Ten Principles of Economics
In this chapter, look for the answers to these questions:

- What kinds of questions does economics address?
- What are the principles of how people make decisions?
- What are the principles of how people interact?
- What are the principles of how the economy as a whole works?
What economics is all about

- **Scarcity** refers to the limited nature of society’s resources – there’s just not enough of everything.
- **Economics** is the study of how society manages its scarce resources, e.g.
  - How do people decide how much to work or what to buy?
  - How do firms decide how much to produce, or how many workers to hire?
  - How does society decide how much of its resources to devote to national defense and how much to devote to consumer goods?
HOW PEOPLE MAKE DECISIONS

- Decision-making is at the heart of economics.
- The first four principles deal with 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 might otherwise be used to produce consumer goods.
Principle #1: People Face Tradeoffs

- An important tradeoff facing society: efficiency vs. equity

- **Efficiency**: getting the most out of scarce resources

- **Equity**: distributing prosperity fairly among society’s members

- The tradeoff: To increase equity, redistribute income from the rich to the poor. But this reduces the incentive to work hard, so people work less, produce fewer goods, generate less income.
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.
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. (Movies are very expensive for lawyers that earn $200/hour!!)
Principle #3: Rational People Think at the Margin

- A person is rational if she systematically and purposefully does the best she can to achieve her objectives.

- Many decisions are not “all or nothing,” but involve marginal changes – incremental adjustments to an existing plan.

- Evaluating the costs and benefits of marginal changes is an important part of decision-making.
Principle #3: Rational People Think at the Margin

Examples:

- A student considers whether to go to college for an additional year, comparing the fees & foregone wages to the extra income he could earn with an extra year of education.

- A firm considers whether to increase output, comparing the cost of the needed labor and materials to the extra revenue.
Principle #4: People Respond to Incentives

- An **incentive** is something that induces a person to act, such as the prospect of a reward or punishment.

- Rational people respond to incentives because they make decisions by comparing costs and benefits. Examples:
  - When the price of gas rises, sales of fuel-efficient vehicles increase.
  - An increase in the cigarette tax reduces teen smoking.
Quick Quiz 1

You are selling your 1995 Mustang. You have already spent $1000 on repairs. Blue book value if in good running condition = $6500

At the last minute, the transmission dies. Fixing it will cost $600. If you don’t fix it, blue book value = $5700.

1. Should you have the transmission fixed, or try to sell the car “as is”?

Now suppose a glut of used Mustangs comes on the market, driving the blue book value down to
   $6000 if in good running condition
   $5500 if you do not fix transmission

2. Should you fix the transmission?
Answers to Quick Quiz 1

1. Should you have the transmission fixed, or try to sell the car “as is”? To solve, find the marginal cost & benefit of having the transmission fixed:

• marginal cost = $600
• marginal benefit = $6500 – 5700 = $800.

The benefit outweighs the cost by $200, so you’re better off having the transmission fixed.
2. In this new scenario, should you have the transmission fixed?

Now, if you have the transmission fixed,

- marginal cost = $600
- marginal benefit = $6000 – 5500 = $500.

The cost outweighs the benefit by $100, so you’re better off putting the car on the market “as is.”

*Notice how the change in incentives from the first scenario to the second one affects your decision.*
An “economy” is just a group of people interacting with each other.

The next three principles deal with how people interact.
Principle #5: Trade Can Make Everyone Better Off

- Rather than being self-sufficient, people can specialize—produce one good or service and do it very well—and exchange it for other goods.

- Countries can benefit from trade:
  - Get a better price abroad for goods they produce
  - Buy other goods more cheaply from abroad than could be produced at home
Principle #6: Markets Are Usually A Good Way to Organize Economic Activity

- A market is a group of buyers and sellers. (They need not be in a single location.)

- “Organize economic activity” means to decide what goods to produce, how to produce them, how much of each to produce, and who gets them.

- In a market economy, these decisions result from the interactions of many households and firms.
Principle #6: Markets Are Usually A Good Way to Organize Economic Activity

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

- The invisible hand works through the price system:
  - The interaction of households and firms determines the prices of goods and services.
  - 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.
 Principle #7: Governments Can Sometimes Improve Market Outcomes

- One important role for govt is to enforce property rights (with police and a court system):
  - A farmer won’t grow food if he expects his crop to be stolen.
  - A restaurant won’t serve meals unless it is assured that customers will pay before they leave.
  - A music company won’t produce CDs if too many people avoid paying by making illegal copies.
Principle #7: Governments Can Sometimes Improve Market Outcomes

- Two broad reasons for a government to alter the market’s allocation of resources:
  1. To promote efficiency
  2. To promote equity
Principle #7: Governments Can Sometimes Improve Market Outcomes

1. Promoting efficiency:

- A market failure is when the market on its own fails to provide an efficient allocation of resources.

- Two sources of market failures:
  - externalities
  - market power
Principle #7: Governments Can Sometimes Improve Market Outcomes

Two sources of market failures

- **Externalities**: the impact of one person’s actions on the well-being of a bystander, e.g. a factory that generates pollution.

- **Market power**: when an individual buyer or seller has substantial influence on market price, e.g. a monopoly firm.
Principle #7: Governments Can Sometimes Improve Market Outcomes

2. Promoting equity:

- Sometimes, the market’s distribution of economic well-being is not optimal.

- In such cases, govt can change how the economic “pie” is divided with tax or welfare policies.
Discussion Questions

In each of the following situations, what is the government’s role? Does the government’s intervention improve the outcome?

a. Public schools for K-12
b. Workplace safety regulations
c. Public highways
d. Minimum wage laws
e. Patent laws which allow pharmaceutical companies to charge high prices for life-saving drugs.
The last three principles deal with the economy as a whole.
Principle #8: A country’s standard of living depends on its ability to produce goods & services.

- There is 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.
  - In the U.S., the standard of living today is about eight times as large as 100 years ago.
Principle #8: A country’s standard of living depends on its ability to produce goods & services.

- The most important determinant of living standards is **productivity** – the amount of goods and services produced from each hour of a worker’s time.

- In turn, 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.
Principle #9: Prices rise when the government prints too much money.

- “Inflation” means increases in the general level of prices.
- In the long run, the cause of inflation is almost always excessive growth in the quantity of money: The creation of large quantities of money causes the value of money to fall.
- The faster govt creates money, the greater the inflation rate.
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.
FYI: How to read your textbook

1. **Summarize, don’t highlight.**
   Highlighting is a passive activity that won’t improve your comprehension or retention. Instead, summarize each section in a few sentences of your own words. When you finish, compare your summary to the one at the end of the chapter.

2. **Test yourself.**
   Try the “QuickQuiz” that follows each section before moving on to the next section. Write your answers down, and compare them to the answers in the back of the book. If your answers are incorrect, review the section before moving on.
FYI: How to read your textbook

   Work through the end-of-chapter review questions and problems. They are often good practice for the exams. And the more you use your new knowledge, the more solid it will become.

4. Go online.
   The book comes with excellent web resources, including practice quizzes, tools to strengthen your graphing skills, helpful video clips, and other resources to help you learn the textbook material more easily and effectively.
FYI: How to read your textbook

5. **Study in groups.**
   Get together with a few of your classmates to review each chapter, quiz each other, and help each other understand the material in the chapter.

6. **Don’t forget the real world.**
   Read the Case Studies and In The News boxes in each chapter. They will help you see how the new terms, concepts, models, and graphs apply to the real world. As you read the newspaper or watch the evening news, see if you can find the connections with what you’re learning in the textbook.
Conclusion

- The field of economics offers many insights about the behavior of people, markets, and economies.
- It is based on a few ideas that can be applied in many situations.
- Whenever we refer back to one of the *Ten Principles* discussed in this chapter, you will see an icon like this one:
CHAPTER SUMMARY

The principles of decision-making are:

- People face tradeoffs
- The cost of any action is measured in terms of foregone opportunities.
- Rational people make decisions by comparing marginal costs and marginal benefits.
- People respond to incentives.
CHAPTER SUMMARY

- The principles of interactions among people are:
  - Trade can be mutually beneficial.
  - Markets are usually a good way of coordinating trade.
  - Govt can potentially improve market outcomes if there is a market failure or if the market outcome is inequitable.
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.