Chapter 1 - First Principles

Note - italicized means from video tutorials, not from lectures

Economics

- How to make choices when faced with scarcity
- **Economics is the science of choice**
- What do economists do?
    - Study how ppl make decisions
    - Study how ppl interact with each other

All about choices

- How will you allocate your resources?
- Choices for an individual or a household or a society
- Choices must be made bc **resources are scarce**

Scarcity

- A condition in which the resources available are insufficient to satisfy people's wants
    - Society cannot produce all the goods and services people wish to have
    - Affects everyone

How we Distribute Resources

- Fairness, or efficiency?
- Pizza example: allocate for equal portions or for who values the most?

Principles of Economics

- The principles underlie…
    - The economics of individual choice
    - The interactions of individual choice
    - Economy-wide interactions

The first four principles deal with how people make decisions

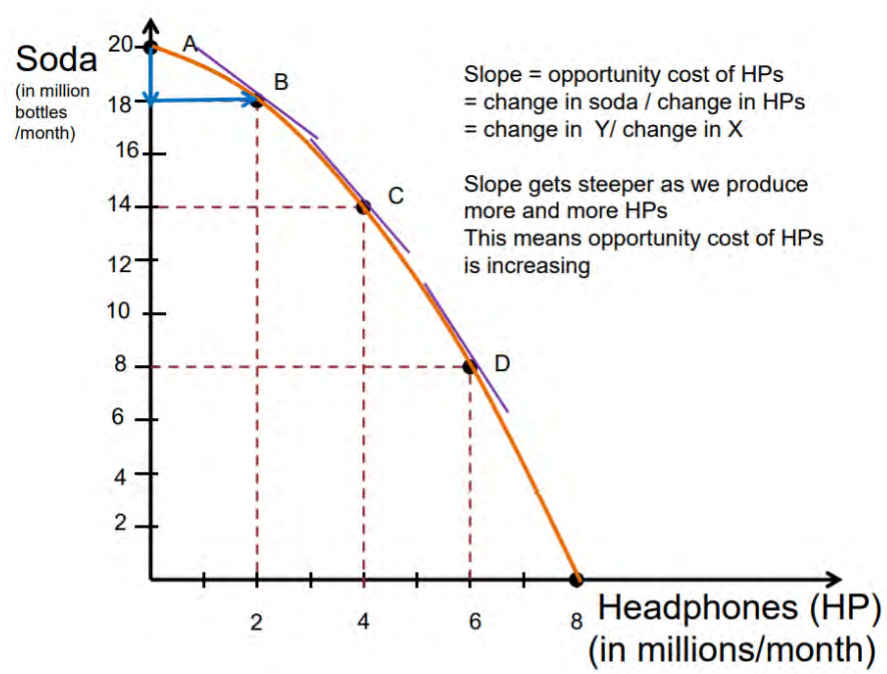
Principle 1 - Choices are Necessary Because Resources are Scarce

- One way to make choices is to allow ppl to make ind. Choices
- Depends on individual behavior
- Sometimes decisions are best not left to individual choice

- Making ppl as well off as possible

Bow-Shaped PPFs

- An outward slope that gets steep means the opportunity cost of the x axis is increasing
- "Negative increasing slope"
- Called bow-shaped



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- Why the Opportunity Cost Might Change
    - When different workers have different skills
        - At point A, most workers are producing soda, even those that are better suited to making headphones. So one doesn't have to give up a lot of soda for more headphones
        - But at point C, the workers left making soda are the best soda makers. So switching them to make headphones would cause a big drop in output
    - When there are resources with varying opportunity costs
        - Ex: different types of land suited for different uses
        - Opportunity cost rises as a country produces more of one good
    - Basically, resources that are shifted may not be as efficient in the different productions. There are diminishing returns when moving such resources away from producing what they are best suited for.

A Market is Efficient When….

- They allocate consumption of the good to the potential buyers who most value it
- They allocate sales to the potential sellers who most value the right to sell the good, aka whoever has the lowest cost
- They ensure that all transactions are mutually beneficial

Equity vs Efficiency

- Efficiency - make the pie as big as possible
- Equity - when the pie is divided fairly
  - Fair is subjective, hard to evaluate
- Efficiency is important, but society also cares about equity

Why Private Property Is Important

- Private property rights create and protect incentives to trade with others, and to innovate
- Property rights:
  - The rights of owners of valuable items to dispose of them as they choose
    - Gives ppl the power to sell, allows for mutually beneficial trades

Economic Signals

- The equilibrium prices are a signal as to where resources are most valued

Market Failures

- When markets fail to allocate resources efficiently
  - May be bc of a monopoly
  - Or externalities - the side effects of transactions, like pollution
- They lead to inefficiency, bc opportunities are missed

- **Incidence** of an excise tax = the division of who pays between between sellers and buyers

Excise Taxes and Elasticity

- If a product is highly inelastic for demand, then suppliers can increase prices to make up for the taxes and the consumers will pay for it. This leads the consumer to taking on a greater percentage of the tax burden
- For an inelastic demand, the quantity demanded also doesn't decrease by as much, so suppliers still make good revenue
- Gov can get more taxes from inelastic goods
- Tax falls more heavily on the side of the market that is **less elastic**

Note - total surplus includes tax revenue

Tax Fairness

- benefits principle of tax fairness - those who benefit from public spending should bear the burden of the tax that pays for that spending
- Ability to pay principle - those who have the most money should be taxed

Progressive, Regressive and Proportional Taxes

- Progressive - takes larger percent of income from high-income groups
- Proportional - takes same percentage from all income groups
- Regressive - takes larger percentage of income from low-income groups

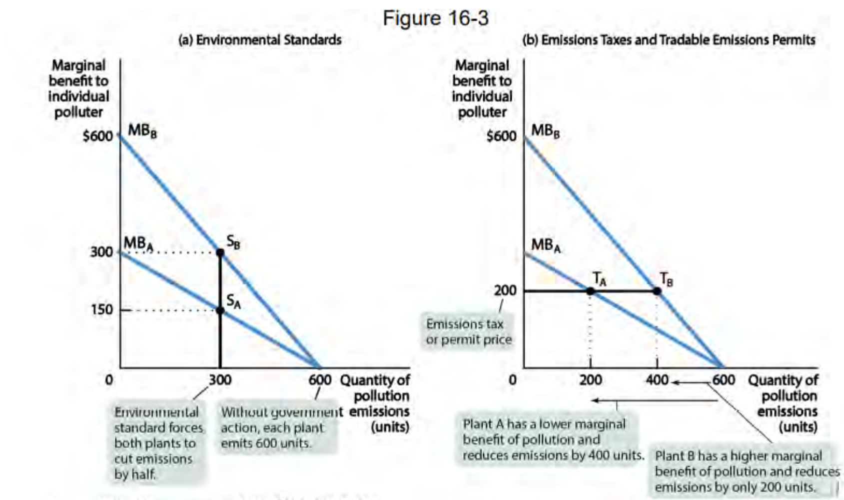
        - **Tacit collusion** - not a literal agreement, but we can assume how another firm will act
- Tacit collusion is limited by…
    - Less concentration
    - Complex products and pricing scheme
    - Differences in interest
    - Bargaining power of buyers
- Engage in repeated activities w/ competitors to establish a level of cooperation over time w/o explicitly colluding
- Stores may choose to match price of competitors
    - Helps eliminate incentive for either store to charge a lower price
    - Companies can signal to one another that they'll use the same price
    - (this is done at the expense of the consumers, who end up paying more)

Public Policy Towards Oligopolies

- In oligopolies, production is too low and prices are too high relative to the social optimum
- Role for policymakers
    - Promote competitions, prevent cooperation to move the oligopoly outcome closer to the efficient outcome
- They're controlled under legal restrictions by antitrust policies
    - Bc gov doesn't want oligopolistic industries to behave like monopolies

Product Differentiation and Price Leadership

- When collusion breaks down and prices collapse, it can lead to a price war
- To limit competition, oligopolists often engage in product differentiation
- Firms will often engage in **nonprice competition**, such as advertising
- In **price leadership**, one firm sets a price, and others will follow

- 

Positive Externalities

- Eg: education creates benefits for students + the society they live in
- Eg: motorcycle riders provide an external benefit to those waiting for an organ transplant
- With positive externalities, the market tends to produce too little of the ood
    - Bc the marked doesn't take into account the positive external benefits from the consumption of the good
- Pigouvian subsidy
    - A payment designed to encourage activities that yield external benefits
    - The socially optimal quantity can be achieved by a pigouvian subsidy = to the marginal social benefit at the optimal quantity

- Network Externalities
- When the value of the good to an individual is greater when a large number of ppl also use the good
- Eg:
    - Telephones, telegraphs, fax machines
- A good is subject to **positive feedback** when success breeds greater success and failure breeds failure
    - Eg: Windows, the more popular it is, the more software is made for it, and then it becomes even more popular