

SUMMARY OF SECTIONS 1-2

1. Positive versus Normative

Positive (Descriptive) Economics = What will happen in the economy under different circumstances.

Key Assumptions: **Selfishness** - Economic actors self-interested.
 Greed - All systematic profit opportunities in the economy are exploited.

Normative (Prescriptive) Economics = What should happen in the economy?

Questions here include –

How should competition be regulated? When should markets be allowed to allocate goods? What legal rules should be set in economies? What is the role of government?

2. Economic Efficiency

Efficiency Rule For Normative Economics - Choose outcomes to maximize efficiency.

Justification - By following this rule we will maximize the \$ value of income in a society, which the government through the democratic process can decide to allocate as it wishes.

The efficiency rule is what guides the general consensus among economists on the advantage of free trade, and the undesirability of market interventions such as minimum wages, rent controls, and the undesirability of both monopoly and unionization.

Note: You might not want to apply the efficiency criteria in making economic decisions in a dictatorship or oligarchy such as Syria, China, or Saudi Arabia. You should be able to explain why not.

a. Sufficient Conditions for Efficiency (if we meet either condition we are guaranteed efficiency. i. e. 1 or 2 => efficiency)

1. No further trades are possible that will make one or more people better off without hurting someone else.
2. We have maximized the dollar value of the goods produced in the economy. That is we have maximized all surplus (in \$) derived by consumers and producers in the economy.

b. Necessary Conditions for efficiency (we cannot be at an efficient outcome unless we meet this condition, but it does not guarantee efficiency. i. e. efficiency => 1 or 2)

1. Production is on the **Production Possibilities Frontier** – that is we cannot produce more of any good without producing less of some other good.
2. The **marginal benefit** (or **marginal value**) of each good to consumers (measured in \$) **equals the marginal cost** (mc) to society of producing the good (measured in \$). Where a good is sold to many consumers at one price the marginal value is just the price (p) of the good. Thus the rule then becomes

$$p = mc$$

This rule is the $e=mc^2$ of normative economics! We will frequently use this test to examine the functioning of the economy.

3. Equity

This is the appropriateness of the distribution across individuals of the output of the economy. It is decided by the political process.

4. Marginal Cost

Economic (Opportunity) Cost to society of producing the last unit of any good. The marginal cost of goods can vary dramatically according to demand conditions.

Example: Suppose a plane has 200 seats. If it has empty seats for a given flight then the marginal cost of adding another passenger is only the extra fuel cost + cost of meal. If the plane is full the marginal cost of adding another passenger (serving passenger 201) would be enormous, since we would have to schedule another flight and pay for the fuel, crew, depreciation.

If the plane is full the marginal cost of the last passenger served (#200) measured in opportunity cost terms is how much the person who valued the flight 201st would have paid for the seat. This means that in order to have efficiency ($p=mc$) the price of a seat when the plane is not full would have to be roughly 0, while when the plane is full it would vary but could be extremely high.