Ch 1: What is Economics

Goals

- Introduce some economic principles.
- Clarify terms used
- Show some contradictions with observed behavior

Individual Principles

- Principle #1: Choices are necessary because resources are scarce.
- Principle #2: The true cost of something is its opportunity cost.
- Principle #3: “How much” is a decision at the margin.
- Principle #4: People usually respond to incentives, exploiting opportunities to make themselves better off.

Principle 1: Choices are necessary because resources are scarce.

Resource: Anything that can be used to produce something else

Scarce: In short supply, limited.

- To be clear, money is only part. Time, attention, daylight, break in the storm.
- Even if you have enough of some resources for what you want, there is always one that is limited.

"Should I kill myself, or have a cup of coffee?" – (Not) Camus

Principle 2: The true cost of something is its opportunity cost.

Opportunity Cost: What you must give up in order to get something.

- Always beyond the direct financial.
- Often the financial is hidden

"I love sourdough bread. I don't eat it, not because it is expensive, but because it makes me sleepy and have to spend more time at the gym." – Jamie

Principle 3: "How much" is a decision at the margin.

- People compare costs and benefits.
- Opportunity cost with quantities.
- A little more of this for a little less of that.
- Most often violated through "The sunk cost fallacy"

"No matter how far you've gone down the wrong road, turn back." – Tradional Turkish Proverb (Sunk Cost Fallacy)

Principle 4: People usually respond to incentives, exploiting opportunities to make themselves better off.

- Note “themselves” not “all of us”
- If you are lucky that results in all of us being better off.
- **Incentives**: The rules of how rewards and punishments for action or inaction are awarded.

A key goal in designing incentive systems to align individual self-interest with social well-being.

Interaction

- Principle #5: There are gains from trade
- Principle #6: Markets move toward equilibrium
- Principle #7: Resources should be used efficienty to achive society's goals
- Principle #8: Markets usually lead to efficency.

Principle #5: There are gains from trade

- This is why we split chores
- Why being totally, “self-sufficent”, producing all your needs, makes you miserable.
- Says possible but not always true for everything and only if voluntary.

“It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. . . What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom.” – Adam Smith

Principle #6: Markets move toward equilibrium

- **Equilibrium**: Stable equilibrium is a very general idea.
- Make a small temporary change and the system returns to its previous state.

This is what allows us to predict future events.

Principle #7: Resources should be used efficienty to achive society's goals

Efficently: Has many different meanings.

- Can't get more with same resources.
- Can't make someone better off without making someone worse off.
- Gets complicated after that.

"I will definitly help you if it doesn't harm me, but I will often help when the harm to me is less than the benfit to you" – Jamie

Principle #8: Markets usually lead to efficency.

- Markets are good at distributed information processing:
  - Information about needs and costs to satisfy needs are communicated with prices, bids and ask.
  - Prices also transfer resources needed to satisfy the need.
- Similar to your body handles needs. Blood transports information and resources.
- We do mean usually.
  - Sometimes markets don't work.
  - Sometimes governments need in modify market rules to make them work better. See Principle 4

"In Republican adminstrations, it is the economists job to explain that sometimes markets don't work. In Democratic, that sometimes markets do work" – Severin Borenstein, Economist

Macro Principles

Principle #10: One person's spending is another person's income.

Principle #11: Overall spending sometimes gets out of line with the economy's productive capacity.

Principle #12: Government policies can change spending.

Principle #10: One person's spending is another person's income.

- Critical insight in macroeconomics.
- Remember "Principle #5: There are gains from trade"?
- When you decrease your spending by, say, savings, the income earned by others from your spending falls.

This should remind you of a food chain. Every species is food for another.

Principle #11: Overall spending sometimes gets out of line with the economy's productive capacity.

- Out of line can be too high or too low.
- Inflation if too high and unemployment if too low.
- Principle #6 (Markets move toward equilibrium), says markets will fix themselves – eventually.

"But this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task, if in tempestuous seasons they can only tell us, that when the storm is long past, the ocean is flat again." – Keynes

Principle #12: Government policies can change spending.

- See:
  - Principle #11: Overall spending sometimes gets out of line with the economy's productive capacity.
  - Principle #4: People usually respond to incentives, exploiting opportunities to make themselves better off.

Economists are the most manipulative non-sociopaths you will meet.