Ten Principles of Economics
Economy . . .

. . . The word *economy* comes from a Greek word for “one who manages a household.”
A household and an economy face many decisions:

- Who will work?
- What goods and how many of them should be produced?
- What resources should be used in production?
- At what price should the goods be sold?
TEN PRINCIPLES OF ECONOMICS

• Society and Scarce Resources:
  • The management of society’s resources is important because resources are scarce.
  • *Scarcity*... means that society has limited resources and therefore cannot produce all the goods and services people wish to have.
TEN PRINCIPLES OF ECONOMICS

*Economics* is the study of how society manages its scarce resources.
HOW PEOPLE MAKE DECISIONS

• People face trade-offs.

• The cost of something is what you give up to get it.

• Rational people think at the margin.

• People respond to incentives.
Principle #1: People Face Trade-offs.

- “There is no such thing as a free lunch!”
Principle #1: People Face Trade-offs.

• To get one thing, we usually have to give up another thing.
  • Guns v. butter
  • Food v. clothing
  • Leisure time v. work
  • Efficiency v. equity
Principle #1: People Face Trade-offs

- Efficiency v. Equity
  - *Efficiency* means society gets the most that it can from its scarce resources.
  - *Equity* means the benefits of those resources are distributed fairly among the members of society.

- Decisions require comparing costs and benefits of alternatives.
  - Whether to go to college or to work?
  - Whether to study or go out on a date?
  - Whether to go to class or sleep in?

- The *opportunity cost* of an item is what you give up to obtain that item.

• Basketball star LeBron James understands opportunity costs and incentives. He chose to skip college and go straight from high school to the pros where he earns millions of dollars.
Principle #3: Rational People Think at the Margin.

- *Marginal changes* are small, incremental adjustments to an existing plan of action.

People make decisions by comparing costs and benefits at the margin.
Principle #4: People Respond to Incentives.

• Marginal changes in costs or benefits motivate people to respond.

• The decision to choose one alternative over another occurs when that alternative’s marginal benefits exceed its marginal costs!
HOW PEOPLE INTERACT

• Trade can make everyone better off.
• Markets are usually a good way to organize economic activity.
• Governments can sometimes improve economic outcomes.

- People gain from their ability to trade with one another.
- Competition results in gains from trading.
- Trade allows people to specialize in what they do best.
Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- A *market economy* is an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.
  - Households decide what to buy and who to work for.
  - Firms decide who to hire and what to produce.
Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

• Adam Smith made the observation that households and firms interacting in markets act as if guided by an “invisible hand.”
  • Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social costs of their actions.
  • As a result, prices guide decision makers to reach outcomes that tend to maximize the welfare of society as a whole.
Principle #7: Governments Can Sometimes Improve Market Outcomes.

• Markets work only if property rights are enforced.
  • *Property rights* are the ability of an individual to own and exercise control over a scarce resource

• *Market failure* occurs when the market fails to allocate resources efficiently.

• When the market fails (breaks down) government can intervene to promote efficiency and equity.
Principle #7: Governments Can Sometimes Improve Market Outcomes.

- Market failure may be caused by:
  - an *externality*, which is the impact of one person or firm’s actions on the well-being of a bystander.
  - *market power*, which is the ability of a single person or firm to unduly influence market prices.
HOW THE ECONOMY AS A WHOLE WORKS

• A country’s standard of living depends on its ability to produce goods and services.
• Prices rise when the government prints too much money.
• Society faces a short-run trade-off between inflation and unemployment.

- Standard of living may be measured in different ways:
  - By comparing personal incomes.
  - By comparing the total market value of a nation’s production.

• Almost all variations in living standards are explained by differences in countries’ productivities.

• *Productivity* is the amount of goods and services produced from each hour of a worker’s time.

• Standard of living may be measured in different ways:
  • By comparing personal incomes.
  • By comparing the total market value of a nation’s production.
Principle #9: Prices Rise When the Government Prints Too Much Money.

• *Inflation* is an increase in the overall level of prices in the economy.
• One cause of inflation is the growth in the quantity of money.
• When the government creates large quantities of money, the value of the money falls.

- The Phillips Curve illustrates the trade-off between inflation and unemployment:
  - Inflation or Unemployment
    - It’s a short-run trade-off!
  - The trade-off plays a key role in the analysis of the business cycle—fluctuations in economic activity, such as employment and production
• The principles of personal decision making are:
  – People face trade-offs.
  – The cost of something is what you give up to get it.
  – Rational people think at the margin.
  – People respond to incentives.
Summary

• The principles of economic interaction are:
  – Trade can make everyone better off.
  – Markets are usually a good way to organize economic activity.
  – Governments can sometimes improve market outcomes.
The principles of the economy as a whole are:

– A country’s standard of living depends on its ability to produce goods and services.
– Prices rise when the government prints too much money.
– Society faces a short-run trade-off between inflation and unemployment.