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Ten Principles of Economics

PRINCIPLES OF

MICROECONOMICS

FOURTH EDITION

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PowerPoint® Slides

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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?

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What Economics Is All About

▪ **Scarcity** refers to the limited nature of society's resources.

▪ **Economics** is the study of how society manages its scarce resources, including

• how people decide how much to work, save, and spend, and what to buy

• 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

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## HOW PEOPLE MAKE DECISIONS

- Decision making is at the heart of economics.
- The first four principles deal with how people make decisions.



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## 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.

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## HOW PEOPLE MAKE DECISIONS

### Principle #1: People Face Tradeoffs

- Society faces an important tradeoff:  
**efficiency vs. equity**
- efficiency**: getting the most out of scarce resources
- equity**: distributing prosperity fairly among society's members
- Tradeoff: To increase equity, can redistribute income from the well-off to the poor.  
But this reduces the incentive to work and produce, and shrinks the size of the economic "pie."

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## 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.

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## 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.

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## HOW PEOPLE MAKE DECISIONS

### 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.

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## HOW PEOPLE MAKE DECISIONS

### 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.

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## HOW PEOPLE MAKE DECISIONS

### 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 because they make decisions by comparing costs and benefits.

Examples:

- In response to higher gas prices, sales of "hybrid" cars (e.g., Toyota Prius) rise.
- In response to higher cigarette taxes, teen smoking falls.

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### ACTIVE LEARNING 1: Exercise

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?

- 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

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### ACTIVE LEARNING 1: 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.

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### ACTIVE LEARNING 1: 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.

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### HOW PEOPLE INTERACT

- An "economy" is just a group of people interacting with each other.
- The next three principles deal with how people interact.



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## 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

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## HOW PEOPLE INTERACT

### 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 determining
  - what goods to produce
  - how to produce them
  - how much of each to produce
  - who gets them

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## HOW PEOPLE INTERACT

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

- In a market economy, these decisions result from the interactions of many households and firms.
- 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.

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## 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 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.

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## 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.
  - A restaurant won't serve meals if customers do not pay before they leave.
  - A music company won't produce CDs if too many people avoid paying by making illegal copies.

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## HOW PEOPLE INTERACT

### Principle #7: Governments Can Sometimes Improve Market Outcomes

- Govt may alter market outcome to promote efficiency
- **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 increase efficiency.

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## 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.

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### ACTIVE LEARNING 2: Discussion Questions

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

- Public schools for K-12
- Workplace safety regulations
- Public highways
- Patent laws, which allow drug companies to charge high prices for life-saving drugs

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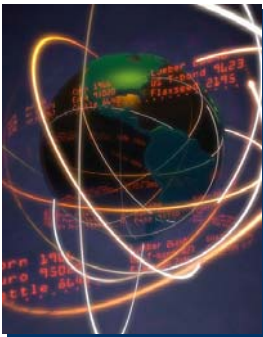
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## HOW THE ECONOMY AS A WHOLE WORKS



- The last three principles deal with the economy as a whole.

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## HOW THE ECONOMY AS A WHOLE WORKS

**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.

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## 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.

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## 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.
- In the long run, inflation is almost always caused by excessive growth in the quantity of money, which causes the value of money to fall.
- The faster the govt creates money, the greater the inflation rate.

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## 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.

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## 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.

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## FYI: How to Read Your Textbook

### 3. Practice, practice, practice.

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.

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### 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.

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### CONCLUSION

- 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** from this chapter, you will see an icon like this one:



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### 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.

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## 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.

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## 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.

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