

Chapter 1

Wednesday, January 21, 2015 1:17 PM

What Economics is all about

Scarcity: the limited nature of resources

Economics: the study of how society manages its scarce resources

- How people decide what to buy
- How much to work save and spend
- How firms decide how to produce
- How many workers to hire
- How society decides how to divide its resources between national defense, consumer goods, protecting the environment and other needs

Principles

#1 People Face Tradeoffs

- All decisions involve tradeoffs.
 - Having more money to buy stuff requires working longer hours, which leaves less time for leisure.
Time is a limited resource.
- Society faces the tradeoff of efficiency vs. equality
 - **Efficiency:** when society gets the most from its scarce resources
 - **Equality:** when prosperity is distributed uniformly among society's members
 - Tradeoff: to achieve greater equality, could redistribute income from wealthy to poor. But this reduces incentive to work and produce, shrinks the size of the economic "pie"
 - Government regulates equality (prosperity is distributed uniformly among society's members)
Taxes are a mechanism for the redistribution of wealth.

#2 The cost of something is what you give up to get it

- Making decisions requires comparing the costs and benefits of alternative choices.
- The **opportunity cost** of any item is whatever must be given up to obtain it
- It is the relevant cost for decision making
 - Ex: Opportunity cost of getting an education is paying tuition, room and board, etc **AND** the earnings you could have made if you had worked rather than going to school.
- Consciously and subconsciously we quantify our decisions by choosing the opportunity with a greater return. Everything is subjective.

#3 Rational people think at the margin

Rational people

- Systematically and purposefully do the best they can to achieve their objectives
- Make decisions by evaluating costs and benefits of **marginal changes** (small changes that can hypothetically change someone's decision), incremental adjustments to an existing plan
 - Ex: you go to the store and see oranges have gone up a few cents. You may buy less oranges, switch to apples, not buy anything, etc.

#4 People respond to incentives

- **Incentive:** something that induces a person to act, i.e. the prospect of a reward or punishment
- Rational people respond to incentives
 - Ex: when cigarette taxes increase, teen smoking falls

#5 Trade can make everyone better off

- Rather than being self-sufficient, people can specialize in producing one good or service and exchange it for other goods
- Countries also benefit from trade and specialization:
 - Get a better price abroad for goods they produce

- Buy other goods more cheaply from abroad than could be produced at home
 - *A country might still make unfavorable trades for political reasons*

The value of money is what you can get for the paper. Not the piece of paper itself.

#6 Markets are usually a good way to organize economic activity

- **Market:** a group of buyers and sellers (need not be in a single location)
- "organize economic activity" means determining
 - What goods to produce
 - How to produce them
 - How much of each to produce
 - Who gets them
- A **market economy** allocates resources through the decentralized decisions of many households and firms as they interact in markets
 - A closed economy does not interact with others, does not invest, etc
 - A centrally planned economy is controlled by one entity (government, dictator) making all decisions
- When the market (Invisible hand) sets the price, it regulates itself. When someone sets the price from above, they need to know a lot of information that is constantly changing. Any changes to regulations they make may be overimposed or too late.

Consumers, catastrophe and other unpredictable factors make central economies difficult to manage.

#7 Governments can sometimes improve market outcomes

- Important role for government: enforce property rights (with police and courts)
- People are less inclined to work, produce, invest or purchase if there is a large risk of their property is being stolen.
 - If nobody made sure to enforce laws, things would lose value. If you could just steal something, why would you pay for it?
- **Market failure:** when the market fails to allocate society's resources efficiently
- Causes of market failure:
 - **Externalities**, when the production or consumption of a good affects bystanders (ex: pollution)
 - A company is producing a lot and polluting a lake which affects the people that use the lake. Government needs to step in and set environmental regulations to that company. If not for the government, nobody else would do it.
 - **Market power**, a single buyer or seller has substantial influence on market price (ex: monopoly)
- Public policy may promote efficiency
- Government may alter market outcome to promote equality
 - If the market's distribution of economic well-being is not desirable, tax or welfare policies can change how the economic "pie" is divided

#8 A country's standard of living depends on its ability to produce goods and services

- The most important determinant of living standards: **productivity**, the amount of goods and services produced per unit of labor
- Productivity depends on the equipment, skills, and technology available to workers
- Other factors (ex: labor unions, competition from abroad) have far less impact on living standards

#9 Prices rise when the government prints too much money

- **Inflation:** increases in the general level of prices
- In the long run, inflation is almost always caused by excessive growth in the quantity of money, which causes the value of money to fall
- The faster the government creates money, the greater the inflation rate

#10 Society faces a short-run tradeoff between inflation and unemployment

- In the short-run (1-2 years), many economic policies push inflation and unemployment in opposite directions
- Other factors can make this tradeoff more or less favorable, but the tradeoff is always present

Chapter 2

Monday, January 26, 2015 12:57 PM

Thinking like an Economist

Assumptions and Models

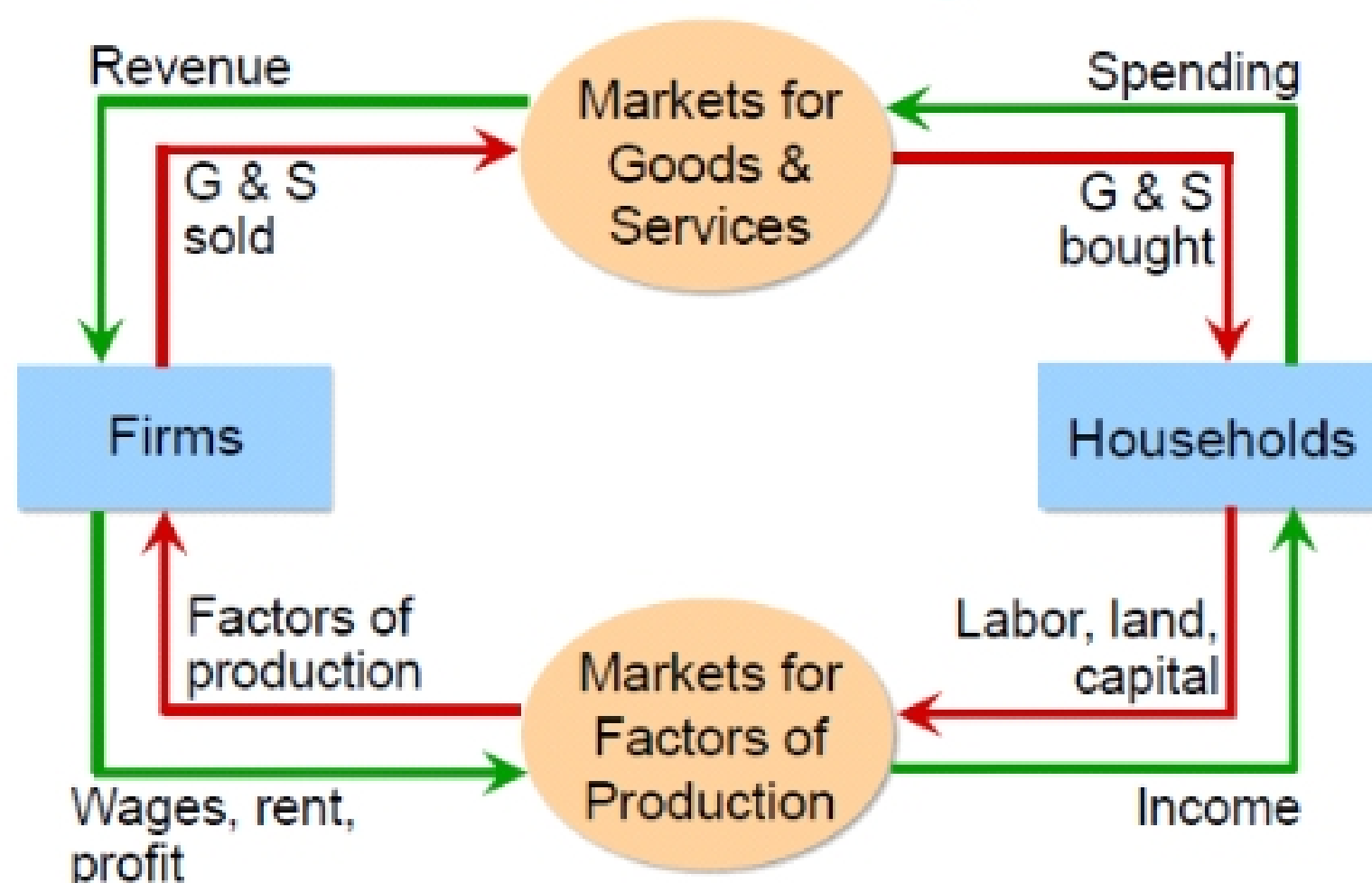
- Assumptions simplify the complex world
 - Ex: to study international trade, assume two countries and two goods.
Unrealistic, but simple to learn and gives useful insights about the real world
- **Model:** a highly simplified representation of a more complicated reality

The Circular-Flow Diagram

- The **Circular-Flow Diagram:** a visual model of the economy, shows how dollars flow through markets among household and firms
- Two types of "actors":
 - Households
 - Firms
- Two markets:
 - The market for goods and services
 - The market for "factors of production"

Factors of Production

- **Factors of production:** the resources the economy uses to produce goods and services, including:
 - Labor
 - Land
 - Capital (buildings and machines used in production)



The Production Possibilities Frontier

- The **Production Possibilities Frontier (PPF):** a graph that shows the combinations of two goods the economy can possibly produce given the available resources and the available technology
 - Two goods: Computers and Wheat