

August 25, 2014
EC 110

What Economics is All About

- Scarcity**: the limited nature of society's resources
- Economics**: the study of how society manages its scarce resources, e.g.
 - How people decide what to buy, how much to work, save, and spend
 - How firms decide how much to produce, how many workers to hire
 - How society decides how to divide its resources between national defense, consumer goods, practicing the environment, and other needs.

Principle #1: People Face Tradeoffs

All decisions involve tradeoffs.

→Ex:

- Going to a party the night before your midterm leaves less time for studying.
- Having more money to buy stuff requires working longer hours, which leaves less time for leisure.
- Protecting the environment requires resources that could otherwise be used to produce consumer goods.
- Society faces an important tradeoff:

Efficiency vs. equality

- Efficiency**: when society gets 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 economic "pie."

Principle #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.
- Examples:

→The opportunity cost of...

- ... Going to college for a year is not just the tuition, books, and fees, but also the foregone wages.
- ... Seeing a movie is not just the price of the ticket, but the value of the time you spend in the theater.

Principle #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**-incremental adjustments to an existing plan.

→ Ex:

-When a student considers whether to go to college for an additional year, he compares the fees and foregone wages to the extra income he could earn with the extra year of education.

-When a manager considers whether to increase output, she compares the cost of the needed labor and materials to the extra revenue.

Principle #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 gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUVs.

-When cigarette taxes increase, smoking falls.

-What is the incentive for Colorado to legalize pot? (January, 2014)

Principle #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.

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

-Market: a group of buyers and sellers (needs 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 decisions of many households and firms as they interact in markets.

-The invisible hand works through the price system: (Adam Smith, wealth of nations)

-The interaction of buyers and sellers determines prices.

-Each price reflects the good’s value to buyers and the cost of producing the good.

-Prices guide self-interested households and firms to make decisions that, in many cases, maximize society’s economic well-being.

Principle #7: Governments can sometimes improve market outcomes

-Important role for govt: enforce property rights (with police, courts)

-People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.

-**Market Failure:** when the market fails to allocate society's resources efficiently.

→ Causes:

-**Externalities:** when the production or consumptions of a good affects bystanders (e.g. pollution)

-**Market power:** a single buyer or seller has substantial influence on market price (e.g. monopoly)

-In such cases, public policy may promote efficiency.

-Govt may alter market outcome to promote equity

-If the market's distribution of economic well-being is not desirable, tax or welfare policies can change how the economic "pie" is divided.

Principle #8: A country's standard of living depends on its ability to produce good 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 (e.g., labor unions, competition from abroad) have far less impact on living standards.

Principle #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.

Principle #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.