Chapters 1,2

Basic Principles of Microeconomics

What is Economics?

- Economics is the study of how society allocates its scarce resources to satisfy peoples' unlimited wants.

- Scarcity means that society has limited resources and therefore cannot produce all the goods and services people wish to have.

- Microeconomics focuses on the individual parts of the economy.
- How households and firms make decisions and how they interact in specific markets

- Macroeconomics looks at the economy as a whole.
- Economy-wide phenomena, including inflation, unemployment, and economic growth

- A market economy is one that allocates resources through the decentralized decisions of firms and households.
- Households decide what to buy and who to work for.
- Firms decide who to hire and how much to produce.

- A command or centrally planned economy is one where all production and distribution decisions are made by a central authority, like a government.
- The former USSR was a command economy.

- A traditional economy is a system in which economic decisions are made based on customs, beliefs, religion and habits.
- Often, the term is used to refer to underdeveloped economies that rely heavily on agriculture for domestic consumption (subsistence economies).

- Most economies are mixed economies – a combination of mainly market and command economies.
- Canada is a mixed economy.
- We are mostly a market economy, but we do have government-run and/or regulated industries.

Basic Principles of Economics

- A household and an economy face many decisions:
- Who will work?
- What goods and how much will be produced?
- What resources should be used in production?
- At what price should goods be sold?

- Every economic issue involves individual choice.

- We assume that when people are making decisions, they are acting rationally.
- Economic rationality involves making decisions that maximize the benefits the decision maker receives from their decision.
- Consumers want to maximize their satisfaction from their purchases.
- Firms want to maximize their profits.
- We often assume that people have perfect information to use when making a decision.
- For example, firms know all prices, what the best technology is to use, how other firms and consumers will react if they change their prices…

- In practice, it is hard (if not impossible) for everyone to have perfect information.
- We often run into situations that involve asymmetrical information.
- For example, an eBay sellers knows if their good is in perfect working order, but potential buyers don't know for sure and have to take the sellers' word.
- The sellers have more information than the buyers.
- Lack of perfect information makes it harder to make the best decisions.

Resources are Scarce

- A resource is anything that can be used to produce something else.
- The big 3 resources: land, labour, physical capital (buildings, machinery, etc.)

To get one thing, we usually have to give up something else.

- Full-time schooling v. full-time employment
- Food v. clothing
- Leisure time v. work

Making decisions requires trading off one goal against another.

Opportunity Costs

- The opportunity cost of something is everything you have to give up to get it.
- It is the cost of the best forgone alternative.

EXAMPLE

- You decide to attend Mac. Your tuition costs $8000, books cost $1000 and your apartment costs $6000. Your total explicit costs are $15000.
- You could have spent that money on something else – say, a car.
- That car is a foregone alternative – it is an implicit cost of coming to Mac.

- But there are other things you give up when you come to Mac.
- Instead of coming to Mac, you could have lived at home for free and held a full-time job that earned you $28000. You gave up the $28000 income – this is a larger foregone alternative and implicit cost.
- So what is the opportunity cost of coming to Mac?
- It's the value of the best foregone alternative – the lost wages (value of $28000 versus the $15000 car) plus the $15000 spent on tuition, books and accommodation.

Marginal Thinking

- Marginal changes are small, incremental adjustments to an existing plan of action.
- For example, a firm will wonder "What will happen to my profit if I decide to produce just one more good?"
- People make decisions by comparing marginal benefits to marginal costs.

- Marginal changes in costs or benefits motivate people to respond.
- The decision to choose one alternative over another occurs when that alternative’s marginal benefits exceed its marginal costs.
- For example, if producing one more good adds more to a firm’s revenue than to its costs, the firm will produce that good.

- Adam Smith observed that households and firms act as if guided by an “invisible hand.”
- If each consumer is allowed to choose freely what to buy and each producer is allowed to choose freely what to sell and how to produce it, the market will settle on a product distribution and prices that are beneficial to all the individual members of a community, and hence to the community as a whole.

- The reason for this is that greed will drive economic actors to beneficial behavior.
- Efficient methods of production will be adopted in order to maximize profits.
- Low prices will be charged in order to undercut competitors.
- Investors will invest in those industries that are most urgently needed to maximize returns, and withdraw capital from those that are less efficient in creating value.

- Students will be guided to prepare for the most needed (and therefore most remunerative) careers.
- And all these effects will take place dynamically and automatically.

Markets Move Toward Equilibrium

- An economic situation is in equilibrium when there is no incentive for any economic actors – households, firms, governments, etc. – to change their behaviour.
- No individual would be better off doing something different.
- Markets usually reach an equilibrium through changes in prices.
- Prices guide decision makers to reach outcomes that maximize the welfare of society as a whole.

Gains from Trade

- In a market economy, people engage in trade with each other.
- Not every family or nation can produce everything it needs efficiently.
- We specialize in tasks we do best and trade with others for the things we need that they can provide.
- In this way, we have gains from trade.

Efficiency

- An economy's resources are used efficiently when they are used as best as possible to meet society's goals.
- The welfare of society is maximized.
- Markets that are left to operate freely usually lead to efficiency.

- Market failure occurs when the market fails to allocate resources efficiently.
- When the market fails (breaks down) government can intervene to promote efficiency and equity.
- Efficiency means society makes the best use of its resources (economic decisions).
- Equity involves the fair distribution of resources (political decisions).

Market failure may be caused by

- an externality, which is the impact of one person or firm's actions on the well-being of a bystander.
- market power, which is the ability of a single person or firm to unduly influence market prices.
- some goods just aren't suited to the market – for example, donor organs.

The Economist's Roles

- When economists are trying to explain the world, they are scientists.
- When economists are trying to change the world, they are policy advisors.

Positive Versus Normative Statements

- Positive statements are statements that attempt to describe the world as it is.
- Called descriptive analysis

- Normative statements are statements about how the world should be.
- Called prescriptive analysis

Positive or Normative Statements?

- An increase in the minimum wage will cause a decrease in employment among the least-skilled.

  POSITIVE

- The income gains from a higher minimum wage are worth more than any slight reductions in employment.

  NORMATIVE

Why Economists Disagree

- They may disagree about the validity of alternative positive theories about how the world works.

- They may have different values and, therefore, different normative views about what policy should try to accomplish.

Economic Models

- Economists use models for many reasons.
- We try to model human behaviour so we can make accurate predictions about potential economic outcomes.
- We use models to help us explain how the economy works.

Our First Model: The Circular-Flow Diagram

Firms

- Produce and sell goods and services
- Hire and use factors of production

Households

- Buy and consume goods and services
- Own and sell factors of production

The Circular-Flow Diagram

Markets for Goods and Services

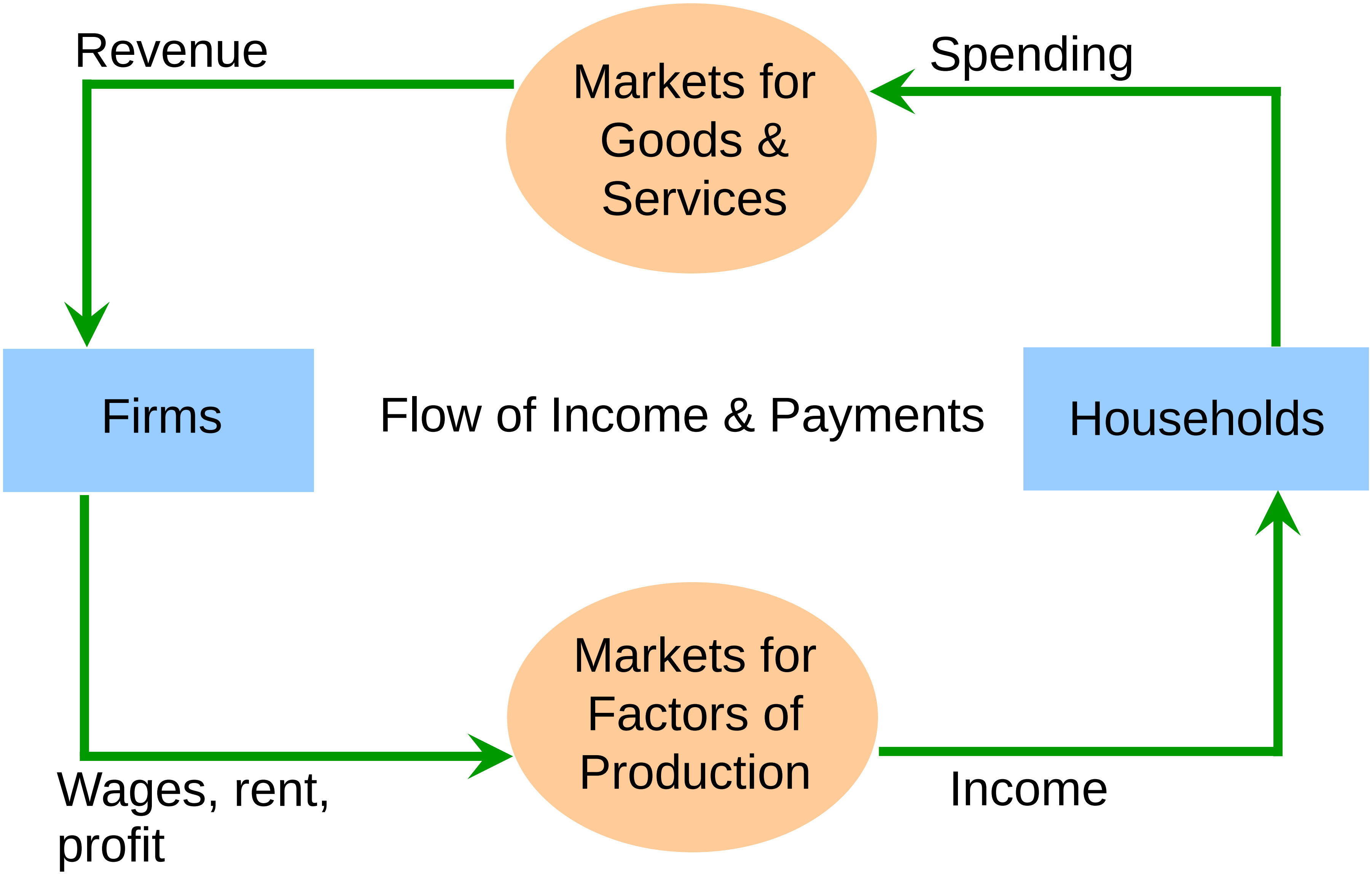
- Firms sell
- Households buy

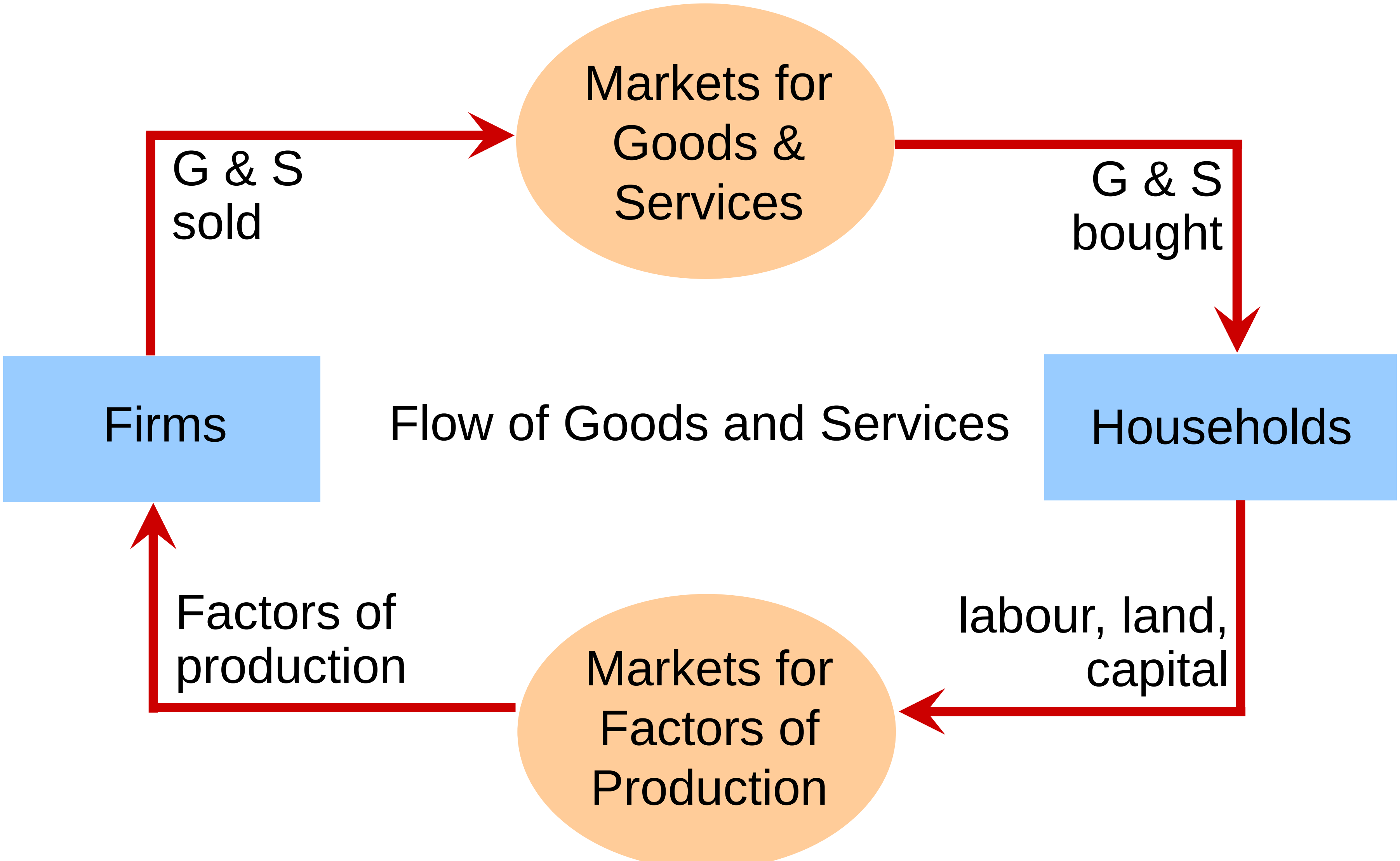
Markets for Factors of Production

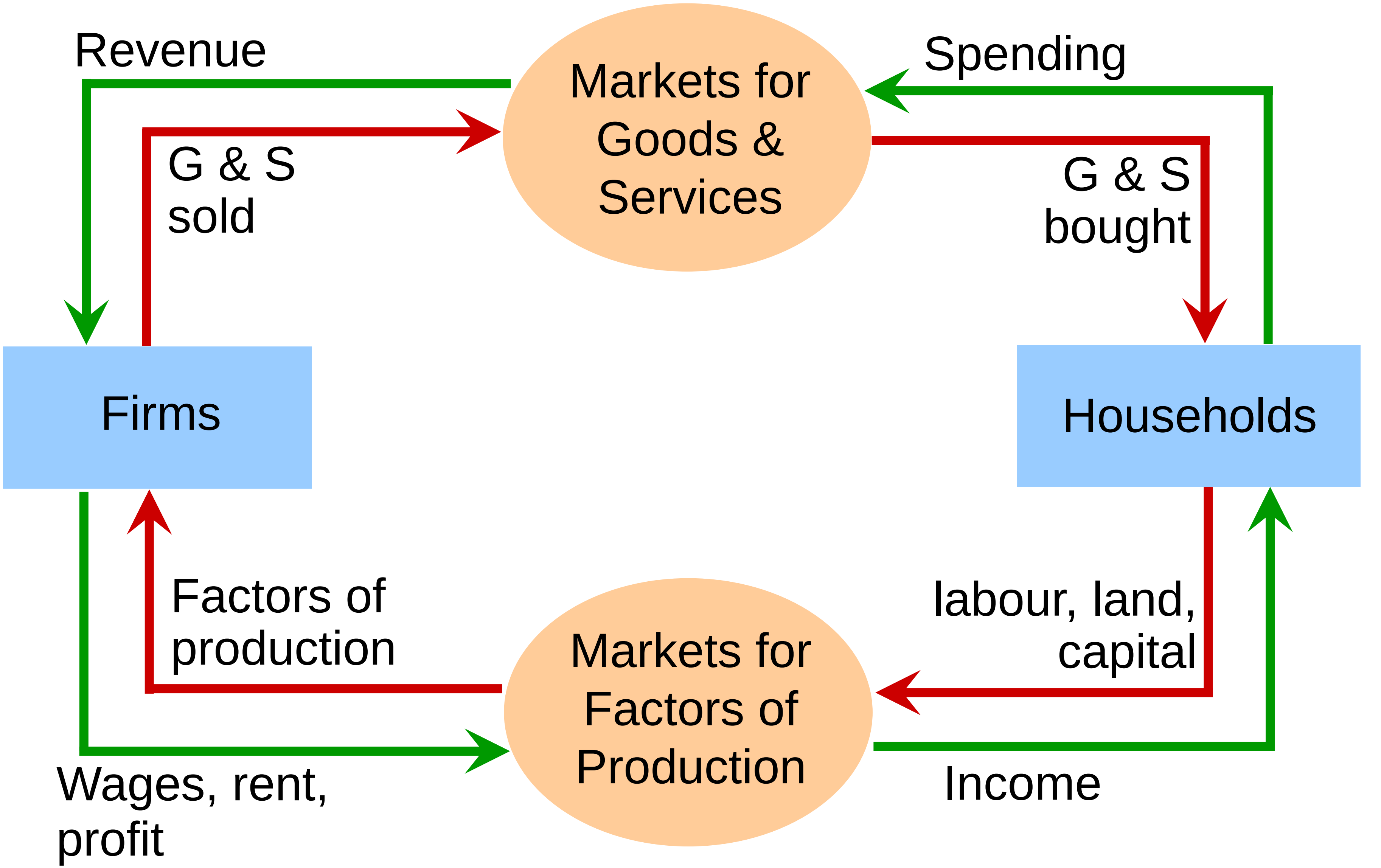
- Households sell
- Firms buy

Factors of Production

- Inputs used to produce goods and services
- Land, labour, and capital


Revenue
Markets for Goods & Services
Spending
Firms
Flow of Income & Payments
Households
Markets for Factors of Production
Wages, rent, profit
Income


Markets for Goods & Services
G & S sold
G & S bought
Firms
Flow of Goods and Services
Households
Factors of production
labour, land, capital
Markets for Factors of Production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