



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.”



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.

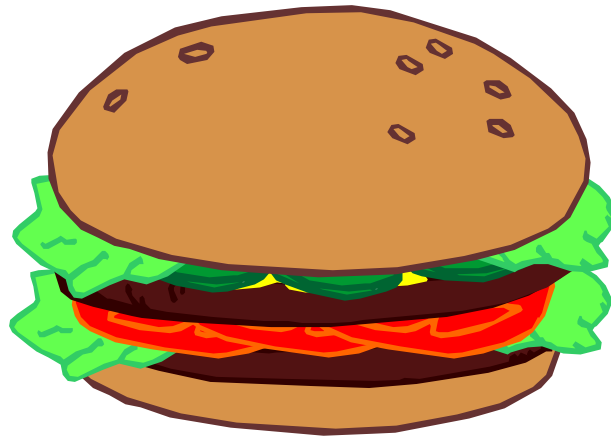


HOW PEOPLE MAKE DECISIONS

- 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: People Face Trade-offs.

- “There is no such thing as a free lunch!”



Principle: 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: 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: 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: 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: 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: 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: 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: 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: 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: 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: 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.

Thinking Like an Economist

Every field of study has its own terminology

- Mathematics

- integrals ❖ axioms ❖ vector spaces

- Psychology

- ego ❖ id ❖ cognitive dissonance

- Law

- promissory ❖ estoppel ❖ torts ❖ venues

- Economics

- supply ❖ opportunity cost ❖ elasticity ❖ consumer surplus ❖ demand ❖ comparative advantage ❖ deadweight loss

Thinking Like an Economist

Economics trains you to. . . .

- Think in terms of alternatives.
- Evaluate the cost of individual and social choices.
- Examine and understand how certain events and issues are related.

THE ECONOMIST AS A SCIENTIST

The economic way of thinking . . .

- Involves thinking analytically and objectively.
- Makes use of the scientific method.
- Uses abstract models to help explain how a complex, real world operates.
- Develops theories, collects and analyzes data to evaluate the theories.

The Scientific Method: Observation, Theory, and More Observation

- Uses abstract models to help explain how a complex, real world operates.
- Develops theories, collects and analyzes data to evaluate the theories.

The Role of Assumptions

- Economists make assumptions in order to make the world easier to understand.
- The art in scientific thinking is deciding which assumptions to make.
- Economists use different assumptions to answer different questions.

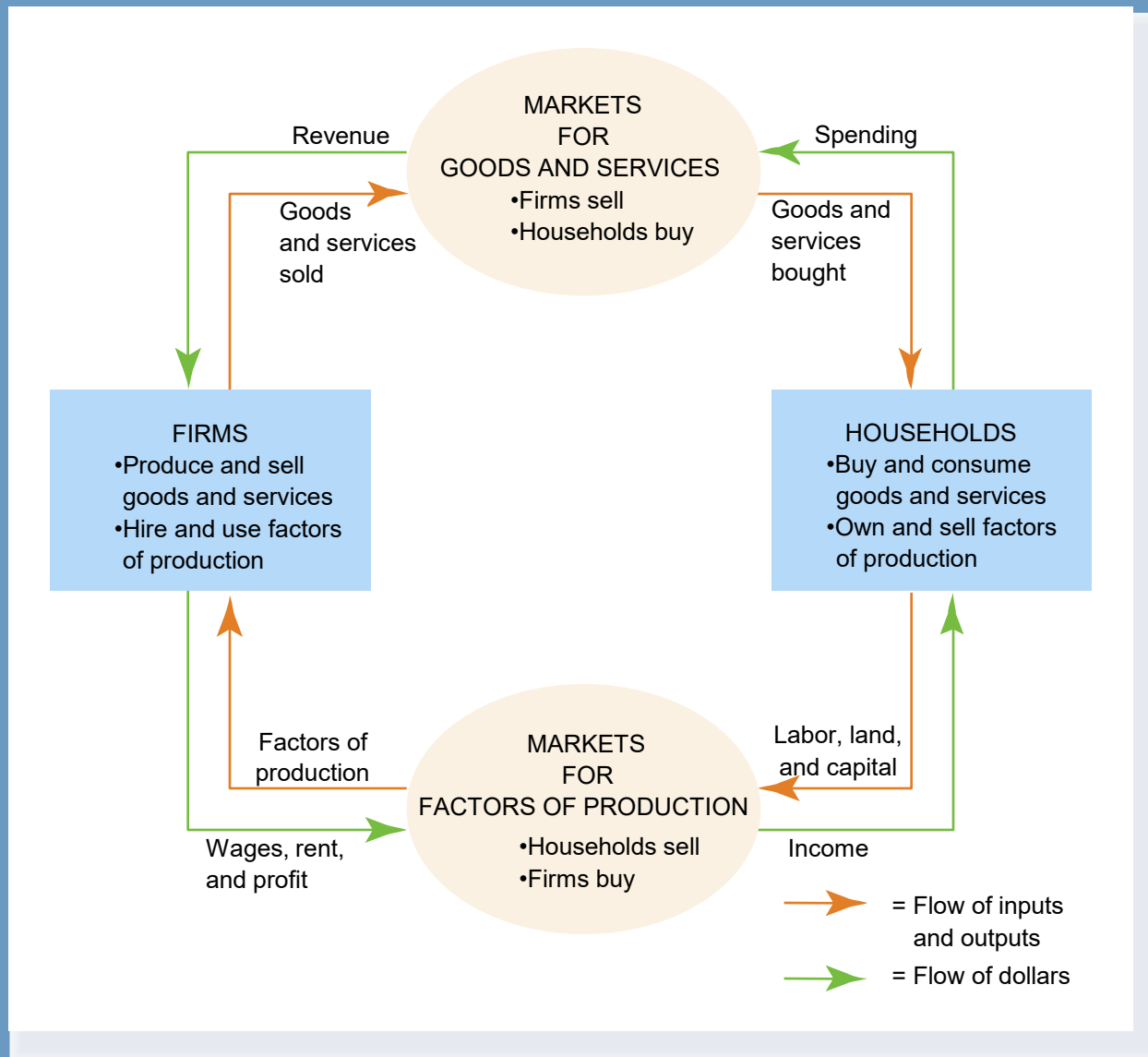
Economic Models

- Economists use models to simplify reality in order to improve our understanding of the world.
- Two of the most basic economic models are:
 - The Circular Flow Diagram
 - The Production Possibilities Frontier

Our First Model: The Circular-Flow Diagram

- The *circular-flow diagram* is a visual model of the economy that shows how dollars flow through markets among households and firms.

Figure 1 The Circular Flow



Our First Model: The Circular-Flow Diagram

- Firms
 - Produce and sell goods and services
 - Hire and use factors of production
- Households
 - Buy and consume goods and services
 - Own and sell factors of production

Our First Model: The Circular-Flow Diagram

- Markets for Goods and Services
 - Firms sell
 - Households buy
- Markets for Factors of Production
 - Households sell
 - Firms buy

Our First Model: The Circular-Flow Diagram

- Factors of Production
 - Inputs used to produce goods and services
 - Land, labor, and capital

Our Second Model: The Production Possibilities Frontier

- The *production possibilities frontier* is a graph that shows the combinations of output that the economy can possibly produce given the available factors of production and the available production technology.

Figure 2 The Production Possibilities Frontier

Quantity of
Computers
Produced

3,000

2,200

2,000

1,000

0

300

600

700

1,000

Quantity of
Cars Produced

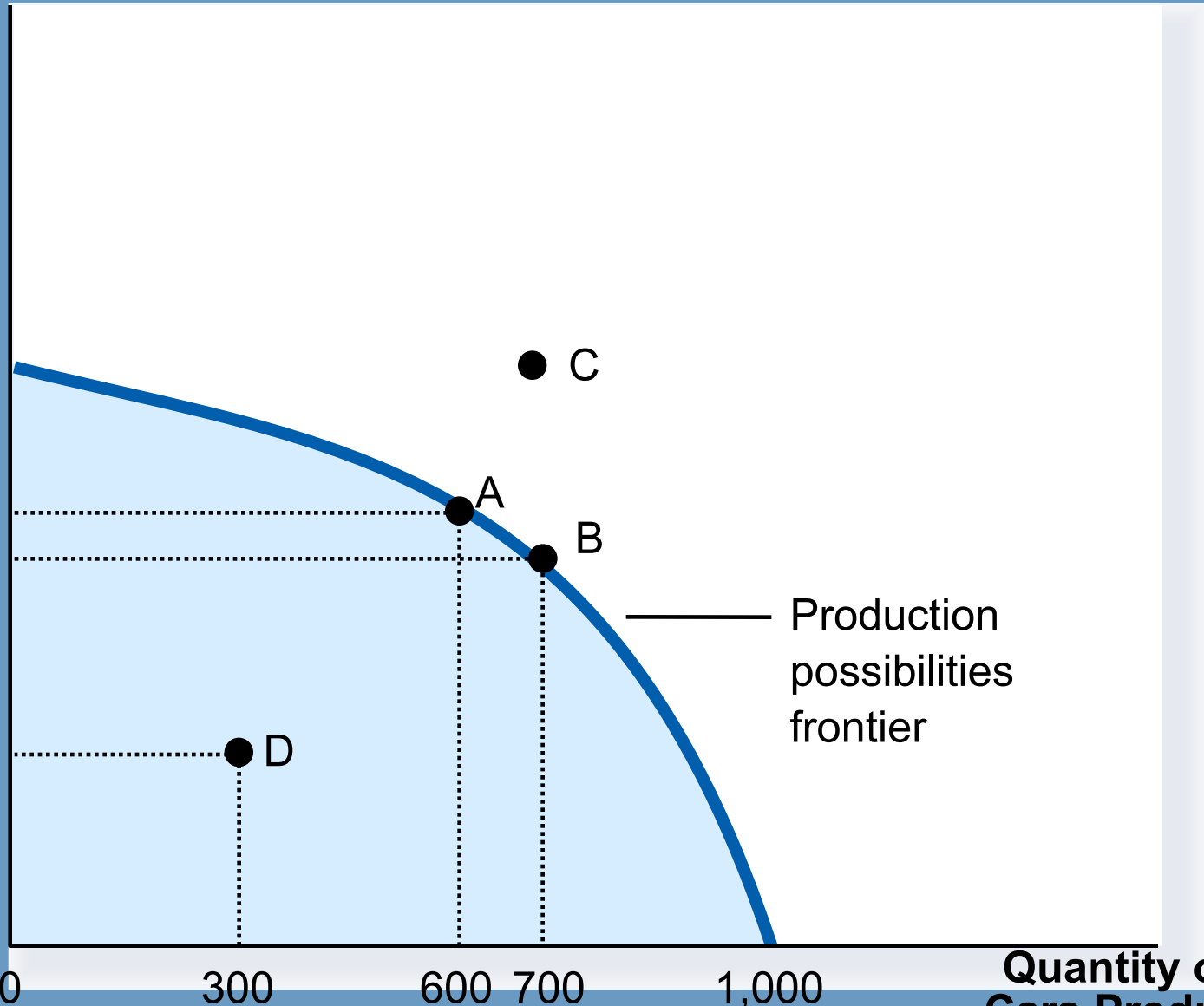
C

A

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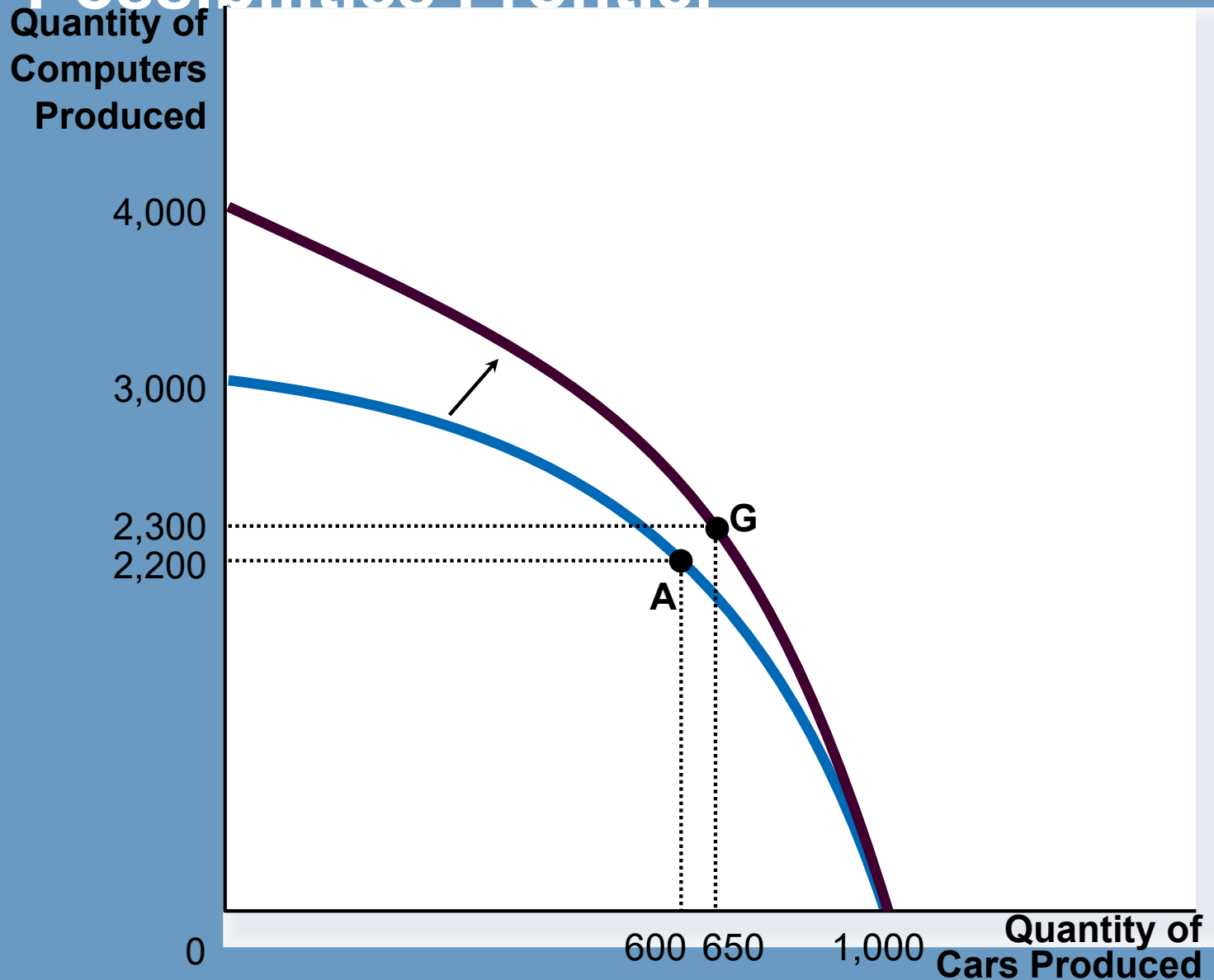
Production
possibilities
frontier



Our Second Model: The Production Possibilities Frontier

- Concepts illustrated by the production possibilities frontier
 - Efficiency
 - Trade-offs
 - Opportunity cost
 - Economic growth

Figure 3 A Shift in the Production Possibilities Frontier



Microeconomics and Macroeconomics

- *Microeconomics* focuses on the individual parts of the economy.
 - How households and firms make decisions and how they interact in specific markets
- *Macroeconomics* looks at the economy as a whole.
 - Economy-wide phenomena, including inflation, unemployment, and economic growth

THE ECONOMIST AS POLICY ADVISOR

- When economists are trying to explain the world, they are scientists.
- When economists are trying to change the world, they are policy advisors.

Positive versus Normative Analysis

- *Positive statements* are statements that attempt to describe the world as it is.
 - Called descriptive analysis
- *Normative statements* are statements about how the world should be.
 - Called prescriptive analysis

Positive Versus Normative Analysis

• Are the following positive or normative statements?

?

- An increase in the minimum wage will cause a decrease in employment among the least-skilled.

- **POSITIVE**

- Higher federal budget deficits will cause interest rates to increase.

- **POSITIVE**

?

?

Positive Versus Normative Analysis

- Are the following positive or normative statements?



- The income gains from a higher minimum wage are worth more than any slight reductions in employment.



- **NORMATIVE**

- State governments should be allowed to collect from tobacco companies the costs of treating smoking-related illnesses among the poor.

- **NORMATIVE**



WHY ECONOMISTS DISAGREE

- They may disagree about the validity of alternative positive theories about how the world works.
- They may have different values and, therefore, different normative views about what policy should try to accomplish.

SUMMARY

- Economists try to address their subjects with a scientist's objectivity.
 - They make appropriate assumptions and build simplified models in order to understand the world around them.
 - Two simple economic models are the circular-flow diagram and the production possibilities frontier.

SUMMARY

- Economics is divided into two subfields:
 - Microeconomics is the study of decision-making by households and firms in the marketplace.
 - Macroeconomics is the study of the forces and trends that affect the economy as a whole.

SUMMARY

A positive statement is an assertion about how the world is.

- A normative statement is an assertion about how the world ought to be.
- When economists make normative statements, they are acting more as policy advisors than scientists.

SUMMARY

- Economists who advise policymakers offer conflicting advice either because of differences in scientific judgments or because of differences in values.
- At other times, economists are united in the advice they offer, but policymakers may choose to ignore it.