PowerPoint® Lecture Presentation

Principles of Economics, Fourth Edition

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Ten Principles of Economics

Economy. . .

. . . The word *economy* comes from a Greek word for "one who manages a household."

TEN PRINCIPLES OF ECONOMICS

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

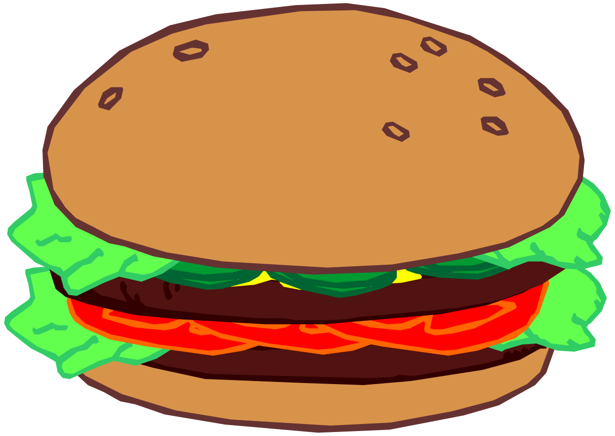
Economics is the study of how society manages its scarce resources.

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.

Principle #2: The Cost of Something Is What You Give Up to Get It.

- 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.

Principle #2: The Cost of Something Is What You Give Up to Get It.

- 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.

Principle #5: Trade Can Make Everyone Better Off.

- 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.