Chapter 1: The Ten Principles of Economics

Choices, choices, choices

You face many decisions
• How will you use your scarce resources (time, money)?

A household faces many decisions
• How does the household allocate its scarce resources?

A society faces many decisions
• How to allocate its scarce resources.

*The management of society’s resources is important because resources are scarce.*

Scarcity

*SCARCITY*: a condition in which the resources available are insufficient to satisfy people’s wants.

⇒ Means that society has limited resources and therefore cannot produce all the goods and services people wish to have.

• This is true of the rich and the poor.
• This is true of all societies at all times, everywhere!

*Faced with scarcity, we must choose among the available alternatives.*
**ECONOMICS** is the science of choice.

The study of

- how society manages its scarce resources.
- the *choices* people make to cope with *scarcity*.

**What do economists do?**

- Study how people make decisions
- Study how people interact with one another
- Analyze forces and trends that affect the economy as a whole

*The management of society’s resources is important because resources are scarce.*

**Big economic questions**

Faced with limited resources we face choices concerning the goods and services our economy will produce.

1. *What* and *how much* will be produced?
2. *How* will the goods and services be produced?
3. *Where* will the goods and services be produced?
4. *When* will the goods and services be produced?
5. *Who* will consume the goods and services?
Ten Principles of Economics

- Several central ideas in economics that define the economic way of thinking.
- These “big ideas” recur throughout the course and all other economics courses you may take.

How People Make Decisions

1. People face tradeoffs

A choice is a tradeoff.

Making decisions involves trading one goal for another.

Examples
- a student trying to decide how to allocate her most valuable resource – her time.
- parents trying to decide how to spend family income.
- society deciding between production of “guns” or “butter”
- society deciding between clean environment versus high level of income.

Making decisions requires comparing the costs and benefits or alternative courses of action.

Example
- Consider the decision whether to go to college.
2. *The cost of something is what you give up to get it*

Important concept: *OPPORTUNITY COST*

The *opportunity cost* of an item is what you give up to get that item --- the highest-valued alternative we give up to get something.

**Example**
Should a college-age athlete drop out and play professionally?

3. *Rational people think at the margins*

We make choices in small steps --- *at the margin* --- and these choices are influenced by incentives.

Margin means edge ⇒ marginal changes are adjustments around the edges of what you are doing.

**Examples**
- When it is time for dinner the decision you face is not between fasting and eating like a pig!
- When exams come around you don’t choose between blowing them off or studying 24 hours a day
- Consider trying to decide how many years to stay in school. You don’t compare the lifestyle of a grade school drop-out to a person with a Ph.D.
Important tool: MARGINAL ANALYSIS

**Marginal benefit** = benefit of consuming one more unit of a good or service

**Marginal cost** = the opportunity cost of producing one more unit of a good or service

**Example**
- Airline deciding how much to charge passengers who fly standby.

A rational decision-maker takes an action if and only the marginal benefit of the action exceeds the marginal cost.

Because people make decisions by comparing costs and benefits, their behavior may change when the costs or benefits change.

4. **People respond to incentives**

Examples:

- Should you add an extra hour to your part-time work schedule? What happens if your wage changes?

- A tax on gas encourages people to drive smaller, more fuel-efficient cars. It also encourages people to take public transportation and to live closer to where they work.

*If a policy changes incentives, it will cause people to alter their behavior.*
How People Interact

5. *Trade can make everyone better off*

Voluntary exchange makes both buyers and sellers better off.

6. *Markets are usually a good way to organize economic activity*

**Question**: How is this exchange best organized?

We will see that markets are an *EFFICIENT* way to organize exchange.

*EFFICIENCY* means that society is getting the most it can from its scarce resources.

**Question**: Why are markets an efficient way to organize exchange?

They send resources to the place where they are valued most highly.

**Question**: How do markets work?

Firms and households interact in the marketplace where *prices* and *self-interest* guide their decisions.

**Most famous observation in all of economics**:

Adam Smith in his 1776 book *An Inquiry into the Nature and Causes of the Wealth of Nations*

*Households and firms interacting as if they are guided by an "invisible hand" that leads them to desirable market outcomes.*

Goal of course is to understand how this invisible hand works it's magic.
We will learn the important role played by prices.

Households and firms look at prices when deciding what to buy and sell.

Prices reflect:
The value of a good to society
The cost to society of making the good

⇒ Households and firms (unknowingly) take into account the social benefits and costs of their actions when deciding what to buy and sell.

Prices guide individual decision-makers to reach outcomes that, in many cases, are efficient ---maximize the well-being of society as a whole.

Corollary:

When the government prevents prices from adjusting naturally to supply and demand, it impedes the invisible hand's ability to coordinate the millions of households and firms that make up the economy.

Explains why:

Taxes adversely affect allocation of resources (they distort prices)
Rent control adversely affect allocation of resources (control prices)

7. **Governments can sometimes improve market outcomes**

The rule that markets are usually a good way to organize economic activity has some important exceptions.

Two broad reasons why government may intervene in the economy:

(1) To promote **efficiency** (to enlarge the economic pie)
(2) To promote **equity** (to change how the pie is divided)
**Market failure.** A situation in which a market left on its own fails to allocate resources efficiently.

- Is it a market failure that the price of oil is high?
- Is it a market failure that high-school dropouts have low wages?
- Is it a market failure that rents are high in Manhattan?

No. This is simply the market doing its job to allocate scarce resources efficiently.

**Market power.** The ability to influence the market, and in particular the market price, by influencing the total quantity offered for sale.

**Example**

Suppose everyone in town needs water but there is only one well. The owner of the well has market power.

Market failure can also arise when producers (or consumers) don’t take into account the costs they impose on other people.

**Externality.** The impact of one person’s actions on the well-being of a bystander.

**Examples**

- Pollution that results from production of some goods.
- Cigar smoke.
Governments can improve on market outcomes in the presence of market failures.

Invisible hand (market system) does not ensure that economic prosperity is distributed fairly.

Remember: The market system rewards people according to their ability to *produce things that people are willing to pay for!*

Just because government can improve on market outcomes does not mean that it always will! (Public policy is made by a political process which is far from perfect.)

*How The Economy As A Whole Works*

8. A country’s living standards depends on its ability to produce goods and services

Living standards improve when production per person increases.

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

We can improve our living standards if productivity increases.

Examples:
- we adopt a technology that increases output per worker
- we train workers so that they can produce more.

**Implication for public policy** – we should consider how policies effect productivity if we are concerned with boosting living standards.
9. *Prices rise when the government prints too much money*

Prices rise in a process called inflation when the quantity of money increases faster than production.

**Inflation** – an increase in the overall level of prices in the economy

What causes inflation?
Too much money chasing too few goods.

10. *Society faces a short-run tradeoff between inflation and unemployment*