

IESE BUSINESS SCHOOL

THE ECONOMIC WAY OF THINKING (ECOWAY)

Economics is most likely not what you think. Yes, many economists talk about “macro” issues such as inflation, unemployment, growth, and the like. But the real beauty of Economics is somewhere else; it is in its building blocks, in its very essence. Some people call that Microeconomics, but that is what *Economics* is really all about.

So what is it about? *Economics is about finding a plausible and coherent explanation to apparently-simple but extremely-intriguing (and deceiving) problems.* Why can seat belts *increase* the number of accidents? Why decreasing the supply of drugs can *increase* the crime rate? Why recycling may lead to a *decrease* in the number of trees? The answer to these and countless similar questions is surprisingly plausible; the method to reach those answers is through the impeccable logic of economic models; and the reaction of most people after learning the answer to this type of questions is to say “Why didn’t I think of something so obvious myself?!”

Economics attempts to explain and predict human (not just economic) behavior. Economic analysis consists of starting from a few plausible assumptions (people face constraints, people try their best to be happy); building a simple model based on those assumptions (no, a model does not *have* to be a bunch of equations); and using the model to understand how people behave and to predict their reactions to changes in the environment.

To illustrate the power and beauty of economic analysis, consider an apparently-simple question: Why is popcorn so expensive at the movie theater? The usual answer to this problem is that once you enter the theater, the theater owner has a *monopoly* on the sale of popcorn and uses his monopoly power to extract a high price from moviegoers. But the usual answer is wrong. Notice that once you entered the theater, the theater owner has a monopoly on a lot of things: He is the only supplier of restrooms, the only supplier of escalators, the only supplier of seats, and does not charge for any of these. The usual reaction to this argument is that, by charging for any of these things, customers would choose to go to other movie theaters; that is, because of *competition* among theaters these things are free. But again the usual reaction is wrong: It does not explain why theaters do not compete also on the price of popcorn and thus reduce it significantly. If competition drives the price of using the restrooms all the way down to 0, why doesn’t it at least lower a bit the price of popcorn?

As you see, the simple question is not so simple. In fact, our reasoning raised two possibilities: 1) Popcorn at the movie theater is not so expensive as it may appear once all the relevant costs are taken into account; or 2) popcorn does leave a substantial margin to the theater owner but we have to look beyond the monopoly story to explain it. (There is, in fact, a good answer to this question.) This what Economics, and this course, is all about.

We will spend seven sessions setting up (and all along applying) a basic framework of economic analysis, and the rest of the course using that framework to think about several issues. The following three pages briefly describe some of the questions we’ll address (and hopefully answer) during the course. Performance in the course will be evaluated through a final exam (70%) and class participation (30%). The final exam will take place in the last session of the course (**Tuesday, Apr/8**).

My office, phone number, email address, and Web page are **U-309, 4322, jestrada@iese.edu**, and **<http://web.iese.edu/jestrada>**. My office hours are unrestricted when I’m around.

ISSUES

- **BLOCK 1: A CRASH COURSE IN ECONOMICS**

- **Session 1: Introduction**

- ✓ What Economics (and this course) is all about.

- **Session 2: Supply, Demand, and Equilibrium**

- ✓ A bit of the classical stuff, plus a whole lot more of non-classical stuff. Ever thought of the demand for murder? For tax evasion? For speeding on highways? We will.
 - ✓ Why cigarette smokers largely get to pay a tax on cigarettes but drivers of Ferraris largely get to avoid a tax on Ferraris?

- **Session 3: Rational (Individual) Behavior**

- ✓ It's all about being as happy as possible subject to some constraints. Human (not just economic) behavior is as simple (or as difficult) as that.
 - ✓ Why may a safer birth-control device increase the number of unwanted pregnancies? Why may energy-efficient cars increase the overall consumption of gasoline? Do some people *choose* to be fat?

- **Session 4: Competition**

- ✓ A powerful lobby effort manages to convince travelers around the world to tip hotel maids so that, on average, the maids' hourly compensation goes from \$8 to \$9 (\$8 from wages and \$1 from tips). Does this lobby effort make maids better off? How about employers? And travelers?
 - ✓ Regarding *Williams v. Walker-Thomas*, one of the most famous contract law cases in American common law, many suggested that the court should invalidate a contract that was so clearly favoring the seller over the buyer, a clear indication of monopoly power on the part of the seller. We'll see about that ...

- **Session 5: Monopoly**

- ✓ Polaroid is the only supplier of Polaroid cameras and Polaroid films. Should the company charge a high price for the camera and a low price for the film? Or should it charge a low price for the camera and a high price for the film?
 - ✓ Coupons and mail-in rebates are very popular in the US. Are these devices that companies use to save some customers a few bucks? Or are they far more sophisticated tools to implement price discrimination?

- **Session 6: Externalities**

- ✓ A lawyer's office and a rock star's recording studio are next to each other. The loud music scares away many potential clients and the lawyer sues the rock star. Should the judge stop the rock star from playing? Should the judge tell the lawyer to put up with the music or move out? Does it really matter what the judge decides?
 - ✓ Why do smokers and non-smokers never seem to agree on whether one has the right to clean air or the other has the right to smoke?

• **Session 7: Public Goods**

- ✓ Cleantown and Dirtyville are two very similar towns except in the fact that the air is very clean in the former and very polluted in the latter. The only reason some people choose to live in Dirtyville is that rents are much lower. Suppose the mayor of Dirtyville imposes a clean-air act that contemplates stiff penalties for polluters, and that the law is so effective that the air in Dirtyville quickly becomes as clean as that in Cleantown. Who benefits the most from this law?
- ✓ Rhinos are an endangered species but cows are not. Why? What is the key factor driving the different fate of these two types of animals?

• **BLOCK 2: SELECTED TOPICS**

• **Sessions 8-9: Optimal Precaution**

- ✓ A doctor fails to perform a test on a patient. Eventually the patient develops a condition that could have been anticipated and prevented by running the test. Is the doctor negligent?
- ✓ Edward Ivey was a GM engineer that in 1973 wrote a crash-safety report. The two-page 'Ivey report,' which we'll discuss, became one of the most damning documents ever written for the auto industry.
- ✓ We'll also discuss the following related questions: Should companies run cost-benefit analyses on safety measures where life is at stake? If no, why? If yes, how?

• **Sessions 10-11: Optimal Punishment**

- ✓ Should fines be based on the harm caused by the offense or on the offender's level of wealth?
- ✓ The "three-strikes" law (commit a third crime and you go to prison for life) is popular among voters. But is it efficient? Is it the best way to punish repeat offenders?
- ✓ The death penalty is the ultimate form of punishment, allowed in some countries and outlawed in some others. The moral debate is endless. But should it be allowed on *economic* grounds?

• **Sessions 12-13: Economics and the Environment**

- ✓ If you could save a person's life by taking an action that costs \$69 or another action that costs \$180 million, which one would you choose? (Environmentalists would probably choose the other.)
- ✓ You probably heard (more than enough) about the Kyoto agreement and the positions taken by different governments. What is your position? Should Kyoto be enforced? Should it be repelled?
- ✓ Can a factory buy or sell the right to pollute? Yes, it can, and we'll see how.

• **Session 14: Economics of Information**

- ✓ A drop of your blood contains genetic information very valuable to predict your future health. Should health insurers be entitled to this information? Should it remain private and for your own use only?
- ✓ You are thinking of buying full insurance for your car so that instead of paying for indoor parking you could just park the car on the street (making it more likely that it will be stolen). Sounds like you're going to get a free ride from the insurance company. Or are you?

• **Session 15: Marriage**

- ✓ If you think of marriage as a contract, which type would you prefer: The type that gives both parties the right to divorce without consent of the other party, or the type that does not allow divorce without proof of adultery, desertion, or abuse?
- ✓ Did you know that in the first year after a divorce, women's living standards fall by 27% while men's living standards rise by 10%? Does this fact imply that divorce laws are unfair to women?

• **Session 16: Sex**

- ✓ Is there anything peculiar about the market for pornography and the market for prostitution? Are they just like any other markets? What are their distinctive characteristics?
- ✓ Some universities distribute condoms to students at no cost: Is this a good policy? Why? Should there be mandatory testing for AIDS? Why?

• **Session 17: Drugs**

- ✓ Is the “drug problem” as bad as the press claims? How does it compare to the “alcohol problem” or the “tobacco problem?”
- ✓ And as for the billion dollar question: Should drugs be legalized? Simple question, difficult answer.

• **Session 18: Rock ‘n’ Roll**

- ✓ Should Web sites that enable consumers to listen and share music for free be legal?
- ✓ Is it socially desirable to grant monopoly rights to the exploitation of artistic work?

• **Session 19: Sports**

- ✓ Did Michael Jordan make “too much” money during his NBA years? Why do, in some markets, small differences in ability imply huge differences in salaries?
- ✓ Why are some sports (NBA basketball) highly regulated, whereas others are (European soccer) largely unregulated?

• **Sessions 20-21: Efficiency, Equity, and Some Hard Questions**

- ✓ All the inhabitants of a small town caught a deadly disease. The virus that causes it travels by air and the risk of infection of many neighboring towns inhabited by millions of people is very high. Should the city be wiped out in the name of the greater good?
- ✓ You are the benevolent dictator of a small country and get to allocate the income to all its citizens. Would you distribute income evenly? To each citizen according to how much he/she produces?

• **Session 22: A Final Assessment**

- ✓ So, does economic analysis make any sense at all? Is it practical? Is it useful? Is it essential? Hopefully, you will conclude ‘yes,’ ‘yes,’ ‘yes,’ and ‘yes.’

• **Session 23: Final Exam**

- ✓ Ah, all good things come to an end! Now it’s your time to show how much you learned. No sweat, this will be easy if you kept on top of the course.

READING LIST

• **BLOCK 1: A CRASH COURSE IN ECONOMICS**

◆ **Session 1: Introduction (Jan/14)**

- ☞ Landsburg (1993), *The Armchair Economist*, chapter 1
- ☞ Cooter & Ulen (2000), *Law & Economics*, chapter 2 (*This is an optional reading. It is long but also very, very good, particularly if your economics are a bit rusty or if you had trouble following the Microeconomics course.*)

◆ **Session 2: Supply, Demand, and Equilibrium (Jan/15)**

- ☞ Landsburg (1999), *Price Theory & Applications*, chapter 1

◆ **Session 3: Rational (Individual) Behavior (Jan/21)**

- ☞ Krugman & Wells (2005), *Microeconomics*, chapter 10

◆ **Session 4: Competition (Jan/22)**

- ☞ Mankiw (2004), *Principles of Economics*, chapter 14

◆ **Session 5: Monopoly (Jan/28)**

- ☞ Mankiw (2004), *Principles of Economics*, chapter 15

◆ **Session 6: Externalities (Jan/29)**

- ☞ Mankiw (2004), *Principles of Economics*, chapter 10

◆ **Session 7: Public Goods (Feb/4)**

- ☞ Mankiw (2004), *Principles of Economics*, chapter 11

• **BLOCK 2: SELECTED TOPICS**

◆ **Sessions 8-9: Optimal Precaution (Feb/5 and Feb/11)**

- ☞ Ivey (1973)
- ☞ Cooter & Ulen (1988), *Law & Economics*, chapter 9, section E

◆ **Sessions 10-11: Optimal Punishment (Feb/12 and Feb/18)**

- ☞ Friedman (2001), *Law's Order*, chapter 15

◆ **Sessions 12-13: Economics and the Environment (Feb/19 and Feb/25)**

- ☞ Landsburg (1993), *The Armchair Economist*, chapter 24

◆ **Session 14: Economics of Information (Feb/26)**

☞ Friedman (2001), *Law's Order*, chapter 6

◆ **Session 15: Marriage (Mar/3)**

☞ Friedman (2001), *Law's Order*, chapter 13

◆ **Session 16: Sex (Mar/4)**

☞ Coyle (2002), *Sex, Drugs & Economics*, chapter 1

◆ **Session 17: Drugs (Mar/10)**

☞ Coyle (2002), *Sex, Drugs & Economics*, chapter 2

◆ **Session 18: Rock 'n' Roll (Mar/11)**

☞ Coyle (2002), *Sex, Drugs & Economics*, chapter 5

◆ **Session 19: Sports (Mar/25)**

☞ Coyle (2002), *Sex, Drugs & Economics*, chapter 4

◆ **Sessions 20-21: Efficiency, Equity, and Some Hard Questions (Mar/31 and Apr/1)**

☞ Baumol (1986), *Superfairness*, chapter 1

◆ **Session 22: A Final Assessment (Apr/7)**

☞ Coyle (2002), *Sex, Drugs & Economics*, chapter 27

☞ Landsburg (1997), *Fair Play*, chapter 20

◆ **Session 23 FINAL EXAM (Apr/8)**

☞ *EVERYTHING!!!*

Ⓢ *Note:* The exam's date is *non-negotiable*; no interviews, no grandmothers to take care of, no little brothers to take to school, etc. Also, don't ask me for old exams, the material you should "really know," and the like. This is grad school, not high school, so here's all I have to say about the exam: It's on **Tuesday, Apr/8, 11.15a-12.30p**; it goes for 75 minutes; it covers all readings and discussions; it is closed book; and it is multiple choice. Further questions on this issue will be unwelcome ...

REFERENCES

- Baumol, William (1986). *Superfairness*. MIT Press.
- Cooter, Robert, and Thomas Ulen (1988). *Law & Economics*. Harper Collins.
- Cooter, Robert, and Thomas Ulen (2000). *Law & Economics*. Addison Wesley Longman.
- Coyle, Diane (2002). *Sex, Drugs & Economics*. Texere.
- Friedman, David (2001). *Law's Order*. Princeton University Press.
- Ivey, Edward (1973). "Value Analysis of Auto Fuel Fed Fire Related Fatalities." Unpublished General Motors report.
- Krugman, Paul, and Robin Wells (2005). *Microeconomics*. Worth.
- Landsburg, Steven (1993). *The Armchair Economist*. The Free Press
- Landsburg, Steven (1997). *Fair Play*. The Free Press
- Landsburg, Steven (1999). *Price Theory & Applications*. SouthWestern.
- Mankiw, Gregory (2004). *Principles of Economics*. Harcourt College.