Chapter Outline

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Appendix Using Graphs and Formulas

Does Apple Manufacture the iPhone in the United States?

When Apple began selling computers in the 1970s and 80s, it manufactured them in the United States.

But while Apple designed the iPhone in the U.S., most iPhones are assembled in China.

Why are many products manufactured overseas? Can we change this? Should we?

What Is This Class About?

People make choices as they try to attain their goals. Choices are necessary because we live in a world of scarcity.

Scarcity: A situation in which unlimited wants exceed the limited resources available to fulfill those wants.

Economics is the study of the choices people make to attain their goals, given their scarce resources.

Economists study these choices using **economic models**, simplified versions of reality used to analyze real-world economic situations.

Some Typical “Economics” Questions

- We will learn how to answer questions like these:
  - How are the prices of goods and services determined?
  - Why do firms engage in international trade, and how do government policies, such as tariffs, affect international trade?
  - Why does government control the prices of some goods and services, and what are the effects of those controls?

1.1 Three Key Economic Ideas

Explain these three key economic ideas: People are rational, people respond to economic incentives, and optimal decisions are made at the margin.

Economic agents interact with one another in markets.

Market: A group of buyers and sellers of a good or service and the institution or arrangement by which they come together to trade.

In analyzing markets, we generally assume:

1. People are rational
2. People respond to economic incentives
3. Optimal decisions are made at the margin

1. People Are Rational

Economists generally assume that people are rational, using all available information to achieve their goals.

Rational consumers and firms weigh the benefits and costs of each action and try to make the best decision possible.

Example: Apple doesn’t randomly choose the price of its iPhones; it chooses the price(s) that it thinks will be most profitable.

2. People Respond to Economic Incentives

As incentives change, so do the actions that people will take.

Example: In many states, convicted felons are required to submit DNA samples. DNA from new crimes is checked against the databased of submitted DNA, so repeat offenders are more likely to be caught.

The introduction of this process reduced repeat convictions by serious violent offenders by 17%. Even criminals respond to economic incentives.

Apply the Concept: How Could a Congressional Bill Backfire? (1 of 2)

Some firms pay their workers so little that the workers are still eligible for government assistance.

A 2018 Congressional bill proposed taxing firms an amount equal to the government assistance the workers received.

What would be the effect of such a law?

Apply the Concept: How Could a Congressional Bill Backfire? (2 of 2)

1. The effect might be as intended: the firms increase wages so the workers are no longer eligible for government assistance
2. But firms might instead avoid hiring those workers who are eligible for government assistance, hurting the people the law was designed to help.

3. Optimal Decisions Are Made at the Margin

While some decisions are all-or-nothing, most decisions involve doing a little more or a little less of something.

Example: Should you watch an extra hour of TV or study instead?

Economists think about decisions like this in terms of the marginal cost and benefit (MC and MB): the additional cost or benefit associated with a small amount extra of some action.

Analysis that involves comparing marginal benefits and marginal costs is called **marginal analysis**.

1.2 The Economic Problem That Every Society Must Solve

Discuss how an economy answers these questions: What goods and services will be produced? How will the goods and services be produced? Who will receive the goods and services produced?

In a world of scarcity, we have limited economic resources to satisfy our desires.

- Therefore we face trade-offs.

Trade-off: The idea that, because of scarcity, producing more of one good or service means producing less of another good or service.

1. What Goods and Services Will Be Produced?

Individuals, firms, and governments must decide on the goods and services that should be produced.

An increase in the production of one good requires the reduction in the production of some other good. This is a trade-off, resulting from the scarcity of productive resources.

The highest-valued alternative given up in order to engage in some activity is known as the **opportunity cost**.

Example: the opportunity cost of increased funding for space exploration might be giving up the opportunity to fund cancer research.

2. How Will the Goods and Services Be Produced?

A firm might have several different methods for producing its goods and services.

Example #1: A music producer can make a song sound good by

- **Hiring a great singer and using standard production techniques;**
- **Hiring a mediocre singer and using Auto-Tune to correct the inaccuracies.**

Example #2: As the cost of manufacturing labor changes, a firm might respond by

- **Changing its production technique to one that employs more machines and fewer workers**
- **Moving its factory to a location with cheaper labor**

3. Who Will Receive the Goods and Services Produced?

The way we are most familiar with in the United States is that people with higher incomes obtain more goods and services.

Changes in tax and welfare policies change the distribution of income, though people often disagree about the extent to which this “redistribution” is desirable.

Types of Economies

Centrally planned economy: An economy in which the government decides how economic resources will be allocated.

Market economy: An economy in which the decisions of households and firms interacting in markets allocate economic resources.

Mixed economy: An economy in which most economic decisions result from the interaction of buyers and sellers in markets but in which the government plays a significant role in the allocation of resources.

Which of these best describes the United States today?

Efficiency of Market Economies

Market economies tend to be more efficient than centrally-planned economies.

Market economies promote:

- **Productive efficiency**, a situation in which a good or service is produced at the lowest possible cost; and
- **Allocative efficiency**, a state of the economy in which production is in accordance with consumer preferences; in particular, every good or service is produced up to the point where the last unit provides a marginal benefit to society equal to the marginal cost of producing it.

Source of Economic Efficiency

Productive efficiency comes about because of competition.

Allocative efficiency arises due to voluntary exchange.

Voluntary exchange: A situation that occurs in markets when both the buyer and the seller of a product are made better off by the transaction.

- Each transaction that takes place improves the well-being of the buyer and seller; transactions continue until no further improvement can take place.

Caveats about Market Economies

Markets may not result in fully efficient outcomes. For example:

- People might not immediately do things in the most efficient way
- Governments might interfere with market outcomes
- Market outcomes might ignore the desires of people who are not involved in transactions – ex: pollution

Market Economies and Equity

Economically efficient outcomes are not necessarily desirable.

- Less efficient outcomes may be more fair or equitable.

Equity: The fair distribution of economic benefits.

An important trade-off for a government is that between efficiency and equity.

Example: If we tax income, people might work less or open fewer businesses, but those tax receipts can fund programs that aid the poor.