<u>Microeconomics</u> is the study of how individual units (households and firms) make decisions to allocate limited resources, especially in markets where goods or services are being bought and sold.

<u>Macroeconomics</u> is the study of economy-wide phenomena, including inflation, unemployment, and economic growth.

Seven Principles of Economics

1. People Face Trade-offs

All decisions involve tradeoffs, e.g.

- Going to a party the night before your midterm leaves less time for studying

- Having more money to buy stuff requires working longer hours, which leaves less time for leisure

2. The Cost of Something is what you give up to get it

- Making decisions requires comparing the costs and benefits of alternative choices

- The opportunity cost of any item is whatever must be given up to obtain it

The opportunity cost of

- ✓ Going to college for a year is not just the tuition, books, and fees, but also the forgone wages
- ✓ Seeing a movie is not just the price of the ticket, but the value of the time you send in the theater

3. **Rational people think at the margin**

- ➢ Systematically and purposefully do the best they can to achieve their objectives
- ➢ Make decisions by evaluating costs and benefits of marginal changes=incremental adjustments to an existing plan

E.g.

- ✓ When a student considers whether to go to college for an additional year, he compares the fees and forgone wages to the extra income he could earn with the extra year of education
- ✓ When a manager considers whether to increase output, she compares the cost of the needed labor and materials to the extra revenue

4. **People respond to incentives**

Incentive: something that induces a person to act, i.e. the prospect of a reward or punishment

Rational people respond to incentives.

E.g.
When gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUVs

Assignment

You are selling your 1996 Mustang. You have already spent $1000 repairs. At the last minute, the transmission dies. You can pay $600 to have it repaired, or sell the car "as is."

In each of the following scenarios, should you have the transmission repaired? Explain

A. Blue book value is $6500 if transmission works, $5700 if it doesn't

B. Blue book value is $6000 if transmission works, $5500 if it doesn't

Answer

Cost of fixing transmission = $600

A. Blue book value is $6500 if transmission works, $5700 if it doesn't

   Benefit of fixing the transmission = $800 ($6500 - 5700)
   It's worthwhile to have the transmission fixed

C. Blue book value is $6000 if transmission works, $5500 if it doesn't

   Benefit of fixing the transmission = $500
   Paying $600 to fix transmission is not worthwhile

5. Trade can make everyone better off

- Rather than being self-sufficient, people can specialize in producing one good or service and exchange it for other goods

- Countries also benefit from trade and specialization

6. **Markets are usually a good way to organize economic activity**

Market: A group of buyers and sellers (need not be in a single location)
Market forces: No govt intervention, rather leave everything to the market.

"Organize economic activity" means determining

- What goods to produce
- How to produce them
- How much of each to produce
- Who gets them
- The interaction of buyers and sellers determine prices
- Each price reflects the goods value to buyers and the cost of producing the good

Market failure: market can fail due to

1. **Externality:** it's an effect arising from production and consumption of goods and services where the third party receives no appropriate compensation e.g. pollution, second-hand smoking

Positive externalities occur when a benefit accrues to someone outside of the production or consumption of a good.
E.g.
Individuals consuming vaccine against the influenza virus , those who do not vaccinate themselves receive the benefit of a reduced prevalence of the virus in the community.

Damming of rivers for electricity is a good example of positive externality. Damming not only provides for flood mitigation for those living downstream of the river but also provides an area for enjoying water based recreational activities.

2. **Market power:** ability of a single economic agent, (or group) to influence market prices.

Government intervene in the economy for the following reasons

Promote

- ✓ Efficiency and equality

7. **Government can sometimes improve market outcomes (through govt policies)**

- ➢ Important role for govt: enforce property rights, pollution reduction, (with police, courts, tax)
- ➢ If the market's distribution of economic well-being is not desirable, tax or welfare policies can change how the economic "pie" is divided.