ECO 2306 – Principles of Microeconomics

Week 1

Hello and Welcome to the weekly resources for ECO 2306 – Principles of Microeconomics!

This week is Week 1 of class, and typically in this week of the semester, your professors are covering these topics below. If you do not see the topics your particular section of class is learning this week, please take a look at other weekly resources listed on our website for additional topics throughout of the semester.

We also invite you to **look at the group tutoring chart on our website to see if this course has a group tutoring session offered this semester**.

If you have any questions about these study guides, group tutoring sessions, private 30 minute tutoring appointments, the Baylor Tutoring YouTube channel or any tutoring services we offer, please visit our website www.baylor.edu/tutoring or call our drop in center during open business hours. M-Th 9am-8pm on class days 254-710-4135.

Our main resource is going to be Principles of Microeconomics by N. Gregory Mankiw.

Topic of the week

Principles of Economics

Keywords: Scarcity, trade-offs, decision-making, marginal benefit, productivity.

Concepts:

What do we study here? We're learning about economics, which is the study of how limited **(scarce)** resources are allocated. In microeconomics, we are mainly concerned with how individuals and firms make decisions withing an economy. What are the main principles behind these decisions? That's what we learn in this chapter.

How People Make Decisions

1. People face trade-offs.

Nothing in life is free. People have to give something to receive goods or services. Even if something is seemingly free, like a YouTube video, one still has to spend time to watch it. Since resources are scarce, individuals (and by extension, societies) have to come up with reasonable tradeoffs: choose to spend money on education vs leisure, or choose to work for higher pay or better benefits. On a higher level, a society has to make a trade-off between **efficiency** (maximizing the outcome of resources) and **equality** (distributing prosperity among its members).

2. The cost of something is what you give up to get it.

Your everyday understanding of cost is usually in terms of money. In economics, we think about **opportunity cost**, which is everything you give up to do or achieve something. For example, in order to spend your time to read this study guide, you are not spending your time watching TV or playing sports. Watching TV and playing sports would be the opportunity cost of studying.

3. Rational people think at the margin.

We assume people are rational and make decisions accordingly. Rational thinking is the basis for thinking about **marginal benefit** and **marginal cost.** Marginal benefit is the utility you get from the next unit of consumption; the next hour of studying, the next tortilla chip, the next car, etc. Most individual and business decisions are made at the margins; should I hire the next worker? Should I invest the next dollar? Should I watch the next episode? A rational player performs an action only if its marginal benefit exceeds its marginal cost.

4. People respond to incentives.

An **incentive** is something that induces a person to act, such as the prospect of a punishment or reward. Incentives are very important in public policy as they can alter people's demands and behaviors. For example, high taxes on cigarette sales leads to lower levels of smoking, since the resulting high price incentivizes people to look for cheaper hobbies. Think of incentives that alter your everyday behavior.

How People Interact

5. Trade can make everyone better off.

International trade is not a zero-sum game; in order for one country to win, no other country has to lose. Trade allows countries to focus on what they can do better, and get more benefit out of their scarce resources. You are constantly competing against your classmates. At the same time, you will not perform best if you were to isolate yourself from everyone and go through college alone. Cities, states, countries, families, and various competing organizations can be considered trade partners who are mutually beneficial to one another.

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

Economic activity can be centrally planned or be decentralized. History shows that multiple minds tend to perform better than a single mind, no matter how smart. In a **market economy**, the decisions of a central planner are replaced by the decisions of millions of firms and households. Households and firms interacting in markets act as if they are guided by an "**invisible hand**" that leads them to desirable market outcomes. In microeconomics, we study the mechanisms that form this invisible hand. Think of the difference between the decentralized network of Uber drivers versus the centrally planned traditional taxis.

7. Governments can sometimes improve market outcomes.

The voluntary exchange of goods and services in a market economy is great, but it is only made possible if institutions enforce **property rights** so individuals can own and control scarce resources. Farmers need protection from marauders, stores from looters, and banks from robbers. Our goal is to use scarce resources efficiently, and sometimes the free actors in a market can't do that on their own. This is called a **market failure** and can be fixed by some government intervention. Also, the government can promote more equality through taxation and creating a welfare system.

How the Economy as a Whole Works

8. A country's standard of living depends on its ability to produce goods and services.

The quantity of goods and services that result from one unit of labor is known as **productivity.** Differences in productivity explains almost all differences in average incomes in different countries. Many fluctuations in a country's standard of living may be attributed to competition with other countries or laws and regulations by politicians, but economists show that productivity levels explain these fluctuations better than any other factor. Productivity is usually affected by the level of education and access to technology.

9. Prices rise when the government prints too much money.

An increase in overall prices in an economy is called **inflation**. In almost all cases of large or persistent inflation, the culprit is growth in the quantity of money. The high inflation of the 1970s was associated with rapid growth in the quantity of money, and the return of low inflation in the 1980s was associated with slower growth in the quantity of money.

10. Society faces a short-run trade-off between inflation and unemployment.

When the supply of money increases, the demand for goods and services goes up, and consequently unemployment goes down. This is a very important short-run trade-off between inflation and unemployment. This is important to know when analyzing **business cycles**; mostly unpredictable fluctuations in economic activity, such as employment and production. Policy makers respond to business cycle by deciding to handle the issue that is more urgent: unemployment or inflation.

What you might struggle with

Try to think as hard as you can about marginal cost and marginal benefit. Zero marginal cost does not mean zero cost, it simply means that the cost of consuming the next unit is zero. Once you buy a gym membership and hit the gym once, the marginal cost of working out again is going to be zero. Once you have studied enough to secure an A, the marginal benefit of studying one more hour is zero. Try to think real life examples with increasing or decreasing marginal cost and benefit. Thinking at the margin will be a recurring idea throughout economics.

It's sometimes hard to conceptualize the short-term relationship between unemployment and inflation. We think of both concepts as problems; therefore, it is tempting to think they are directly correlated. Also, keep in mind that we have a short-term trade-off here and the long-term analysis is much more complicated.

Check your learning

1. A 1996 bill reforming the federal government's antipoverty programs limited many welfare recipients to only 2 years of benefits.

    a. How does this change affect the incentives for working?

    b. How might this change represent a trade-off between equality and efficiency? (Source: Mankiw)

2. Discuss each of the following statements from the standpoints of equality and efficiency.

    a. "Everyone in society should be guaranteed the best healthcare possible."

    b. "When workers are laid off, they should be able to collect unemployment benefits until they find a new job." (Source: Mankiw)

3. In what ways is your standard of living different from that of your parents or grandparents when they were your age? Why have these changes occurred? (Source: Mankiw)

4. During the Revolutionary War, the American colonies could not raise enough tax revenue to fully fund the war effort. To make up the difference, the colonies decided to print more money. Printing money to cover expenditures is sometimes referred to as an "inflation tax." Who do you think is being "taxed" when more money is printed? Why?

5. You were planning to spend Saturday working at your part-time job, but a friend asks you to go skiing. What is the true cost of going skiing? Now suppose you had been planning to spend the day studying at the library. What is the cost of going skiing in this case? Explain. (Source: Mankiw)

Answers

These are my answers. You should be able to come up with your own arguments that may or may not differ from mine.

1a. People are incentivized to work more and reserve their benefits for a time of dire need.

1b. It lowers equality (lower taxes, less money distribution) and increases efficiency (more people working, higher total earnings).

2a. equality in the sense that everyone should get healthcare, but getting the best healthcare possible is a matter of efficiency; b. equality in general, the "until" part emphasizes efficiency.

3. Incomes are higher, the cost of living relative to incomes is lower, medicine is more readily available. This is due to higher productivity which is the result of advancements in education and technology.

4. Everyone is being taxed when inflation increases. However, those who have more cash than investments (the poor) suffer much more, since land and other investments retain their value when inflation goes up.

5. The true cost of going skiing is the amount of money you would have made if you had worked instead of going skiing (opportunity cost). In the second scenario, your opportunity cost is what you would have learned if you had studied at the library.

Thanks for checking out these weekly resources!

Don't forget to check out our website for group tutoring times, video tutorials and lots of other resources: www.baylor.edu/tutoring ! Answers to check your learning questions are below!