Lecture # 2 – Key Concepts in Economics

I. Key Concepts in Economics

- We began class today with a discussion of some of the most important concepts in economics. These are concepts that we will come back to throughout the year, as they are fundamental to the way economists think. I introduce them now to highlight their importance.
- Marginal analysis
    - Economists focus on things at the margin – that is, what is the benefit of the next good that is bought or sold.
    - Once you have purchased something, what matters is what you will do next. Can you make yourself any better?
    - Our goal is to maximize total net benefit: the value of the good minus the cost.
        - To do this, we focus on the marginal benefits and marginal costs.
            - If MB > MC, total benefit will increase. You should purchase.
            - If MC > MB, total benefit will decrease. Do not purchase.
            - The only time that total benefit will not rise or fall is when MB = MC.
                - This is where total net benefit is maximized.
- Sunk costs
    - <u>Sunk costs</u> are expenditures that have been made and cannot be recovered.
    - Following from marginal analysis, sunk costs should be ignored.
        - Since sunk costs cannot be changed, they should not influence decision-making.
- Opportunity costs
    - <u>Opportunity cost</u> is the value of the best alternative use of a resource.
        - It is the cost of forgone opportunities.
    - For MPA students, could have been working and earning a salary. The opportunity cost of going to Maxwell is tuition plus the salary you forgo by not working.
    - Opportunity costs are important to consider, but often ignored.
    - Opportunity costs relate to the key concept of scarcity. Once a resource has been used, it cannot be used for something else.

II. The Market Mechanism

- A <u>market</u> is the collection of buyers and sellers that, through their actions or potential interactions, determine the price of a product or set of products.
  - Markets can include more than one industry.
- We describe a market with supply and demand curves.
- Note that the supply and demand model discussed in class assumes perfect competition. Perfect competition includes four assumptions:
  1. Many buyers and sellers, so that price is taken as given
     - No one firm (e.g. Microsoft) can influence price.
  2. Firms sell identical products
     - It doesn't matter who you buy from.
  3. Perfect information
     - Everyone knows their options.
  4. No barriers to entry or exit
     - Anyone who wants to enter the market (or leave the market if they are losing money) can.
- Our discussion of health care markets will consider how well these assumptions hold for health care
- It is important to evaluate the assumptions for any market you are considering to think about whether perfect competition is a reasonable approximation of the market.