Microeconomics

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chapter:

1

>> First Principles

Krugman/Wells
Economics

What is economics?

- …the painful elaboration of the obvious.
- …"the dismal science," a phrase coined by Thomas Carlyle in his 1849 piece "Occasional Discourse on the Negro Question." This racist screed argued for the reintroduction of slavery into the West Indies.
- …the study of how scarce resources are distributed.

Breaking down the definition

- Resources
  - This includes just about everything.
  - “...the chief part of human happiness arises from the consciousness of being beloved...” – Adam Smith
- Scarcity arises because
  - Resources are not infinitely abundant
  - Human wants are insatiable
- Distribution
  - Efficiency
  - Fairness: who wins, who loses?

Topics that economists work on

- **Economics is a social science**

- **The discipline thus covers virtually anything that affects human welfare, including:**
  - **Finance**
  - **Money and banking**
  - **Environment**
  - **Health**
  - **Transportation**
  - **Labor**
  - **Demographics**
  - **Education**
  - **Others…**

…finance

Over the Cliff: From the Subprime to the Global Financial Crisis, *Journal of Economic Perspectives*
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The Economics of Lesbian and Gay Families

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Money, Sex and Happiness: An Empirical Study

D. Blanchflower and A. Oswald, *Scandinavian Journal of Economics* Vol. 106, 2004.

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H. Mialon, *Economic Inquiry*, Vol. 59, 2011.

…health and happiness

(Un)Happiness in Transition, *Journal of Economic Perspectives*

Sergei Guriev and Ekaterina Zhuravskaya Vol. 23, 2009

The Minimum Legal Drinking Age and Public Health, *Journal of Economic Perspectives*
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Social Media and Fake News in the 2016 Election, *Journal of Economic Perspectives*

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…environment

Climate change: The ultimate challenge for Economics. *American Economic Review*, W. Nordhaus 109(6), 2019.

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Topics that economists work on

- **Although these studies address a diverse array of topics, they all draw from the same set of analytical tools.**

- **This course is intended to familiarize you with these tools and how they can be applied to real-world questions.**

WHAT YOU WILL LEARN IN THIS CHAPTER

- A set of principles for understanding the economics of how individuals **make choices**
- A set of principles for understanding how individual **choices interact**
- A set of principles for understanding **economy-wide interactions**

10 principles of economics

How People Make Decisions	#1: People Face Tradeoffs
	#2: The Cost of Something Is What You Give Up to Get It
	#3: Rational People Think at the Margin
	#4: People Respond to Incentives
How People Interact	#5: Trade Can Make Everyone Better Off
	#6: Markets Are Usually a Good Way to Organize Economic Activity
	#7: Governments Can Sometimes Improve Market Outcomes
How the Economy as a Whole Works	#8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services
	#9: Prices Rise When the Government Prints Too Much Money
	#10: Society Faces a Short-Run Tradeoff between Inflation and Unemployment

Individual Choice

- **Individual choice** is the decision by an individual of what to do, which necessarily involves a decision of what not to do.

- Basic principles behind the individual choices:
  1. Resources are scarce.
  2. The real cost of something is what you must give up to get it.
  3. “How much?” is a decision at the margin.
  4. People usually take advantage of opportunities to make themselves better off.

Resources Are Scarce

- A **resource** is anything that can be used to produce something else.

- Because of resource scarcity, the quantity available isn’t large enough to satisfy all productive uses.

Opportunity Cost

- The real cost of an item is its **opportunity cost**: what you must give up in order to get it.
- Opportunity cost is crucial to understanding individual choice:
- Sleep? Watching TV? Rock climbing? Work?
- *All* costs are ultimately opportunity costs.

“How Much?” Is a Decision at the Margin

- You make a **trade-off** when you compare the costs with the benefits of doing something.
- 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.
- The study of such decisions is known as **marginal analysis**.

People Want to Make Themselves Better Off

- An **incentive** is anything that offers rewards to people who change their behavior.
- There are more well-paid jobs available for college graduates with degrees.
- People respond to these incentives.

Interaction: How Economies Work

Interaction of choices is a feature of most economic situations. My choices affect your choices, and vice versa.

Principles that underlie the interaction of individual choices:

1. There are gains from trade.
2. Markets move toward equilibrium.
3. Resources should be used as efficiently as possible to achieve society’s goals.
4. Markets usually lead to efficiency.
5. When markets don’t achieve efficiency, government intervention can improve society’s welfare.

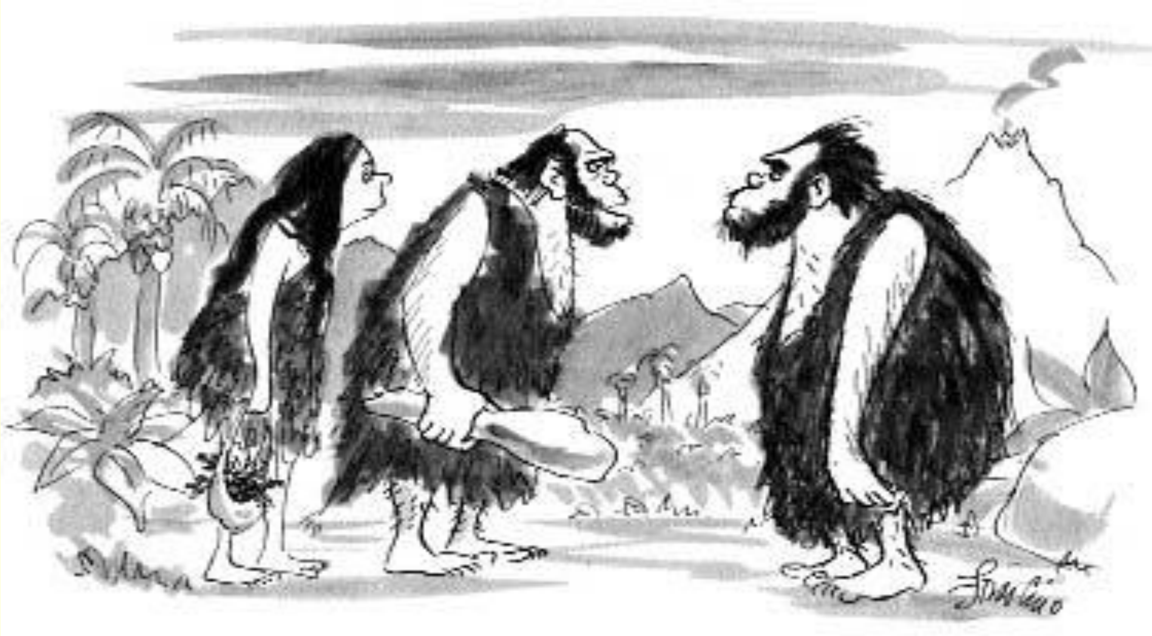
There Are Gains From Trade

- In a market economy, individuals engage in **trade**: They provide goods and services to others and receive goods and services in return.

- There are **gains from trade**: people can get more of what they want through trade than they could if they tried to be self-sufficient.

There Are Gains From Trade

This increase in output is due to **specialization**: each person specializes in the task that he or she is good at performing.



"I hunt and she gathers – otherwise we couldn't make ends meet."

The economy, as a whole, can produce more when each person specializes in a task and trades with others.

Markets Move Toward Equilibrium

- An economic situation is in **equilibrium** when no individual would be better off doing something different.
- Any time there is a change, the economy will move to a new equilibrium.

Resources Should Be Used As Efficiently As Possible to Achieve Society's Goals

- An economy is **efficient** if it takes all opportunities to make some people better off without making other people worse off.

- **Equity** means that everyone gets his or her fair share. Since people can disagree about what's "fair," equity isn't as well-defined a concept as efficiency.

Efficiency vs. Equity

- Ex.: Handicapped-designated parking spaces in a busy parking lot

A conflict between:

- ***equity***, making life “fairer” for handicapped people, and
- ***efficiency***, making sure that all opportunities to make people better off have been fully exploited by never letting parking spaces go unused.
- How far should policy makers go in promoting equity over efficiency?

Markets Usually Lead to Efficiency

- The incentives built into a market economy already ensure that resources are usually put to good use.
- Opportunities to make people better off are not wasted.
- Exceptions: *market failure*, the individual pursuit of self-interest found in markets makes society worse off

  → the market outcome is inefficient.

When Markets Don't Achieve Efficiency, Government Intervention Can Improve Society's Welfare

- Why do markets fail?
- Individual actions have *side effects* not taken into account by the market (externalities).
- One party prevents mutually beneficial trades from occurring in the attempt to capture a greater share of resources for itself.
- Some goods cannot be efficiently managed by markets.

Economy-Wide Interactions

Principles that underlie economy-wide interactions:

1. One person’s spending is another person’s income.

2. Overall spending sometimes gets out of line with the economy’s productive capacity.

3. Government policies can change spending.