Exam 1: Chapter 1 Book Notes

Economics: Foundations and Models

- **Scarcity**, a situation in which unlimited wants exceed the limited resources available to fulfill those wants.
- **Economics** is the study of the choices consumers, business managers, & government officials make to attain their goals, given their scarce resources.
- **Three Key Economic Ideas**
  - A **market** is a group of buyers & sellers of a good or service & the institution or arrangement by which they come together to trade. Most of economics involves analyzing what happens in markets.
  - **People Are Rational**
    - Economists generally assume that people are rational.
    - This assumption does not mean they believe everyone knows everything or always makes the "best" decision. It means they assume that consumers & firms use all available information as they act to achieve their goals.
    - Rational individuals weigh the benefits & costs of each action, & they choose an action only if the benefits outweigh the costs.
  - **People Respond To Economic Incentives**
    - Human beings act from a variety of motives, including religious belief, envy, & compassion.
    - Economists emphasize that consumers & firms consistently respond to economic incentives.
  - **Optimal Decisions Are Made at the Margin**
    - Most decisions in life involve doing a little more or a little less, not all or nothing.
    - Economists use the word marginal to mean "extra" or "additional".
    - Economists reason that the optimal decision is to continue any activity up to the point where the marginal benefit equals the marginal cost. where MB=MC
    - Economists refer to analysis that involves comparing marginal benefits and marginal costs as **marginal analysis**.
- **The Economic Problem That Every Society Must Solve**
  - Because we live in a world of scarcity, any society faces the economic problem that it has only a limited amount of economic resources - such as workers, machine & raw materials - and so can produce only a limited amount of goods & services.
  - Therefore, every society faces **trade-offs**, producing more of one good or service means producing less of another good or service.

- The best way to measure the cost of producing a good or service is the value of what has to be given up to produce it.
- The **opportunity cost** of any activity is the highest-valued alternative that must be given up to engage in that activity.
- Trade-offs force society to make choices when answering the following fundamental questions.

What goods and Services Will Be Produced?

- Determined by the choices that consumers, firms, & the government make.
  - Consumers, firms, & the government face the problem of scarcity by trading off one good or service for another. And each choice made comes with an opportunity cost, measured by the value of the best alternative given up.

How will the goods and services be produced?

- Firms choose how to produce the goods & services they sell.
  - In many cases, firms face a trade-off between using more workers or using more machines.

Who Will Receive the Goods and Services Produced?

- In the US, who receives the goods & services produced depends largely on how income is distributed. Individuals with the highest income have the ability to by the most goods & services.
- Often, people are willing to give up some of their income by donating to charities to increase the incomes of poorer people.
- An important policy question is whether the government should intervene to make the distribution of income more equal.

Centrally Planned Economies versus Market Economies

- To answer the 3 questions society organizes their economy in 2 main ways.
- A society can have a **Centrally planned economy** in which the government decides how economic resources will be allocated.
- Or a society can have a **market economy** in which the decisions of households and firms interacting in markets allocate economic resources.
- Centrally planned economies have not been successful in producing low-cost, high-quality goods & services, as a result the standard of living tends to be low, all have been political dictatorships.

- All the high-income democracies have market economies, they rely primarily on privately owned firms to produce goods & services and to decide how to produce to them, markets determine who receives the goods & services produced.
- In a market economy, firms must produce goods & services that meet the wants of consumers, or the firms will go out of business, so ultimately consumers decide what will be produced.
- Because firms in a market economy compete to offer the highest-quality products at the lowest price, they are under pressure to use the lowest-cost methods of production.
- In a market economy, the income of an individual is determined by the payments he receives for what he has to sell. One of the attractive features of markets is that they reward hard work.
- We can conclude market economies respond to the question "Who receives the goods & services produced?" with "those who are most willing & able to buy them."

• The Modern "Mixed" Economy

- In the 19th & early 20th centuries, the US government engaged in relatively little regulation of markets for good & services.
- Beginning in the middle of the 20th century, government intervention dramatically increased, caused primarily by the Great Depression of the 1930s, some intervention was also intended to raise the incomes of the elderly, the sick, & people with limited skills.
- In recent years government intervention has expanded to meet such goals as protection of the environment, the promotion of civil rights, & the provision of medical care to low-income people & the elderly.
- Some economists argue that the extent of government intervention makes it no longer accurate to refer to the US, Canadian, Japanese, & Western European economies as pure market economies, instead they should be referred to as mixed economies.
- A **mixed economy** is still primarily a market economy because most economic decisions result from the interaction of buyers & sellers in markets. However, the government plays a significant role in the allocation of resources.
- One of the most important developments in the international economy in recent years has been the movement of China from being a centrally planned economy to being a more mixed economy. It remains a dictatorship, but production of most goods & services is now determined in the market. The result has been rapid economic growth that in the near future may lead to total production supassing total production in the US.