The Principles of Economics

What Economics Is All About

- **Scarcity**: the limited nature of society's resources
- **Economics**: the study of how society manages its scarce resources, *e.g.*
  - how people decide what to buy, how much to work, save, and spend
  - how firms decide how much to produce, how many workers to hire
  - how society decides how to divide its resources between national defense, consumer goods, protecting the environment, and other needs

HOW PEOPLE MAKE DECISIONS

Principle #1: People Face Tradeoffs

All decisions involve tradeoffs. Examples:

- Going to a party the night before your midterm leaves less time for studying.
- Having more money to buy stuff requires working longer hours, which leaves less time for leisure.
- Protecting the environment requires resources that could otherwise be used to produce consumer goods.

HOW PEOPLE MAKE DECISIONS

Principle #1: People Face Tradeoffs

- Society faces an important tradeoff:
  efficiency vs. equality
- **Efficiency**: when society gets the most from its scarce resources
- **Equality**: when prosperity is distributed uniformly among society's members
- Tradeoff: To achieve greater equality, we could redistribute income from wealthy to poor. But this reduces incentive to work and produce, and shrinks the size of the economic "pie."

HOW PEOPLE MAKE DECISIONS

Principle #2: The Cost of Something Is What You Give Up to Get It

- Making decisions requires comparing the costs and benefits of alternative choices.
- The **opportunity cost** of any item is whatever must be given up to obtain it.
- It is the relevant cost for decision making.

HOW PEOPLE MAKE DECISIONS

Principle #2: The Cost of Something Is What You Give Up to Get It

Examples:

The opportunity cost of…

…going to college for a year is not just the tuition, books, and fees, but also the foregone wages.

…seeing a movie is not just the price of the ticket, but the value of the time you spend in the theater.

HOW PEOPLE MAKE DECISIONS

Principle #3: Rational People Think at the Margin

Rational people

- systematically and purposefully do the best they can to achieve their objectives.
- make decisions by evaluating costs and benefits of **marginal changes** – incremental adjustments to an existing plan.

HOW PEOPLE MAKE DECISIONS

Principle #3: Rational People Think at the Margin

Examples:

- When a student considers whether to go to college for an additional year, he compares the fees & foregone wages to the extra income he could earn with the extra year of education.
- When a manager considers whether to increase output, she compares the cost of the needed labor and materials to the extra revenue.

Principle #4: People Respond to Incentives

- **Incentive:** something that induces a person to act, *i.e.* the prospect of a reward or punishment.
- Rational people respond to incentives.

  Examples:
  - When gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUVs.
  - When cigarette taxes increase, teen smoking falls.

Example

You are selling your 1996 Mustang. You have already spent $1000 on repairs.

At the last minute, the transmission dies. You can pay $600 to have it repaired, or sell the car "as is."

In each of the following scenarios, should you have the transmission repaired? Explain.

A. Blue book value is $6500 if transmission works, $5700 if it doesn't
B. Blue book value is $6000 if transmission works, $5500 if it doesn't

Answers

Cost of fixing transmission = $600

A. Blue book value is $6500 if transmission works, $5700 if it doesn't

Benefit of fixing the transmission = $800 ($6500 – 5700).

It's worthwhile to have the transmission fixed.

B. Blue book value is $6000 if transmission works, $5500 if it doesn't

Benefit of fixing the transmission is only $500.

Paying $600 to fix transmission is not worthwhile.

Answers

Observations:

- The $1000 you previously spent on repairs is irrelevant. What matters is the cost and benefit of the *marginal* repair (the transmission).
- The change in incentives from scenario A to scenario B caused your decision to change.

HOW PEOPLE INTERACT

Principle #5: Trade Can Make Everyone Better Off

- Rather than being self-sufficient, people can specialize in producing one good or service and exchange it for other goods.
- Countries also benefit from trade & specialization:
  - Get a better price abroad for goods they produce
  - Buy other goods more cheaply from abroad than could be produced at home

HOW PEOPLE INTERACT

Principle #6: Markets Are Usually A Good Way to Organize Economic Activity

- **Market:** a group of buyers and sellers (need not be in a single location)
- "Organize economic activity" means determining
  - what goods to produce
  - how to produce them
  - how much of each to produce
  - who gets them

HOW PEOPLE INTERACT

Principle #6: Markets Are Usually A Good Way to Organize Economic Activity

- A **market economy** allocates resources through the decentralized decisions of many households and firms as they interact in markets.
- Famous insight by Adam Smith in *The Wealth of Nations* (1776):

  Each of these households and firms
  acts as if "led by **an invisible hand**"
  to promote general economic well-being.

HOW PEOPLE INTERACT

Principle #6: Markets Are Usually A Good Way to Organize Economic Activity

- The invisible hand works through the price system:
  - The interaction of buyers and sellers determines prices.
  - Each price reflects the good's value to buyers and the cost of producing the good.
  - Prices guide self-interested households and firms to make decisions that, in many cases, maximize society's economic well-being.

HOW PEOPLE INTERACT

Principle #7: Governments Can Sometimes Improve Market Outcomes

- Important role for govt: enforce property rights (with police, courts)
- People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.

HOW PEOPLE INTERACT

Principle #7: Governments Can Sometimes Improve Market Outcomes

- **Market failure:** when the market fails to allocate society's resources efficiently
- Causes:
  - **Externalities**, when the production or consumption of a good affects bystanders (*e.g.* pollution)
  - **Market power**, a single buyer or seller has substantial influence on market price (*e.g.* monopoly)
- In such cases, public policy may promote efficiency.

HOW PEOPLE INTERACT

Principle #7: Governments Can Sometimes Improve Market Outcomes

- Govt may alter market outcome to promote equity
- If the market's distribution of economic well-being is not desirable, tax or welfare policies can change how the economic "pie" is divided.

Principle #8: A country's standard of living depends on its ability to produce goods & services.

- Huge variation in living standards across countries and over time:
  - Average income in rich countries is more than ten times average income in poor countries.
  - The U.S. standard of living today is about eight times larger than 100 years ago.

HOW THE ECONOMY AS A WHOLE WORKS

Principle #8: A country's standard of living depends on its ability to produce goods & services.

- The most important determinant of living standards: **productivity**, the amount of goods and services produced per unit of labor.
- Productivity depends on the equipment, skills, and technology available to workers.
- Other factors (*e.g.*, labor unions, competition from abroad) have far less impact on living standards.

HOW THE ECONOMY AS A WHOLE WORKS

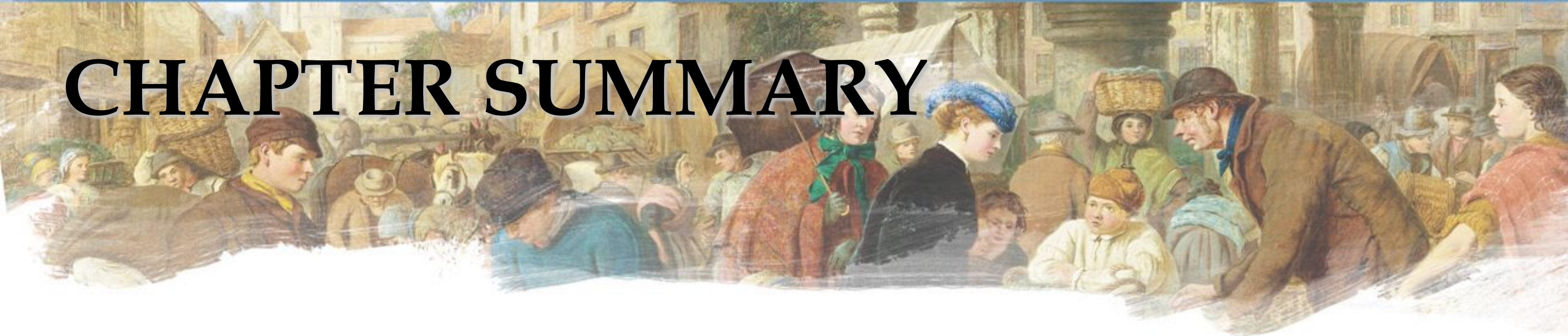
Principle #9: Prices rise when the government prints too much money.

- **Inflation**: increases in the general level of prices.
- The faster the govt creates money,
  the greater the inflation rate.

HOW THE ECONOMY AS A WHOLE WORKS

Principle #10: Society faces a short-run tradeoff between inflation and unemployment

- In the short-run (1 – 2 years),
  many economic policies push inflation and unemployment in opposite directions.
- Other factors can make this tradeoff more or less favorable, but the tradeoff is always present.



CHAPTER SUMMARY

The principles of the economy as a whole are:

- Productivity is the ultimate source of living standards.
- Money growth is the ultimate source of inflation.
- Society faces a short-run tradeoff between inflation and unemployment.