Chapter 01 Ten Principles of Economics

- Scarcity
  - The limited nature of society's resources.
- Economics
  - The study of how society manages its scarce resources.

1.1 How People Make Decisions

Principle 1: People Face Trade-offs

There ain't no such thing as a free lunch.

1. Making Decisions Requires *Trading off One Goal against Another*.

- Guns (defense) v. butter (consumer goods)
- A clean environment v. a high level of income
- Efficiency v. equality
  - Efficiency
    - ◇ The property of society getting the most it can from its scarce resources
    - ◇ The size of the economic pie
  - Equality
    - ◇ The property of distributing economic prosperity uniformly among the members of society
    - ◇ How the pie is divided into individual slices
  - When the government tries to cut the economic pie into more equal slices, the pie gets smaller.

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

1. Opportunity cost

- whatever must be given up to obtain some item
- For most students, the earnings they give up to attend school are the single largest cost of their education.

Principle 3: Rational People Think at the Margin

1. Rational People

- Economists normally assume that people are rational.
- People who systematically and purposefully do the best they can to achieve their objectives, given the available opportunities
  - They know that decisions in life are rarely black and white but usually involve shades of gray.

2. Marginal Change

- A small incremental adjustment to an existing plan of action
  - *Margin means "edge".*
  - Adjustments around the edges of what you are doing

3. Rational People Takes an Action If & Only If MB >= MC [1]
- The marginal benefit depends on how many units a person already has.

Principle 4: People Respond to Incentives

1. Incentive

- Something (such as the prospect of a punishment/reward) that induces a person to act
- "People respond to incentives. The rest is commentary."

2. Rational People's Decisions May Be Changed in Response to Incentives

- The influence of prices on the behavior of consumers and producers is crucial to how a market economy allocates scarce resources.
- Public policies can change the costs & benefits that people face.

1.2 How People Interact

Principle 5: Trade Can Make Everyone Better Off

1. Specialization

- Trade allows each person to specialize in the activities she does best.
- Trade allows countries to specialize in what they do best and to enjoy a greater variety of goods and services.
- By trading with others, people can buy a greater variety of goods and services at lower cost.
  - The Chinese are as much the American's partner as they are their competitors.

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

1. Market Economy

- An economy that allocates resources through the decentralized decisions of many firms & households as they interact in markets for good & services.

2. Central Planning

- Only the government could organize economic activity in a way that promoted economic well-being for the country as a whole.
  - These planners lacked the necessary information about consumers' tastes & producers' costs (reflected in prices in a market economy).
- Failed because they tried to run the economy with one hand tied behind their backs — the invisible hand of the marketplace [2]

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1 Marginal Cost

2 See FYI in the tutorial section of this chapter.

Principle 7: Government Can Sometimes Improve Market Outcomes

1. Gov. is needed because the invisible hand only works under property rights.

- The ability of individuals to own and control scarce resources

2. Gov. is needed because t he invisible hand is powerful but not omnipotent.

- Most policies aim either to enlarge the economic pie (efficiency) / to change how the pie is divided (equality).
- Efficiency - tackle market failure (externality + market power)
  - Market Failure
    - ◇ A situation in which a market left on its own fails to allocate resources efficiently
  - Externality
    - ◇ The impact of one person's actions on the well-being of a bystander
  - Market power
    - ◇ The ability of a single economic actor / small group of actors to have a substantial influence on market prices
- Equality - achieve a more equal distribution of economic well-being

3. To say that the government *can* improve on market outcomes does not mean that it always *will*.

1.3 How the Economy as a Whole Works

Principle 8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services

1. Almost all variation in living standards is attributable to differences in countries' productivity

- The quantity of goods and services produced from each unit of labor input
- Citizens of high-income countries have more TV sets, more cars, better nutrition, better healthcare, and a longer life expectancy than citizens of low-income countries.

Principle 9: Prices Rise When the Government Prints Too Much Money

1. Inflation

- An increase in the overall level of prices in the economy
- Because high inflation imposes various costs on society, keeping inflation at a low level is a goal of economic policymakers around the world.

Principle 10: Society Faces a Short-Run Trade-off between Inflation and Unemployment

- Amount of money ⬆ ⇒ spending ⬆ ⇒ products & services sold ⬆⇒ prices⬆ & demand for workers ⬆⇒ unemployment ⬇
- This short-run trade-off plays a key role in the analysis of the business cycle
  - (The irregular and largely unpredictable) fluctuations in economic activity
  - Measured by the production of goods and services or the number of people employed

1.4 Conclusion

- The field of economics is based on a few big ideas that can be applied in many different situations.
- Even the most sophisticated economic analysis is founded on the ten principles introduced here.

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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

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 Market Outcomes

How the Economy as a Whole Works

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10: Society Faces a Short-Run Trade-off between Inflation and Unemployment

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