

Lecture 2: How Rational People Make Decision (Definition of Key Concepts)

1. **Marginal Analysis:** is the study of the effects of small changes relative to an existing situation or status quo.
2. **The Principle of Rational Behavior:** States that an economic decision maker should take any action from which there is a positive net benefit. A positive net benefit exists when the addition to benefit exceeds the addition to costs. That is , $MB > MC$.
3. **Marginal Utility (Benefit):** The satisfaction or benefit obtained from having one more unit of a given activity (action). For example, the satisfaction obtained from having the 3rd cup of coffee.
4. **The Law of Diminishing Marginal Utility (Benefit):** States that the marginal benefit (utility) of an activity declines as more of that activity is used. The activity could be either consumption or production.
5. **Opportunity Cost:** the foregone benefits of doing that activity instead of others. Or, whatever is given up to do a certain desirable activity.
6. **Marginal Cost:** is the addition to costs (disutilities) that results from taking (using) one more unit of an activity (action). Marginal costs are always opportunity costs.
7. **The Law of Increasing Costs:** As individuals attempt to indulge into more and more of a given activity, the opportunity cost of the additional unit of this activity expressed in terms of other foregone activities will increase. That is the marginal cost of an activity tend to increase.
8. **The Equi-Marginal Principle:** Stop acting when the marginal utility or benefit (i.e., the contribution of utility or benefit from the last unit of activity) comes as close to (without being less than) the marginal disutility or cost (i.e., the losses of utility following the last unit of acting). At equilibrium, or where utility is maximized, $MC = MB$.