

Review – Economics and the Economy

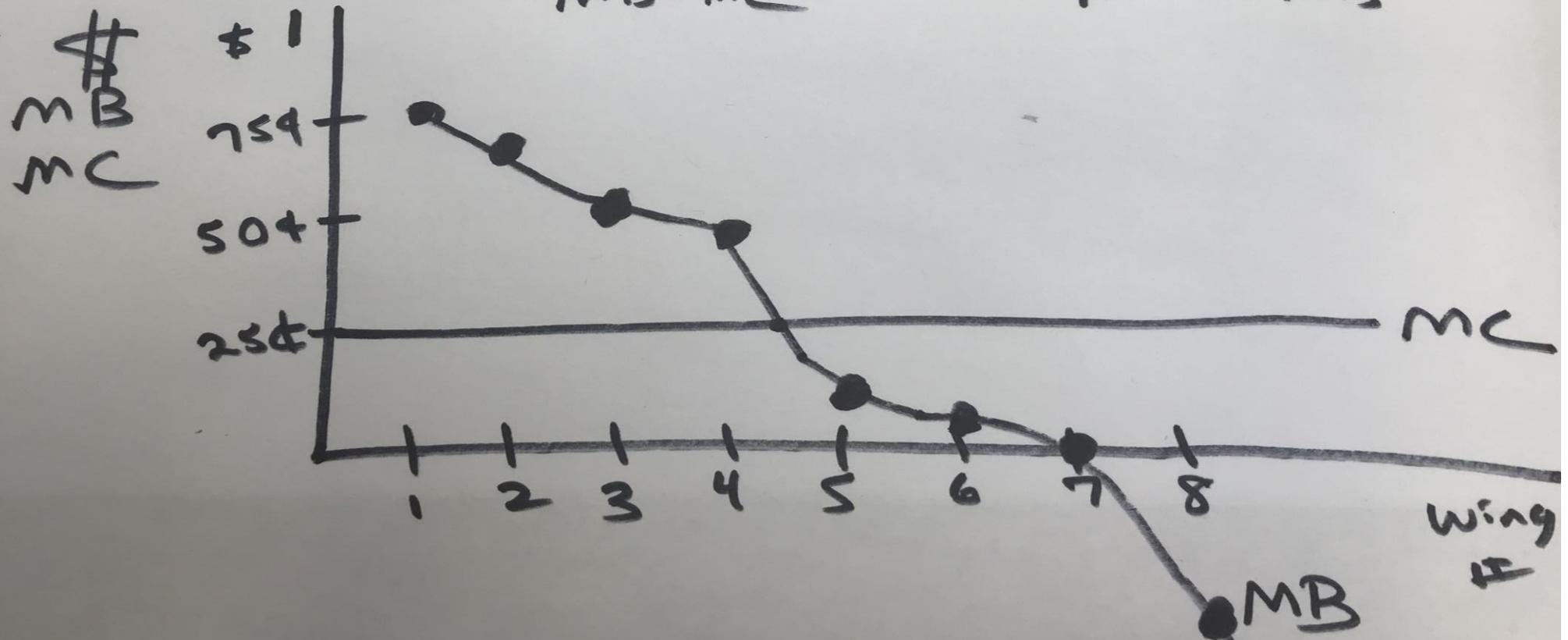
- 10 Principles of Economics:
 - 1. People Face Trade-Offs
 - 2. Opportunity Costs
 - 3. People are economically rational and think at the margin

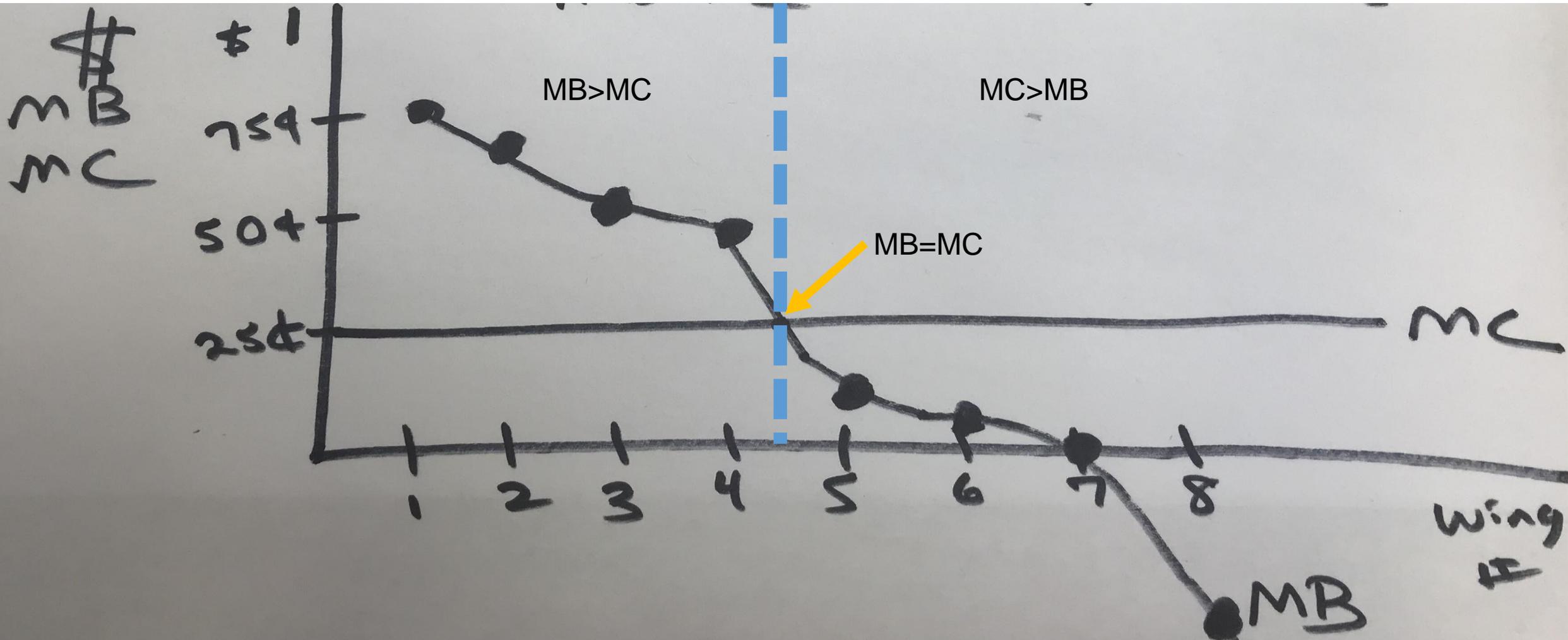


Greg Mankiw
Harvard

Ali Wing #	1	2	3	4	5	6	7	8
MB Marginal Benefit	75¢	60¢	50¢	40¢	10¢	2¢	0	-\$1
MC MARGINAL COST	25¢	25¢	25¢	25¢	25¢	25¢	25¢	25¢
consume?	✓	✓	✓	✓	X	X	X	X

$MB > MC$
 $MC > MB$

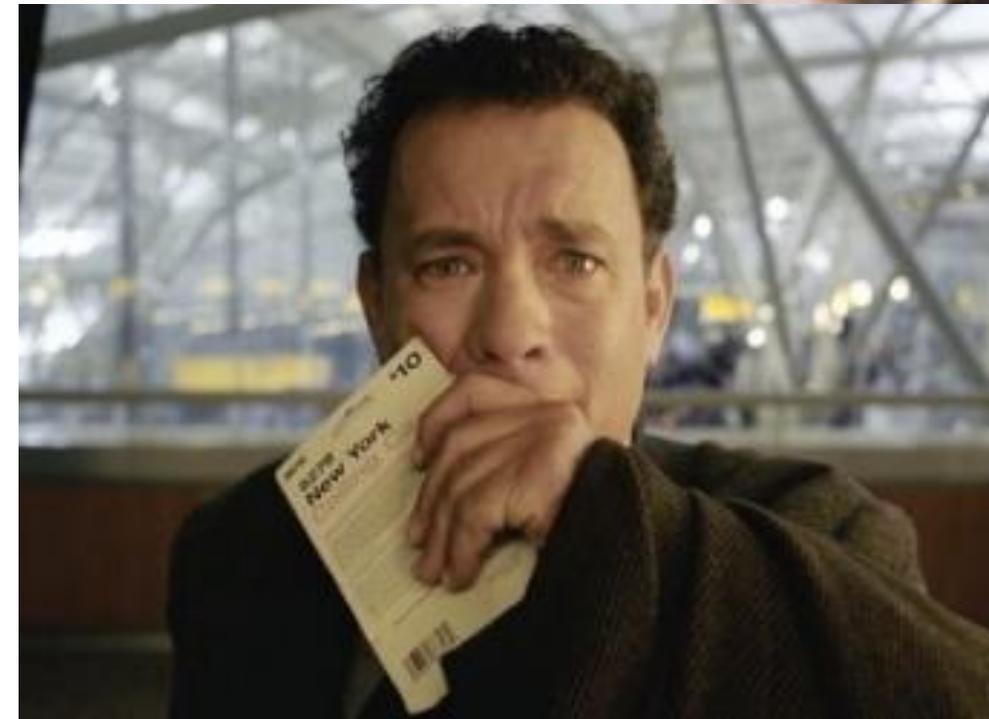




Principle #4:

People
Respond to Incentives
(In predictable ways)
p. 8 in packet

- https://www.youtube.com/watch?v=Gz-QYN_Kl6g





Policies to
reduce smoking?



Incentives to come to class or
disincentives for missing?



Who would you most like to meet?

- A. The Pope
- B. Jennifer Lawrence
- C. Donald Trump
- D. Ryan Reynolds
- E. Beyoncé

A company is trying to decide how many advertisements to run for its product during the Super Bowl. Each advertisement costs 1 million dollars to run. The table below shows the marginal benefit of running consecutive advertisements during the Super Bowl in terms of revenue generated from the ad.

Ad #	1 st Ad	2 nd Ad	3 rd Ad	4 th Ad	5 th Ad	6 th Ad
Marginal Benefit	3 million	2 million	1.5 million	1.25 million	.75 million	.5 million

Assuming the company is rational, what is the optimal number of ads to run during the Super Bowl?

- A. 3
- B. 4
- C. 5
- D. 6

When deciding whether or not you will attend your ECO 201 class which of the following is NOT one of the costs that you should consider?

A. Sleep you would lose by going to class.



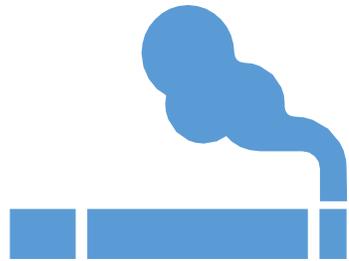
B. Money you could have made if you had worked instead of going to class.



C. Tuition you have to pay to go to class.



D. Gas money spent to get to class.

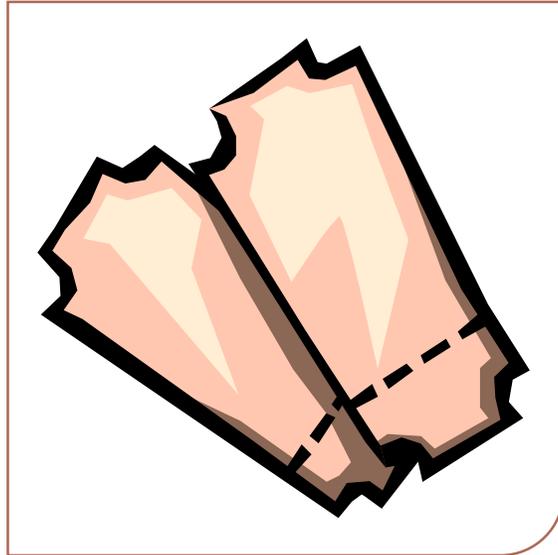


If state government officials want to decrease the amount of cigarette smoking in Kentucky by increasing the cost of smoking for smokers, legislators can

- A. Impose a tax on cigarettes
- B. Charge fines for smoking in certain places
- C. Reduce the number of places where cigarettes can be purchased
- D. All of the above

Interaction with others: p.8
Principle #5: Trade Can Make Everyone Better Off





Facts about trade

- 1) Trade is not a “zero sum game”
- When individuals engage in a voluntary exchange, both parties are made better off.

- 2) Trade Creates Value

- 3) Transaction Costs can inhibit trade
- -time and effort needed to search out, negotiate, and complete an exchange.

- 4) The Middleman reduces costs
- (grocery store, scalper, stubhub, venmo-all reduce transactions costs)

- 5) As trade restrictions are lifted, more value is created from trade.



p. 9 Market forces (supply and demand) ration goods and services by changing the price level

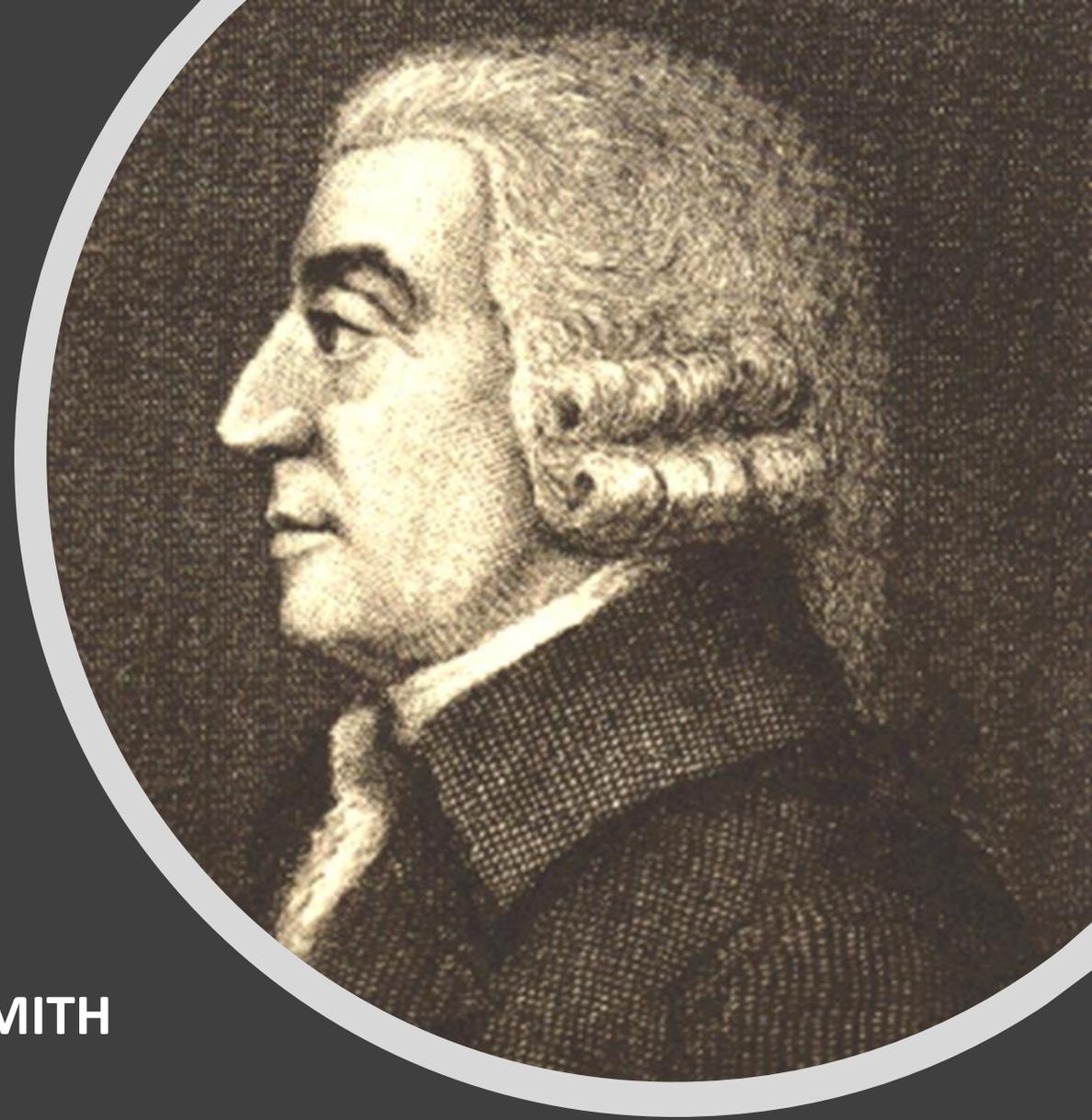


Lexington Farmers' Market

The Invisible Hand is the price mechanism.

- It guides economic forces to coordinate actions and allocate resources.

ADAM SMITH





How many
economists does
it take to change a
light bulb?



One more “invisible” force that
can influence market outcomes
p. 12

- The Invisible Handshake:
Social and historical forces
and cultural norms that
influence market outcomes.

The Invisible Foot - political and legal forces in the market

p. 12



Illegal to sell babies



Illegal to buy alcohol if under 21



Principle #6:
Markets are
usually a good
way to
organize
economic
activity.
p.9

- Market Economy – allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.
- Key assumptions
 - Private property rights
 - Self-Interest Motivates

How a Market Economy Answers the 3 Big ?s

- 1. What and how much to produce
 - Market – what people are willing and able to buy
 - Consumer Sovereignty
- 2. How to produce
 - Private Enterprise
 - Goal – maximize profit
 - Efficiency?
 - Hard budget constraint
- 3. For whom to produce
 - share of economic “pie” based on inheritance, ability, and effort
 - Equality? Equity?



A MARKET-based economy does
not imply the absence of
GOVERNMENT.

- Markets answer 3 economic ?s, but government is needed to:
 - Protect private property rights
 - Support law enforcement and a judicial system
 - Acts as referee for market activity

Another way to
organize economic
activity
p.10

Command Economy-
an economy in which
production,
investment, prices,
and incomes are
determined centrally
by a government.

- Key Assumptions:
 - Communal resource ownership, common property rights
 - Significant government intervention and control
 - Goodwill toward community motivates

How a
Command-
oriented
Economy
Answers the 3
Big ?s

- 1. What and how much to produce
 - What government deems necessary
- 2. How to produce
 - Central planner determines
 - State-owned enterprise
 - Soft budget constraint
 - Typically less “efficient” than market
- 3. For whom to produce
 - share economic “pie” equally (“equity”)

The Dreaded Disease Group Activity

Answer on GREEN quiz sheet, p. 11



- a) What would be the market solution to this problem if the island economy operated as a pure market economy?
- b) What would be a command solution to this problem if the island operated in this fashion?
- c) Suppose that only 200 doses are available. What might the command economy solution be in this case?