Pinciples of

Microeconomics

Sixth Edition

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Let’s Get Started ☺

Today we will look for the answers to these questions:

- What kinds of questions does economics address?
- What are the principles of how people make decisions?
- What are the principles of how people interact?

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, protecting the environment, and other needs

The principles of **HOW PEOPLE MAKE DECISIONS**

PRINCIPLE #1:

People Face Tradeoffs

All decisions involve tradeoffs. Examples:

- Going to a party the night before your midterm leaves less time for studying.
- What was your tradeoff coming to class today morning???

PRINCIPLE #1:

People Face Tradeoffs

- Society faces an important tradeoff:

  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.

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.

PRINCIPLE #2:

The Cost of Something Is What You Give Up to Get It

Examples:

The opportunity cost of…

…going to college for a year is not just the tuition, books, and fees, but also the foregone…..

…seeing a movie is not just the price of the ticket, but the value of ….. 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.

PRINCIPLE #3:

Rational People Think at the Margin

Examples:

- When a student considers whether to go to college for an additional year, he compares the fees & 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.

  Examples:
  - When gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUVs.
  - When cigarette taxes increase, teen smoking falls.

ACTIVE LEARNING 1
Applying the principles

You are selling your 1996 Mustang. You have already spent $1000 on repairs.

At the last minute, the transmission dies. You can pay $600 to have it repaired, or sell the car "as is."

In each of the following scenarios, should you have the transmission repaired? Explain.

- **A.** Blue book value (what you could get for the car) is $6500 if transmission works, $5700 if it doesn't
- **B.** Blue book value is $6000 if transmission works, $5500 if it doesn't

ACTIVE LEARNING 1
Answers

Cost of fixing transmission = $600

A. Blue book value is $6500 if transmission works, $5700 if it doesn't

Benefit of fixing the transmission = $800 ($6500 – 5700).

It's worthwhile to have the transmission fixed.

B. Blue book value is $6000 if transmission works, $5500 if it doesn't

Benefit of fixing the transmission is only $500.

Paying $600 to fix transmission is not worthwhile.

ACTIVE LEARNING 1

Observations

- The $1000 you previously spent on repairs is irrelevant. What matters is the cost and benefit
  of the *marginal* repair (the transmission).
- The change in incentives from scenario A
  to scenario B caused your decision to change.

The principles of

HOW PEOPLE INTERACT

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 (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

PRINCIPLE #6:

Markets Are Usually A Good Way to Organize Economic Activity

- A **market economy** allocates resources through the decentralized decisions of many households and firms as they interact in markets.
- Famous insight by Adam Smith in *The Wealth of Nations* (1776):

  Each of these households and firms
  acts as if "led by **an invisible hand**"
  to promote general economic well-being.

PRINCIPLE #6:

Markets Are Usually A Good Way to Organize Economic Activity

- The invisible hand works through the price system:
  - The interaction of buyers and sellers determines prices.
  - Each price reflects the good’s value to buyers and the cost of producing the good.

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.

PRINCIPLE #7:

Governments Can Sometimes Improve Market Outcomes

- **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 (e.g. pollution)
  - **Market power**, a single buyer or seller has substantial influence on market price
    (e.g. monopoly)
- Public policy may **promote efficiency**.

SUMMARY

The principles of decision making are:

- People face tradeoffs.
- The cost of any action is measured in terms of foregone opportunities.
- Rational people make decisions by comparing marginal costs and marginal benefits.
- People respond to incentives.

SUMMARY

The principles of interactions among people are:

- Trade can be mutually beneficial.
- Markets are usually a good way of coordinating trade.
- Govt can potentially improve market outcomes if there is a market failure