CH 1 – The Five Foundations of Economics

ECON 1B

Sacramento State

The scarcity condition

- What is economics?
  - Study of how people allocate their limited resources to satisfy their unlimited wants

- Scarcity
  - The limited nature of society's resources
  - NOT the same thing as shortage!

Unlimited Wants

- Which do you prefer?
  - $10 or $20?
  - One vehicle or two?
  - One meal a day or three?
  - 200 gigabytes of disk space or 400?

- Idea:
  - More is generally preferred to less. This leads to unlimited wants. We will generally never say “no” to having more.

Overview

- How to “think like an economist”.
- Analyze & interpret daily life decisions: emphasize costs, benefits & possible future consequences.
- We confront economic problems in our daily life.
- Making choices is all about comparing costs & benefits rationally.
- Difference between “micro” and “macro”

Microeconomics versus Macroeconomics

- Microeconomics
  - Concerned with decisions of individuals, households, and businesses
  - What happens to my consumption if I lose my job?
  - Jim decides to buy a house while the interest rate is low.
- Macroeconomics
  - Looks at the broader economy, including inflation, growth, employment, interest rates, and productivity
  - What happens to the economy if there is widespread unemployment?
  - The Federal Reserve decreases interest rates.

Microeconomics versus Macroeconomics

- Microeconomics
  - Individual units that comprise the economy
- Examples
  - Individual choosing to take a job in Florida or California
  - Couple decides to start a family
  - Firm choosing to open another factory
  - Effect of government intervention on a single market

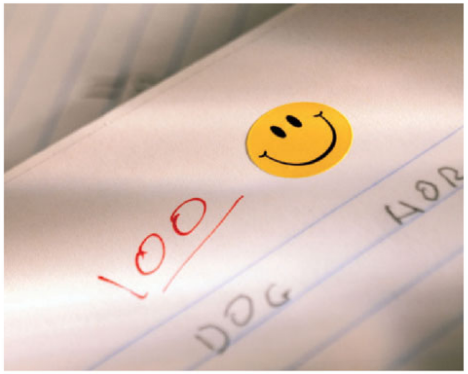
Microeconomics versus Macroeconomics

- Macroeconomics
  - The study of the broader economy
- Examples
  - Inflation
  - Economic growth and productivity
  - Unemployment
  - Interest rates

The Five Foundations of Economics

1. Incentives
2. Trade-offs
3. Opportunity costs
4. Marginal thinking
5. Trade creates value

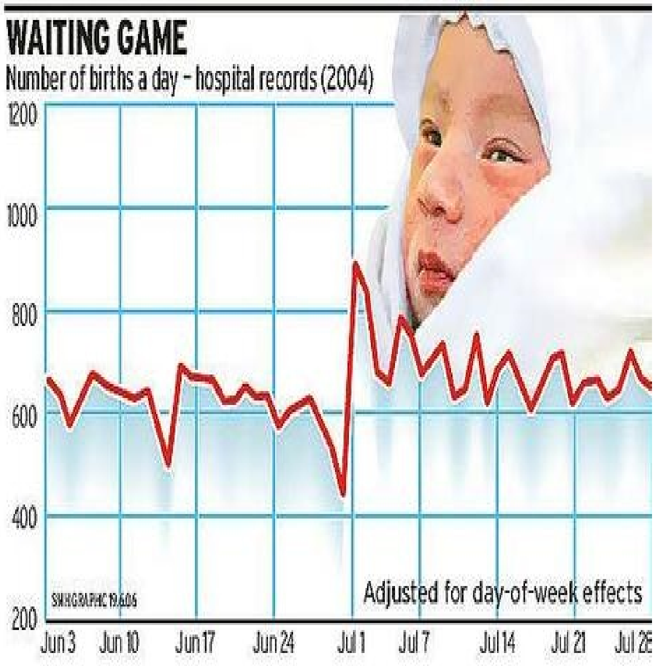
1. Incentives Matter



- Incentives
  - Factors that motivate you to act or exert effort
  - People respond to incentives!
  - Incentives are everywhere, and financial gain often plays a prominent role
- Positive incentives
  - Pay raise, employee of the month award, sticker and a smiley face, extra credit
- Negative incentives
  - Taxes, jail, fees, fines, getting grounded, getting fired, failing class

Incentives

- Incentives and Unintended consequences.
  - born on the First of July



- Incentives and innovation.
  - Patents and copyrights
    - Incentives to innovate
    - Why work hard, bear all costs (time and monetary) if someone could just steal your idea for profit?

2. Life is About Trade-offs

- With scarcity, decisions incur costs
- Individual examples
  - Go to the theater: do I watch the action movie or the romantic comedy?
  - Go to a food court: do I eat at Sbarro’s or Panda Express?
  - After high school: do I attend CSUS or another school?
  - Which candidate do I vote for?

Trade-offs and Policy

- Governments face trade-offs as well
  - Spend tax dollars on education or public safety?
  - Should we penalize polluting companies?
    - Gain: cleaner air, better health
    - Loss: less industry, higher prices in some sectors?

3. Opportunity Cost

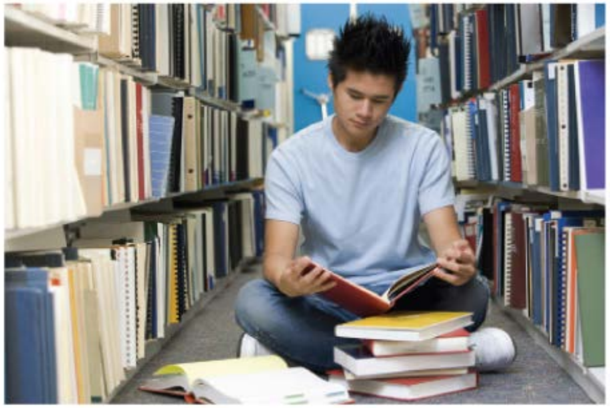
- Opportunity Cost
  - The highest-valued alternative that must be sacrificed in order to get something else
  - **Not** all alternatives, just the next best choice
- In economics:
  - The cost of something is what you give up to get it

Opportunity Cost

- Easy example: go to the mall, pool, or class?
  - Opportunity cost of going to the mall:
    - Lost opportunity to go the more preferred activity between pool and class
  - Opportunity cost of going to the pool:
    - Lost opportunity to go to the more preferred activity between mall and class.
  - Decision-making key:
    - Minimize opportunity cost by selecting the option that has the largest benefit. Go to whichever you enjoy more, the pool, mall or class.
- Another example
  - A business makes a profit. That's great!
  - However, could it have made MORE profit producing something else? This is the economical way of thinking.

4. Marginal Thinking

- Marginal thinking
  - Evaluate whether the <u>benefit</u> of one more unit of something is greater than the <u>cost</u>



  - Margin examples: one more unit (slice of pizza), one more hour of activity (studying, sleeping)

Marginal Thinking Example

- Suppose you are vacuuming your living room. Will you move the couch and china cabinet to vacuum underneath them?
- Marginal benefits
  – A small additional amount of carpet is cleaned
- Marginal costs
  – Vacuuming now takes more time and effort

- Cost-benefit analysis at the margin
  – Do the action (move furniture) only if the marginal benefits are greater than the marginal costs
  – Depends on your valuation of the clean room and the time and effort it takes you to move the furniture

5. Trade Creates Value

- Markets
  - Brings buyers and sellers together to exchange goods and services
- Trade
  - The voluntary exchange of goods and services between two or more parties
  - Key word = voluntary
  - You don't engage in trade if it makes you worse off; therefore, trade only occurs if both parties feel they gain from the trade!

Conclusion

- Economics is the study of how people allocate their limited resources to satisfy nearly unlimited wants.
- The five foundations of economics:
    1. Incentives
    2. Trade-offs
    3. Opportunity cost
    4. Marginal thinking
    5. Trade creates value