

## ECO2013 EXAM 2 COMPLETE STUDY GUIDE - CHAPTERS 1, 2, 3, 7, 8, 9, 16, & 18

### Chapter 1 - The Economic Approach

- Adam Smith - father of economics
  - says that wealth is not about gold or silver, it is about productivity
  - Invisible-Hand Principle - self-interest leads to helping others; you have to figure out how to help people in order to earn money
- Economics - the study of how individuals make choices and use scarce resources; "dismal science" (Thomas Malthus)
  - we all have unlimited wants and limited resources
  - scarcity - there is less of a good freely available from nature than people would like; if it has a price, it's scarce; scarcity is objective and will always be present; SCARCITY IS NOT POVERTY
    - scarcity always necessitates rationing - allocating a limited supply of a good or resource among people who would like to have more of it
  - choices ALWAYS involve trade-offs
  - resources - inputs used to produce goods and services
    - human resources - cannot be separated from the individual; skills/knowledge that we acquire through experience/education
    - physical (capital) resources - machines/tools used to build the goods and services
    - natural resources - self-explanatory, water, land, oil, coal, etc.
- 8 guideposts to economic thinking
  - the use of scarce resources is costly, so decision makers must have trade-offs
    - "there is no such thing as free lunch"
    - opportunity cost - what is given up to get something
  - individuals choose purposefully - they try to get the most from the least
    - economizing behavior - choosing the option that offers the greatest benefit at the least possible cost
    - utility - the subjective benefit or satisfaction a person expects from a choice or course of action
    - people behave rationally - understand their preferences and try to get the most from their scarce resources (to maximize utility)
  - incentives matter - choice is influenced in a predictable way by changes in incentives
    - ALL ECONOMICS IS BASED ON THIS STATEMENT
    - incentive - a threat of a reward or punishment; responses to incentives vary; altering incentives alters behavior
      - The Peltzman Effect, 1975 - good intentions do not guarantee desirable outcomes
  - individuals make decisions at the margins
    - marginal - used to describe the effects of a change in the current situation; marginal = additional
    - diamond/water paradox - diamonds do nothing yet are expensive, we need water to survive yet it's free
    - total benefit does not equal marginal benefit; average cost = total cost/total produced
    - marginal cost = cost of producing each additional unit of product
  - information is costly
    - gathering information isn't free; the bigger the decision, the more resources you'll use gathering information and "shopping"
  - beware of the secondary effects
    - secondary effects - the indirect impact of an event or policy that may not be easily and immediately observable
  - the value of a good or service is subjective
    - preferences differ among individuals, moving goods to those who value them most is a source of economic progress
  - the test of a theory is the ability to predict
    - scientific thinking - developing a theory from basic principles and testing it against real world events
- positive economics - can be proven true or false; negative economics - opinionated, cannot be proven true or false
- \*\*\*REMEMBER: DO NOT VIOLATE CETERIS PARIBUS, GOOD OUTCOMES DO NOT GUARANTEE DESIRABLE OUTCOMES, CORRELATION IS NOT CAUSATION, WHAT IS TRUE FOR ONE IS NOT TRUE FOR ALL\*\*\*

## Chapter 2 - Some Tools of the Economist

- opportunity - the highest valued alternative sacrificed in order to choose an option; different for each person (subjective); money doesn't reflect the total opportunity cost of an action
  - failure to consider opportunity cost leads to false conclusions and poor decision making
- TRADE MAKES BOTH PARTIES BETTER OFF - trade is voluntary, we only engage in mutually beneficial trades, trade increases the total wealth in an economy, and moves goods to people who value them most
- transaction cost - the time, effort, and other resources needed to search out, negotiate, and complete an exchange; transaction costs are a barrier to trade
  - middlemen - a person who buys and sells goods or services or arranged trades; makes trades more efficient and lower their overall cost; reduce transaction costs
- private property rights involves three things: (1) right to exclusive use, (2) legal protection against invasion, (3) right to transfer, sell, exchange, or mortgage
  - owners benefit from using property in ways that others appreciate, owners have an incentive to care for their property, property rights create an incentive to conserve for future use
- common property - multiple people simultaneously claim a good or resource; "when everybody owns something, nobody owns it"
  - tendency to overuse, economic growth is hindered without property rights
- production possibilities curve (PPC) - outlines all possible combinations of output that could be produced, holding fixed resources and technology



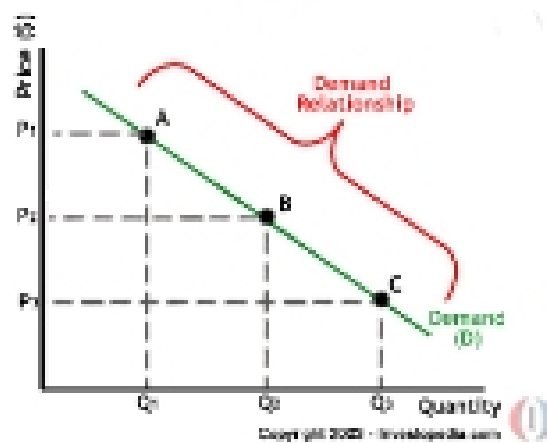
- slope of PPC - amount of one product that must be given up to obtain another
- points outside the curve are impossible, points on the curve are inefficient, an outward shift represents economic growth
- things that shift PPC outward
  - increase in economy's resources
    - investment - improvements that expand on economy's resources, called capital formation, required a decrease in current consumption
  - advancement in technology
    - creative destruction - the replacement of old products and methods by new ones that are superior
  - improvements in the "rules"
    - when contracts are enforced fairly (property rights are stable, international and domestic trade are open)
  - working harder and giving up leisure
- divisions of labor - method that breaks down the production

of a product into a series of specific tasks

- law of comparative advantage - total output will be greatest when each good is produced by the individual with the lowest opportunity cost; buyers benefit from lower cost, seller benefit from higher output and incomes
- gains from mass production and innovation - (1) mass production can reduce per unit cost, (2) no one would produce on a large scale if they couldn't trade, and (3) trade allows the economic pie to grow
- market organization - private parties make their own decisions with the guidance of unregulated market prices
  - buyers and sellers individually decide what to produce, how to produce it, and who to trade with
- collective decision making - use of the political process to allocate resources

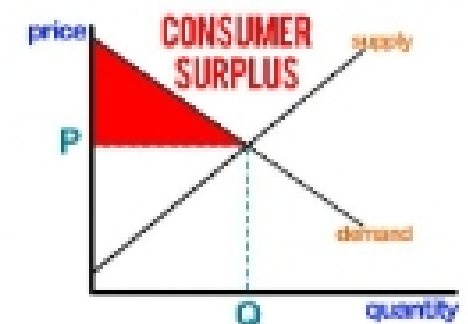
- the government decides what to produce, how to produce it, and who will get it

## Chapter 3 - Supply, Demand, and the Market Process



- DEMAND

- the law of demand - there is an inverse relationship between the price of a good and the quantity of its buyers that are willing and able to purchase; when price rises, quantity demanded falls and vice versa (*ceteris paribus!*)
- quantity demanded - the number of that people are willing and able to buy at each price
- consumer surplus - the difference between the maximum price the consumers are willing to pay and the price that they actually pay



- lower price → more consumer surplus; higher price → less consumer surplus
- marginal value - height of demand curve at each quantity
- elastic demand - many substitutes are available, quantity demanded is responsive to price change, the demand curve is relatively flat (still downward sloping)
- inelastic demand - few substitutes available, quantity demanded is not very responsive to price change, demand curve is relatively steep (still downward sloping)
- change in quantity demanded - caused by a change in the *price of a good*
- change in demand - caused by changes in *consumer income, number of consumers, price of related goods, expectations, demographics, and tastes/preferences*
  - demand shifter #1 - change in consumer income
    - an increase in income leads to an increase in demand; a decrease in income leads to a decrease in demand
  - demand shifter #2 - number of consumers
    - when the number increases, demand increases; when the number decreases, demand decreases
  - demand shift #3 - changes in price of related goods
    - substitutes - goods that perform similar functions of fulfill similar needs
      - an increase price of in one leads to an increase in demand for the other; a decrease in price of one leads to a decrease in demand for the other
    - complements - products consumed jointly
      - an increase in price of one leads to a decrease in demand for the complement; a decrease in the price of one product leads to an increase in demand for the complement
  - demand shifter #4 - consumer expectations
    - expectations about the future can shift demand curves; "I'll wait until it goes on sale"
  - demand shifter #5 - demographic changes
    - changes in sex, race, or age of a population change demand for certain goods
  - demand shifter #6 - change in consumers tastes/preferences
    - tastes and preferences change due to changes in trends, information, and people