is available on the web page.
Review

The *Opportunity Cost* of a decision is the decision maker’s next best alternative to the chosen decision.

Review: Survey Results

<table>
<thead>
<tr>
<th>Statement to which students responded “true” or “false”</th>
<th>Percent “True”</th>
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<tbody>
<tr>
<td></td>
<td>Before</td>
</tr>
<tr>
<td>The best things in life are free.</td>
<td>52</td>
</tr>
<tr>
<td>The biggest college cost is tuition and fees.</td>
<td>37</td>
</tr>
<tr>
<td>Anything worth doing is worth doing well.</td>
<td>83</td>
</tr>
<tr>
<td>Life should be sustained at any cost.</td>
<td>28</td>
</tr>
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The Scarcity Principle:
Because resources are scare, choices entail costs.

Your “Reservation Price” is the most you would pay to obtain a good or service.

Your “Surplus” in a transaction is the difference between your reservation price and what you actually pay.

Reservation Price

What is the most you would be willing to pay right now for a package or Oreo cookies and permission to eat them in class?

That amount is your reservation price for those cookies at this moment.
Surplus

Suppose I offer you at package or Oreo cookies for $0.60.

What is your economic surplus?

Two Types of Clicker Questions

Graded Questions provide students and incentive to stay alert and engaged during lectures.

Non-Graded Questions provide students an opportunity to work together to meet more difficult challenges. These questions will show up on exams.

Use Your Clickers To Answer The Following Graded Question

It is hot at the football game and Joe is thirsty. He would pay up to $5.00 for a 20 ounce cola. He goes to the concession stand and finds that he can buy a 20 ounce cola for $3.00. Joe’s economic surplus from the transaction is...

A. $0.00.
B. $3.00.
C. $2.00.
D. $5.00.
You won a free ticket to an Eric Clapton concert (which has no resale value). A Bob Dylan concert on the same night is your next-best alternative activity. Tickets to see Dylan cost $40. You would be willing to pay up to $50 to see Dylan. There are no other costs.

What is your opportunity cost of the Clapton Concert?
A. $0  
B. $10  
C. $40  
D. $50  

Using the Scarcity Principle to make sense of the answer.
What are the scarce resources involved in the concert decision?
What do you give up when you decide to attend the Clapton concert?
Why is the opportunity cost of the Clapton concert $10 rather than $40 or $50?

Cost-Benefit Principle

*Marginal Cost* is the cost of doing a little bit more of an activity.

*Marginal Benefit* is the benefit that derives from doing a little bit more of an activity.
Cost-Benefit Principle

To a decision maker, the relevant costs and benefits are *marginal costs and marginal benefits* where marginal means “incremental.”

Most decisions involve choosing a little bit more or less of a good or activity. Few decisions are all or nothing decisions.

Exercise

Raleigh politicians have built a new convention center.

How could “marginal cost” and “marginal benefit” be used to decide how much money to spend on it?
What Kind of Chairs Should Be Chosen for the Convention Center?

Plastic at $50 per chair
Padded vinyl at $100 per chair
Steel (leather seats) at $150 per chair
Padded leather at $200 per chair
Hand tooled cowhide at $400 per chair

The Cost-Benefit Principle

You are about to buy a $25 computer game at the UNC Ram Shop when a friend tells you the same game is on sale for $15 at University Mall (30 minutes away by bus).

Where would you buy the game?
What sort of student is more likely to buy the game at the Ram shop?

The Cost-Benefit Principle

What is the benefit of buying the game at University Mall?

What is the cost of buying the game at University Mall?

For what sort of student is the benefit of the trip to University Mall likely to be greater than the cost?

The Cost-Benefit Principle

You are about to buy computer equipment at the Ram shop for $1000 when a friend tells you the same equipment is available at University Mall for $990.

Where would you buy the computer equipment?
Should your answer be different for the game and for the computer equipment? Why or why not?
Use Your Clickers To Answer The Following Graded Question

You can buy a game for $25 at the Ram shop or $15 at University Mall. You can buy a computer for $1000 at the Ram shop or $990 at University Mall. Should your “where to buy” decision be the same or different in the two cases?

A. Different because buying the game at U Mall provides a greater percentage discount.
B. The same because the marginal costs and marginal benefits are the same in each case.
C. Different because the computer is a higher surplus item.
D. The same because the opportunity cost of buying at the Ram shop is zero.

The Incentive Principle

A person (or firm or group of people) is more likely to take an action if the benefits of the action rise.

A person is less likely to take an action if the costs of the action rise.

People, firms and groups respond to incentives.

The Incentive Principle

Residents of your city are charged a fixed weekly fee of $6 for garbage collection. They are allowed to put out as many trash bags as they wish. The average household disposes of three trash bags of garbage per week under this plan.

Suppose that your city changes to a “tag” system. Each trash bag to be collected must have a tag affixed. Tags cost $2 each and are not reusable.

What effect will introduction of the tag system will have on the total quantity of garbage collected in your city?
The Incentive Principle

How does the tag system change the marginal benefit and marginal cost of disposing of a trash bag?

What are some alternatives to putting out another trash bag?

What incentive has the tag system created?

Do you agree that people are likely to respond to the incentive?

Use Your Clickers To Answer The Following Graded Question

The Tag System is likely to _____ the quantity of garbage collected because _____.

A. Reduce, because the marginal cost of discarding garbage is higher.
B. Reduce, because the marginal benefit of discarding garbage is lower.
C. Leave unchanged, because the marginal benefit of discarding garbage is the same.
D. Leave unchanged, because there are no substitutes for trash removal.

What Have We Learned?
Thinking Like an Economist

The Scarcity Principle
Because resources are scarce, having more of one good or service means having less of another.

The Cost-Benefit Principle
An individual should take an action if and only if the extra benefits from taking the action are at least as great as the extra costs.

The Incentive Principle
A decision maker is more likely to take an action if its benefits rise and less likely to take it if its costs rise.