Introduction to Economics – Noemi Pace

**Chapter 1: First Principles**

Slide one

* Definition of “Economics”  
  Basic meaning of economics. If you extend it you arrive to its definition. System that regulates what, how to consume…
* Principles that underlie individual choices
* Principles that underlie interactions between individual choices
* Principles that underlie Economy-Wide Interaction

**What is Economics?**

* The word “economics” originates from the link of two Greek words: οἴκος (oikos), "home/house" and νόμος (nomos), "norm/rule/regulation" or "law ". Therefore, it litterally means "regulation/management of the house".
* A great nineteenth-century economist, Alfred Marshall, defined “economics” as “a study of mankind in the ordinary business of life”.
* What can economics say about this “ordinary business”? Quite a lot, it turns out.
* What we will see in this course is that even familiar scenes of economic life pose some very important questions – questions that economics can help answer.
* Among these questions are:
* How does our economic system work? That is, how does it manage to deliver the goods?
* When and why does our economic system go astray, leading people into counterproductive behavior?
* Why are there ups and downs in the economy? That is, why does the economy sometimes have a “bad year”? (2nd module)
* Finally, why is the long run mainly a story of ups rather than downs? That is why many developed countries become so much richer over time? (2nd module)
* Economics is the social science studying how people make decisions given scarcity

- scarcity of income (money is not infinite)

- scarcity of time (our day Is 24h)

- scarcity of resources

* **Scarcity** is a situation in which the amount of something available is insufficient to satisfy the desire for it.
* Economics helps understand how to make decision cause the previous three elements are not infinite
* Note: This definition complements the definition used by Krugman and

Wells, which defines economics as “. . . the social science that studies production, distribution, and consumption of goods and services.“

* In this lecture we focus on some key economic principles that underlie much of what we will discuss in this course, broken down into three categories: Principles that underlie

1. Individual choice

2. the interactions of individual choices

3. economy-wide interactions

**Principle # 1: People must make choices because resources are scarce (1)**

* For the individual, there are many types of scarcity, but they all stem from two basic limitations

1. Scarce time

2. Scarce spending power (income)

* These limitations force each of us to make choices
* Economists study (reasons on utility and functionality, to maximize our wellbeing) how we make these choices as individuals and consequences of those choices
* Economists also study more subtle and indirect effects of individual choice on our society

**Principle # 1: People must make choices because resources are scarce (2)**

* For society as a whole, scarcity takes a variety of forms:

1. Scarcity of labor; i.e., time human beings spend producing goods and services.
2. Scarcity of capital; i.e.; something produced that is long-lasting, and used to make other things that we value, including  
   - Physical capital  
   - Human capital
3. scarcity of land/natural resources (regenerated until a certain point); i.e., the physical space on which production occurs and the natural resources that come with it.

* As a society our resources (land, labor, and capital) are insufficient to produce all the goods and services we might desire

**Principle # 2: The Real Cost of Something is What You Must Give Up to Obtain It (1)**

* We are used to thinking of the cost of an item in monetary terms.

- The cost of the course textbook package is $127.30.

- The cost of a Toyota Prius is roughly $30,000.

* While monetary measures of cost suffice for many goods, it can be very deceptive for others.
* Economists emphasize that the true cost of a choice that we make is its **opportunity cost**; i.e., what you must give up in order to obtain the item in question.
* <https://www.youtube.com/watch?v=Mko1OVHwzoU&feature=youtu.be>
* <https://genius.com/G-eazy-opportunity-cost-lyrics>

**Principle # 2: The Real Cost of Something is What You Must Give Up to Obtain It (2)**

EXAMPLE #1:

* Consider the opportunity cost of a complete homemade breakfast, say including eggs, bacon, a scone, fresh coffee, and orange juice:

1 Materials cost (conservatively) = monetary cost of the raw materials

- 2 eggs at 12 cents/egg

- 3 slices of bacon at 25 cents/slice

- 1 scone at 60 cents/scone

- 1 glass of OJ at 30 cents/glass

- 1 cup of coffee at 20 cents/cup

Totalling $2.09

2 Production cost (probably less than 50 cents) - did anyone make themselves such a breakfast this morning? Why not? What costs did we miss?

3 The cost of time, which you could spend doing something else; e.g.,

- sleeping

- listening to music

- studying economics. . .

* Opportunity cost includes both the monetary and non-monetary cost of a choice.

EXAMPLE #2:

* What is the cost of college education in the US?

1. Explicit Monetary Costs:

- Tuition and fees: $6,997 per year

- Books and fees: $1,014

- Room and Board: $7,472

- Personal Expenses: $3,438

Gross Out-of-Pocket costs: $18,920 per year

Subtracting out living costs (would have paid anyway) yields a Net Out-of-Pocket costs: $11,448 per year

**Principle # 2: The Real Cost of Something is What You Must Give Up to Obtain It (3)**

EXAMPLE #2:

2. Implicit or Indirect Costs:

- Time

- Forgone income: year round $21,948

Allowing for summer jobs: -$3,000

- Net Foregone income: $18,948

Of course, there may be other ways to spend that time that would be even more valuable.

3. Total opportunity cost of college

$30,396 per year

$121,584 for four years

4. The flip side of this is that there are significant benefits from a college education as well.

**Principle # 3: “How much” is a decision at the margin**

* Some important decisions involve an “either-or” choice – for example, you decide either to go to college or to begin working; you decide either to take economics or to take something else.
* Other important decisions involve “how much” choices – for example if you are taking both economics and philosophy this semester, you must decide how much time to spend studying for each.
* When it comes to understanding “how much” decisions, economics has an important insight to offer: “how much” is a decision made at the margin.
* We will see throughout this course the importance of marginal analysis.
* At the margin, we will choose the quantity of goods so that the marginal benefits = marginal costs

**Principle # 4: People Usually Exploit Opportunities to Make Themselves Better Off (1)**

* While this seems like an obvious idea, the point here is that understanding people's behavior in any economy requires understand the incentives they face.
* An incentive is anything that offers rewards to people who change their behavior.  
  Consider the following examples:

1. The electric power company offers a $100 rebate for individuals purchasing an efficient refrigerator.
2. Individuals on welfare programs would lose much, if not all, of their benefits if they get a job.
3. Conditional Cash Transfers Programs in Latin America (ex. Progresa/Oportunidades) provide cash transfers to poor households that meet certain requirements (enrolment of children at school, vaccinations, visits in health centers).

**Principle # 4: People Usually Exploit Opportunities to Make Themselves Better Off (2)**

* The principle that people will exploit opportunities to make themselves better off is the basis of all predictions by economists about individual behavior.
* If the earnings of those who get MBAs soar while the earnings of those who get law degrees decline, we can expect more students to go to business school and fewer to go to law school.
* Final note, economists tend to be skeptical of any attempt to change people’s behavior that doesn’t change their incentives. Example: the one-child policy in China.  
  - We are only able to really modify individuals’ behaviors if we modify the incentives behind them.

**Principle # 4: People Usually Exploit Opportunities to Make Themselves Better Off (3)**

* China: big country with lots of people: 1,354,040,000 (in 2012) over one billion three hundred and fifty million.
* In 1978, the government of China introduced the “one-child policy” to address the economic and demographic challenges presented by China’s large population.
* The one-child policy had an unfortunate unintended consequence: sex-ratio unbalanced in favor of boys.  
  - Because China was an overwhelmingly rural country and sons can perform the manual labor of farming, families had a strong preference for sons over daughters.  
  - In addition, tradition dictates that brides become part of their husbands’ families and that sons take care of their elderly parents.

**Principle # 5: There are gains from trade**

* A market economy relies upon this basic principle (Agents gain from trade); i.e., that people can get more of what they want through trade than by being self-sufficient.
* These gains stem from the fact that total output can be increased with specialization.
* This idea applies to the Households, Firms, Communities and Nations

**Principle # 6: Markets move towards equilibrium**

* As the book defines it, an economic situation is in equilibrium when

no individual (economic agent) would be better off doing something different.  
- Economic agent have no incentives to modify economic equilibrium (consumers consume all that workers produce)

* Changing conditions create opportunities (incentives) that a market

economy encourages individuals to take advantage of, moving us to a

new equilibrium.

* What are some examples of new equilibria?

- The emergence of Toyota and Honda during the OPEC oil embargo.

- Cable TV requires a large investment, typically limiting the number of

cable companies in a region, giving cable companies market power to

keep rates high.

- Medicare and Medicaid cap reimbursements to physicians.

**Principle # 7: Resources Should be Used as Efficiently as Possible to Achieve Society's Goals**

* An economy is **efficient** (or **Pareto Optimal**) if there is no way to make anyone better off without making others worse off.
* As we shall see later on in the class, recessions are an example of a situation of inefficiency.
* It is important to note that efficiency is not a very strong criteria. **It says nothing about the equity of the situation**.

**Principle # 8: Markets usually lead to efficiency**

* A market economy creates incentives for each individual, acting in their own self interest, to increase efficiency. Market per-se is able to be efficient without external interaction.
* This is Adam Smith's so called Invisible Hand.
* As we will see in detail in subsequent chapters, if there is unmet demand for a commodity at current price, individuals will bid up the price for the good, creating an incentive for producers to increase production until that demand is met

**Principle # 9: When Markets Don't Achieve Efficiency, Government Can Improve Society's Welfare**

* While markets tend to lead to efficiency, they do not always.
* There are many types of market failures, including:

- externalities

- market power (market is not competitive, in which only few companies produce)

- public goods

- common property resources

* When market's don't achieve efficiency, governments can (but do not necessarily) improve society's welfare.
* Understanding the source of the market failure can be key to resolving the inefficiency.
* In many cases, the problem stems from poorly defined property rights or an incomplete market for the good.

**Principles 10/11/12, individual action 🡪 results on the market**

**Principle # 10: One Person's Spending is Another Person'sIncome (1)**

* If one group of individuals decide to spend less, the impact will spread through the economy.
* We are currently experiencing this in terms of a recession. These interactions are not simply local. They spread

- across communities

* internationally through protectionism.

This principle also suggests how recoveries emerge.

**Principle # 10: One Person's Spending is Another Person's  
Income (2)**

EXAMPLE:

* Impacts of Cash Transfers Programs on local economies.
* Many conditional and unconditional cash transfers programs in Latin America and Africa have proved to improve income and consumption of non-beneficiary households.
* Cash transfers programs generate positive spillover economic effect on the local economy.
* Practical example: Local Economy Wide Impact Evaluation approach adopted in Zambia and Lesotho (suggested reading)

**Principle # 11: Overall Spending Sometimes Gets Out of Line with the Economy's Productive Capacity**

* The recent recession is an example of this.
* Many argue that it was WWII that largely brought the US out of the Great Depression.
* Spending can also lead to inflation.

**Principle # 12: Government policy can change spending**

* The Economic Stimulus Package is an example of such an effort.
* Cash Transfers Programs are another example of policy intervention in developing countries aimed at increasing consumption in more nutritious food, spending in education, spending in agricultural assets. Examples:
* Child Grant Program in Lesotho
* Social Cash Transfers Program in Malawi
* Harmonized Social Cash Transfers in Zimbabwe.