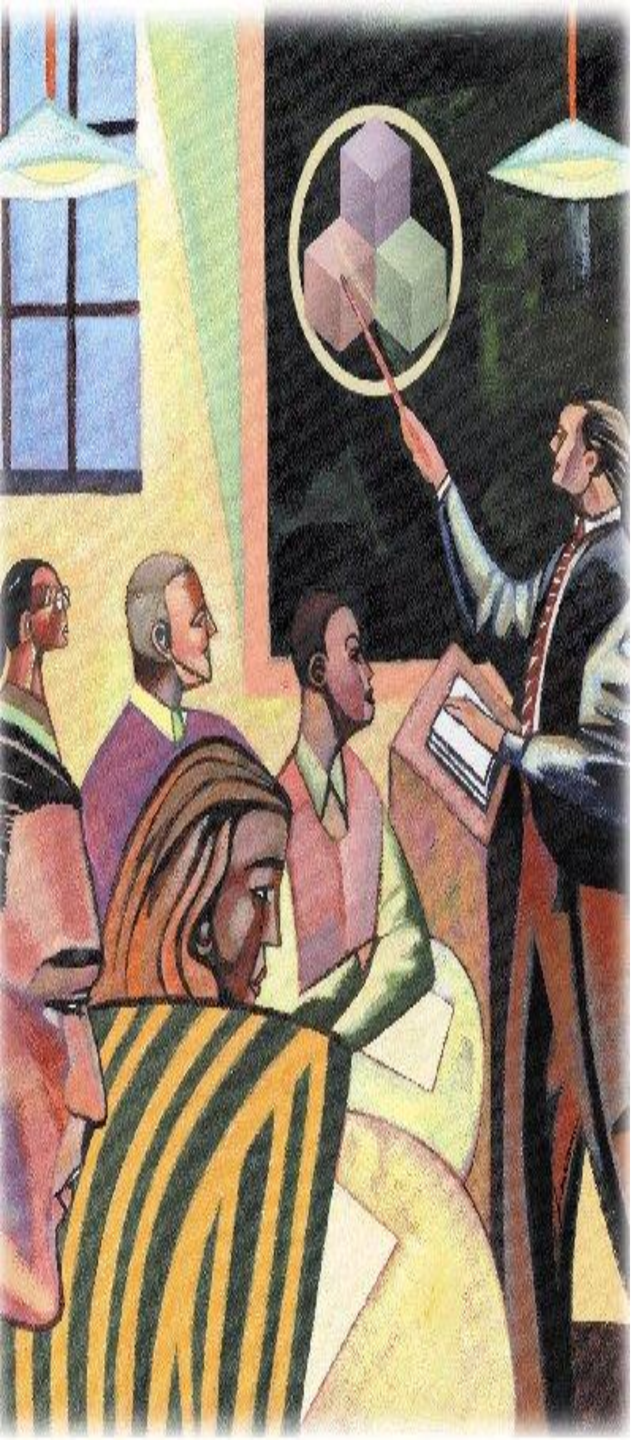

Ten Principles of Economics

Economy. . .

. . . The word economy comes from a Greek word ‘Oikonomos’ for “one who manages a household.”

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?**

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.

Economics

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

Economists seek to understand how well the market economy works, and to identify where governments may need to intervene to correct specific aspects of market failure.

Economists study. . .

- *How people make decisions.*
- *How people interact with each other.*
- *The forces and trends that affect the economy as a whole.*

Ten Principles of Economics

How People Make Decisions

1. People face tradeoffs.
2. The cost of something is what you give up to get it.
3. Rational people think at the margin.
4. People respond to incentives.

Ten Principles of Economics

How People Interact

5. Trade can make everyone better off.
6. Markets are usually a good way to organize economic activity.
7. Governments can sometimes improve economic outcomes.

Ten Principles of Economics

How the Economy as a Whole Works

8. The standard of living depends on a country's production.
9. Prices rise when the government prints too much money.
10. Society faces a short-run tradeoff between inflation and unemployment.

1. People face tradeoffs.

"There is no such thing as a free lunch!"

1. People face tradeoffs.

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

Making decisions requires trading off one goal against another.

1. People face tradeoffs.

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.

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?**

2. The cost of something is what you give up to get it.

The **opportunity cost** of an item is what you give up to obtain that item.

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*.

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!**

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.

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

- **Market economy: an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.**

- **In a <u>market economy</u>, households decide what to buy and who to work for.**
- **Firms decide who to hire and what to produce.**
- **Prices and self-interest guide their decisions.**

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.

7. Governments can sometimes improve market outcomes.

Need of Govt: Property Rights: the ability of an individual to own and exercise control over scarce resources

- **Secondly:**
- **When the market fails (breaks down) government can intervene to promote efficiency and equity.**
- **Market failure occurs when the market fails to allocate resources efficiently.**

Market failure may be caused by an <u>externality</u>, which is the impact of one person or firm's actions on the well-being of a bystander.

Market failure may also be caused by <u>market power</u>, which is the ability of a single person or firm to unduly influence market prices.

8. The standard of living depends on a country's production..

Standard of living may be measured in different ways:

- By comparing personal incomes.
- By comparing the total market value of a nation's production.

Almost all variations in living standards are explained by differences in countries' <u>productivities</u>.

<u>Productivity</u> is the amount of goods and services produced from each hour of a worker's time.

Higher productivity ⇒ Higher standard of living

9. Prices rise when the government prints too much money.

Inflation is an increase in the overall level of prices in the economy.

- One cause of inflation is the growth in the quantity of money.(Germany 1920-1922; USA 1970s)
- When the government creates large quantities of money, the value of the money falls.

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

The <u>Phillips Curve</u> illustrates the tradeoff between inflation and unemployment:

⇩Inflation ⇨ ⇧Unemployment

<u>It's a short-run tradeoff!</u>

Summary

- **When individuals make decisions, they face tradeoffs.**
- **Rational people make decisions by comparing marginal costs and marginal benefits.**

Summary

- **People can benefit by trading with each other.**
- **Markets are usually a good way of coordinating trades.**
- **Government can potentially improve market outcomes.**

Summary

- A country's productivity determines its living standards.
- Society faces a short-run tradeoff between inflation and unemployment.