

Thinking Like An Economist

CHAPTER
1

Economics

- Economics
 - The study of how people make choices under conditions of scarcity and of the results of those choices for society.

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Micro and Macro

- Microeconomics
 - The study of individual choice under scarcity and its implications for the behavior of prices and quantities in individual markets.
- Macroeconomics
 - The study of the performance of national economies, and of the policies that governments use to try to improve that performance.

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Choice In a World of Scarcity

- The Scarcity Principle
 - Boundless wants cannot be satisfied with limited resources.
 - Therefore, having more of one thing usually means having less of another.
 - Because of scarcity we must make choices.

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Choice In a World of Scarcity

- The Cost-Benefit Principle
 - An individual (or a firm or a society) should take an action if, and only if, the extra benefits from taking the action are at least as great as the extra costs.

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Choice In a World of Scarcity

- Choosing the Optimal Class Size
 - Assume that the cost of a class with 20 students is \$1,000 per student more than a class of 100 students
 - Should the class size be reduced to 20 students?
 - Why are honors classes smaller?

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Applying The Cost-Benefit Principle

- Rational Person
 - Someone with well-defined goals who tries to fulfill those goals as best he or she can.

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Applying The Cost-Benefit Principle

- Economic Surplus
 - The benefit of taking any action minus its cost.
 - The goal of economic decision makers is to maximize their economic surplus.

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Applying The Cost-Benefit Principle

- Opportunity Cost
 - The value of the next-best alternative that must be forgone to undertake an activity.
- Key is to correctly recognize what taking a given action prevents us from doing.

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Applying The Cost-Benefit Principle

- What costs are involved in driving across town?
- How much would someone have to pay you to drive across town?

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Four Important Decision Pitfalls

- Pitfall 1: Measuring cost and benefits as proportions rather than absolute dollar amounts.
 - Examples
 - ◆ Would you drive across town to save \$10 on a \$20 DVD? To save \$10 on a \$2,020 laptop computer?
 - ◆ Which is more valuable, saving \$100 on a \$2,000 plane ticket to Tokyo or saving \$90 on a \$200 plane ticket to Chicago?

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Four Important Decision Pitfalls

- Pitfall 2: Ignoring Opportunity Costs
 - Example: Should you go to graduate school?
 - ◆ What are the costs?
 - ◆ What is the next best alternative?

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Four Important Decision Pitfalls

- Pitfall 3: Failure To Ignore Sunk Costs
 - Sunk cost
 - ◆ A cost that is beyond recovery at the moment a decision must be made.
 - The only costs that should influence a decision about whether to take an action are those that we can avoid by not taking the action.
 - Example?

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Four Important Decision Pitfalls

- Pitfall 4: Failure To Understand the Average-Marginal Distinction.
 - Quantity decisions should be made by comparing marginal cost to marginal benefit, not average cost to average benefit.
 - Example: How large of an ice cream cone to buy?

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Four Important Decision Pitfalls

- Marginal Benefit
 - The increase in total benefit that results from carrying out one additional unit of an activity.
- Marginal Cost
 - The increase in total cost that results from carrying out one additional unit of an activity.

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Four Important Decision Pitfalls

- Average Cost
 - The total cost of undertaking n units of an activity divided by n .
- Average Benefit
 - The total benefit of undertaking n units of an activity divided by n .

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