

CHAPTER 1 : 10 PRINCIPLES OF ECON

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10 PRINCIPLES OF ECONOMICS

Introductory Remarks

- Economy – Greek for “one who manages a household”
- Household faces many decisions – must allocate its scarce resources
- Society faces many decisions
- Management of society’s resources is important because resources are scarce

Scarcity: Limited nature of society’s resources : land, labour, capital.

Scarce resources have alternative uses.

- **Economics:** Study of how society manages its scarce resources. Issues studied in economics include:

1. How people make decisions.
2. How people interact with one another.
3. How economy as a whole works.

HOW PEOPLE MAKE DECISIONS

Principle #1: People Face Tradeoffs

- All decisions involve tradeoffs
 - “there is no such a thing as a free lunch”
- Getting one thing entails giving up something.
- Examples of tradeoff:
- “guns and butter” tradeoff

- Clean environment vs. high level of income
- Efficiency vs. equity
- **Efficiency**: getting the most out of scarce resources
- **Equity**: distributing economic prosperity fairly among society's members
- Increasing equity by redistributing income from the rich to the poor reduces the incentive to work and produce and shrinks the size of the economic "pie"

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.
- Opportunity cost: whatever must be given up to obtain an item.
- Opportunity cost is the relevant cost for decision making
- **Examples:**
 1. Going to college
 2. Going to a movie

Principle #3: Rational People Think at the Margin

- Economists assume that people are **rational**
- **rational people** systematically and purposefully do their best to achieve their objectives given the opportunities they have.
- Many decisions are not "all or nothing," but involve **marginal changes**
- **Marginal changes** – small incremental adjustments to an existing plan.
- Evaluating the costs and benefits of marginal changes is an important part of decision making.
- Rational people make decisions by comparing **marginal benefits** and **marginal costs**
- A rational decision maker take an action if and only if the marginal benefit exceeds the marginal cost

benefit exceeds the marginal cost.

- Optimality occurs where:

Marginal benefit = marginal cost

Principle #4: People Respond to Incentives

- **Incentive:** something that induces a person to act, i.e. prospect of a reward or punishment.
- Because rational people make decisions by comparing costs and benefits, they respond to incentives.
- Incentives are crucial to analyzing how markets work; they play a central role in the allocation of scarce resources
- Policy makers must always consider how their policies affect incentives
- Examples:
 - Effect of higher gas prices
 - Effect of higher cigarette taxes
 - Insurance

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 benefit from trade:
 - better price abroad for their goods
 - buy other goods more cheaply from abroad than could be produced at home

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

- A **market** is 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
- In a market economy, these decisions result from the interactions of many households and firms.
- Insight by Adam Smith (1776): households and firms interacting in markets act as if they are guided by an **invisible hand** that leads them to desirable market outcomes - to promote general economic well-being.
- The invisible hand works through prices:
 - 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 households and firms to make decisions that, in many cases, maximize society's economic well-being.

Principle #7: Governments can sometimes improve market outcomes

- Important role for govt: enforce **property rights** - with police, courts
- **Property right**: Individual's ability to own and exercise control over scarce resources
- People are less inclined to work, produce, invest, or purchase if they risk their property being stolen.
- Govt may alter market outcome to promote efficiency
- **market failure**: market fails to allocate society's resources efficiently.
- **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.
- Govt may alter market outcome to promote equity

- 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.

Two broad reasons for government intervention: to promote efficiency; to promote equity

HOW THE ECONOMY WORKS

Principle #8: A country's standard of living depends on its productivity

- There are large differences in living standards around the world
- Changes in living standards over time have also been large
- Primary determinant of living standards is **productivity**
- **Productivity**: amount of goods and services produced per unit of labor
- Incomes are higher if the country's productivity is higher, because of more income
- 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**: 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 government creates money, the greater the inflation rate.

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

- In the short-run, 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.