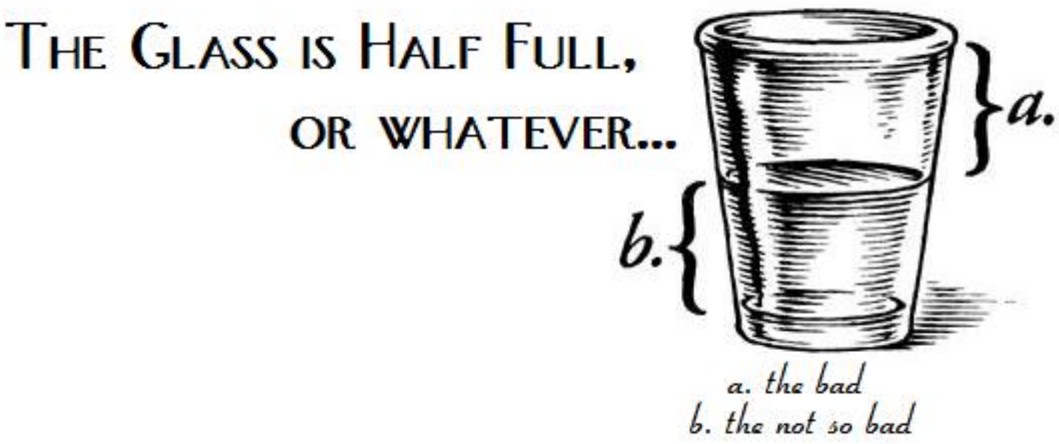
Topic 1

Introduction to Economic Analysis

Economics is the only field in which two people can share a Nobel Prize for saying opposing things.
(Specifically Myrdal and Von Hayek, 1974)



Economics

Individual Choice: The Core of Economics

• **Economics** is the social science that studies the **production**, **distribution**, and **consumption** of goods and services.

• So, **individual choice (**how **economic agents** choose and how these decisions determine the use of the society's scarce resources) is the core of economics.

• Each individual makes choices with some **constraints** (remember that the resources are scarce!) which not only involves a decision of what to do but necessarily of what not to do.

• ***Example:*** You want to go to the cinema and the theatre but you do not have enough money for both.

• A **resource** is anything that can be used to produce something else. Typically, we will assume our resource are K (capital) and L (labour).

• **Resources** are **scarce** - the quantity available isn't large enough to satisfy all productive uses (there is no infinite K and L!)

Economics

Opportunity Cost: The Real Cost of Something Is What You Must Give Up to Get It

• The real cost of an item is **its opportunity cost**, which can be described as what you must give up in order to get it.

•***Example:*** You can go to the cinema or the theatre. You have to choose one of both. What is the opportunity cost of going to the cinema?

• When there are several alternatives (often the case) the opportunity cost is **the value of the best alternative**.

• ***Example:*** You can go to the cinema, the theatre or stay at home watching TV. You have to choose one of them. What is the opportunity cost of staying at home?

Read “Opportunity cost …”, page 6, Krugman *et al.*

Economics

Cost-Profit Analysis

• We assume that economic agents are **rational** and they make decisions **rationally**.

• This means that everybody computes a **cost-profit analysis** in its mind and takes the best alternative.

• The **profits** of a decision cannot always being identified in monetary units. In those cases, it can be measured as: what **are you willing to pay** to get the results of such decision.

• The **total costs** of a decision are often called **economic costs**:

a) Explicit (accounting) costs
b) Opportunity costs
c) Unrecoverable costs

Economic costs = explicit costs + opportunity costs – unrecoverable costs

Economics

Individual Choice: Principles

TABLE 1-1 The Principles of Individual Choice

1. People must make choices because resources are scarce.
2. The opportunity cost of an item—what you must give up in order to get it—is its true cost.
3. "How much" decisions require making trade-offs at the margin: comparing the costs and benefits of doing a little bit more of an activity versus doing a little bit less.
4. People usually respond to incentives, exploiting opportunities to make themselves better off.

Economic Models

What are they for?

• A **model** is a representation of something, either as a physical object which is usually smaller than the real object, or as a simple description of the object which might be used in calculations. (*Cambridge Learner's Dict*.)

• During the bachelor's degree you will learn some models and how to use them. Models are built to analyse some questions and may be very useful for some purpose and utterly useless for others.

• In a model, the **exogenous variables** (or data) come from outside the model and are unexplained by it.

• The **endogenous variables** (or results) are explained within the model in which they appear.

Using Models

Example: Pay for Grades?

- A few years ago, some Florida schools offered cash bonuses to students who improved their scores on the state's standardized exams.

- Why?
- To motivate the students to take the exams as seriously as the school administrators did.

- Did it work?
- Yes. Researchers found the design of the incentives and the characteristics of the people you are trying to motivate mattered a lot.

    - Some Florida schools that have introduced rewards for good grades on state exams report substantial improvements in student performance.

Using Models

Positive vs Normative Economics

• **Positive economics** is the branch of economic analysis that describes the way the economy actually works. It is about description.

• **Normative economics** makes prescriptions about the way the economy **should** work. It is about prescription.

• **Most of this course** will be devoted to **positive economics**. However, we will also carry out a **normative analysis** of some topics.

Read “Using Models”, page 34, Krugman *et al.*

Microeconomics and Macroeconomics

Microeconomics

• **Microeconomics** is the branch of economics that studies how people make decisions and how these decisions interact.

• The **invisible hand** (*Adam Smith, 1776*) refers to the way in which the individual pursuit of self-interest can lead to good results for society as a whole.

Macroeconomics

• **Macroeconomics** is the branch of economics that is concerned with overall ups and downs in the economy.

• For instance, **recessions** (which is a downturn in the economy) or **economic growth** (which is the growing ability of the economy to produce goods and services) are a macroeconomic subject.

Checking your understanding

➢**Even if there were more resources in the world, there would still be scarcity.**

1. opportunity cost
2. resources are scarce
3. people usually exploit opportunities to make themselves better off
4. marginal analysis

Checking your understanding

➢**Different teaching assistants teach several Economics tutorials. Those taught by the teaching assistants with the best reputations fill up quickly, with spaces left unfilled in the ones taught by assistants with poor reputations.**

1. opportunity cost
2. resources are scarce
3. people usually exploit opportunities to make themselves better off
4. marginal analysis

Topic 1

Checking your understanding

➢**To decide how many hours per week to exercise, you compare the health benefits of one more hour of exercise to the effect on your grades of one less hour spent studying.**

1. opportunity cost
2. resources are scarce
3. people usually exploit opportunities to make themselves better off
4. marginal analysis

KEY TERMS

Individual choice

Constraints

Resource

Scarce

Opportunity cost

Cost-profit analysis

Economic costs

Model

Exogenous variables

Endogenous variables

Positive economics

Normative economics

Microeconomics

Macroeconomics