

>> Introduction: The Ordinary Business of Life

ANY GIVEN SUNDAY

IT'S SUNDAY AFTERNOON IN THE SPRING OF 2008, and Route 1 in central New Jersey is a busy place. Thousands of people crowd the shopping malls that line the road for 20 miles, all the way from Trenton to New Brunswick. Most of the shoppers are cheerful—and why not? The stores in those malls offer an extraordinary range of choice; you can buy everything from sophisticated electronic equipment to fashionable

The scene along Route 1 on this spring day is, of course, perfectly ordinary—very much like the scene along hundreds of other stretches of road, all across America, that same afternoon. And the discipline of economics is mainly concerned with ordinary things. As the great nineteenth-century economist Alfred Marshall put it, economics is “a study of mankind in the ordinary business of life.”



Delivering the goods: the market economy in action

clothes to organic carrots. There are probably 100,000 distinct items available along that stretch of road. And most of these items are not luxury goods that only the rich can afford; they are products that millions of Americans can and do purchase every day.

What can economics say about this “ordinary business”? Quite a lot, it turns out. What we’ll see in this book is that even familiar scenes of economic life pose some very important questions—questions that economics can help answer. Among these questions are:

- How does our economic system work? That is, how does it manage to deliver the goods?
 - When and why does our economic system go astray, leading people into counterproductive behavior?
 - Why are there ups and downs in the economy? That is, why does the economy sometimes have a “bad year”?
- Finally, why is the long run mainly a story of ups rather than downs? That is, why has America, along with other advanced nations, become so much richer over time?
- Let’s take a look at these questions and offer a brief preview of what you will learn in this book.

The Invisible Hand

That ordinary scene in central New Jersey would not have looked at all ordinary to an American from colonial times—say, one of the patriots who helped George Washington win the Battle of Trenton in 1776. At the time, Trenton was a small village, and farms lined the route of Washington’s epic night march from Trenton to Princeton—a march that took him right past the future site of the giant Quakerbridge shopping mall.

Imagine that you could transport an American from the colonial period forward in time to our own era. (Isn’t that the plot of a movie? Several, actually.) What would this time-traveler find amazing?

Surely the most amazing thing would be the sheer prosperity of modern America—the range of goods and services that ordinary families can afford. Looking at all that wealth, our transplanted colonial would wonder, “How can I get some of that?” Or perhaps he would ask himself, “How can my society get some of that?”

The answer is that to get this kind of prosperity, you need a well-functioning system for coordinating productive activities—the activities that create the goods and services people want and get them to the people who want them. That kind of system is what we mean when we talk about the **economy**. And **economics** is the social science that studies the production, distribution, and consumption of goods and services.

An economy succeeds to the extent that it, literally, delivers the goods. A time-traveler from the eighteenth century—or even from 1950—would be amazed at how many goods and services the modern American economy delivers and at how many people can afford them. Compared with any past economy and with all but a few other countries today, America has an incredibly high standard of living.

So our economy must be doing something right, and the time-traveler might want to compliment the person in charge. But guess what? There isn’t anyone in charge. The United States has a **market economy**, in which production and consumption are the result of decentralized decisions by many firms and individuals. There is no central authority telling people what to produce or where to ship it. Each individual producer makes what he or she thinks will be most profitable; each consumer buys what he or she chooses.

The alternative to a market economy is a *command economy*, in which there is a central authority making decisions about production and consumption. Command economies have been tried, most notably in the Soviet Union between 1917 and 1991. But they didn’t work very well. Producers in the Soviet Union routinely found themselves unable to produce because they did not have crucial raw materials, or they succeeded in producing but then found that nobody wanted their products. Consumers were often unable to find necessary items—command economies are famous for long lines at shops.

Market economies, however, are able to coordinate even highly complex activities and to reliably provide consumers with the goods and services they want. Indeed, people quite casually trust their lives to the market system: residents of any major city would starve in days if the unplanned yet somehow orderly actions of thousands of businesses did not deliver a steady supply of food. Surprisingly, the unplanned “chaos” of a market economy turns out to be far more orderly than the “planning” of a command economy.

In 1776, in a famous passage in his book *The Wealth of Nations*, the pioneering Scottish economist Adam Smith wrote about how individuals, in pursuing their own

An **economy** is a system for coordinating society’s productive activities.

Economics is the social science that studies the production, distribution, and consumption of goods and services.

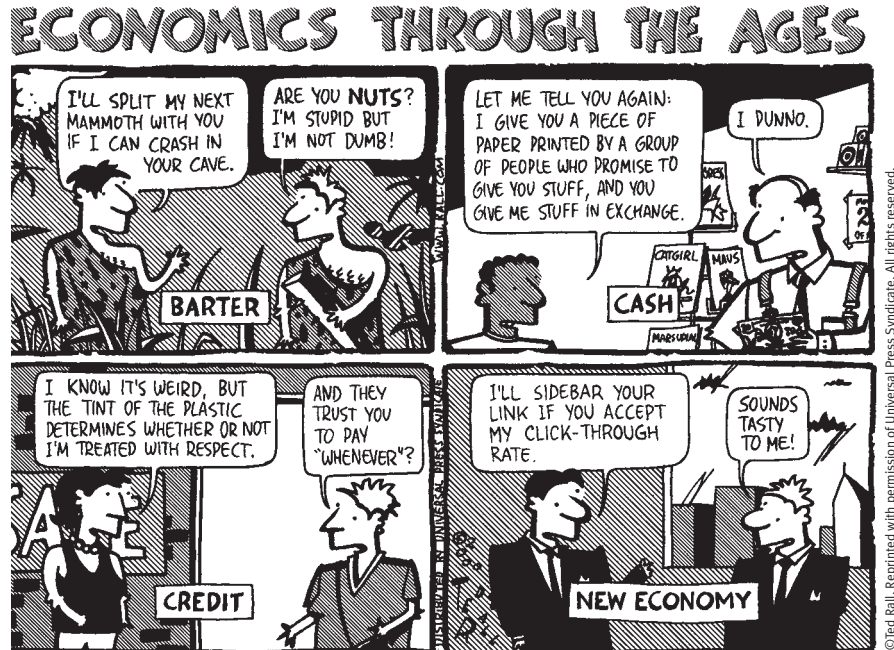
A **market economy** is an economy in which decisions about production and consumption are made by individual producers and consumers.

interests, often end up serving the interests of society as a whole. Of a businessman whose pursuit of profit makes the nation wealthier, Smith wrote: “[H]e intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.” Ever since, economists have used the term **invisible hand** to refer to the way a market economy manages to harness the power of self-interest for the good of society.

The study of how individuals make decisions and how these decisions interact is called **microeconomics**. One of the key themes in microeconomics is the validity of Adam Smith’s insight: individuals pursuing their own interests often do promote the interests of society as a whole.

So part of the answer to our time-traveler’s question—“How can my society achieve the kind of prosperity you take for granted?”—is that his society should learn to appreciate the virtues of a market economy and the power of the invisible hand.

But the invisible hand isn’t always our friend. It’s also important to understand when and why the individual pursuit of self-interest can lead to counterproductive behavior.



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My Benefit, Your Cost

One thing that our time-traveler would not admire about modern Route 1 is the traffic. In fact, although most things have gotten better in America over time, traffic congestion has gotten a lot worse.

When traffic is congested, each driver is imposing a cost on all the other drivers on the road—he is literally getting in their way (and they are getting in his way). This cost can be substantial: in major metropolitan areas, each time someone drives to work, instead of taking public transportation or working at home, he can easily impose \$15 or more in hidden costs on other drivers. Yet when deciding whether or not to drive, commuters have no incentive to take the costs they impose on others into account.

Traffic congestion is a familiar example of a much broader problem: sometimes the individual pursuit of one’s own interest, instead of promoting the interests of society as a whole, can actually make society worse off. When this happens, it is known as **market failure**. Other important examples of market failure involve air and water pollution as well as the overexploitation of natural resources such as fish and forests.

The good news, as you will learn as you use this book to study microeconomics, is that economic analysis can be used to diagnose cases of market failure. And often, economic analysis can also be used to devise solutions for the problem.

Good Times, Bad Times

Route 1 was bustling on that day in 2008. But if you’d visited the malls in 2002, the scene wouldn’t have been quite as cheerful. That’s because New Jersey’s economy, along with that of the United States as a whole, was somewhat depressed in 2002: in early 2001, businesses began laying off workers in large numbers, and employment didn’t start bouncing back until the summer of 2003.

The **invisible hand** refers to the way in which the individual pursuit of self-interest can lead to good results for society as a whole.

Microeconomics is the branch of economics that studies how people make decisions and how these decisions interact.

When the individual pursuit of self-interest leads to bad results for society as a whole, there is **market failure**.

A **recession** is a downturn in the economy.

Macroeconomics is the branch of economics that is concerned with overall ups and downs in the economy.

Economic growth is the growing ability of the economy to produce goods and services.

Such troubled periods are a regular feature of modern economies. The fact is that the economy does not always run smoothly: it experiences *fluctuations*, a series of ups and downs. By middle age, a typical American will have experienced three or four downs, known as **recessions**. (The U.S. economy experienced serious recessions beginning in 1973, 1981, 1990, and 2001.) During a severe recession, millions of workers may be laid off.

Like market failure, recessions are a fact of life; but also like market failure, they are a problem for which economic analysis offers some solutions. Recessions are one of the main concerns of the branch of economics known as **macroeconomics**, which is concerned with the overall ups and downs of the economy. If you study macroeconomics, you will learn how economists explain recessions and how government policies can be used to minimize the damage from economic fluctuations.

Despite the occasional recession, however, over the long run the story of the U.S. economy contains many more ups than downs. And that long-run ascent is the subject of our final question.

Onward and Upward

At the beginning of the twentieth century, most Americans lived under conditions that we would now think of as extreme poverty. Only 10 percent of homes had flush toilets, only 8 percent had central heating, only 2 percent had electricity, and almost nobody had a car, let alone a washing machine or air conditioning.

Such comparisons are a stark reminder of how much our lives have been changed by **economic growth**, the growing ability of the economy to produce goods and services.

Why does the economy grow over time? And why does economic growth occur faster in some times and places than in others? These are key questions for economics because economic growth is a good thing, as those shoppers on Route 1 can attest, and most of us want more of it.

An Engine for Discovery

We hope we have convinced you that the “ordinary business of life” is really quite extraordinary, if you stop to think about it, and that it can lead us to ask some very interesting and important questions.

In this book, we will describe the answers economists have given to these questions. But this book, like economics as a whole, isn’t a list of answers: it’s an introduction to a discipline, a way to address questions like those we have just asked. Or as Alfred Marshall, who described economics as a study of the “ordinary business of life,” put it: “Economics . . . is not a body of concrete truth, but an engine for the discovery of concrete truth.”

So let’s turn the key and start the ignition.

KEY TERMS

Economy, p. 2

Economics, p. 2

Market economy, p. 2

Invisible hand, p. 3

Microeconomics, p. 3

Market failure, p. 3

Recession, p. 4

Macroeconomics, p. 4

Economic growth, p. 4



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>> First Principles

COMMON GROUND

THE ANNUAL MEETING OF THE AMERICAN Economic Association draws thousands of economists, young and old, famous and obscure. There are booksellers, business meetings, and quite a few job interviews. But mainly the economists gather to talk and listen. During the busiest times, 60 or more presentations may be taking place simultaneously, on questions that range from the future of the stock market to who does the cooking in two-earner families.

What do these people have in common? An expert on the stock market probably knows very little about the economics of housework, and vice versa. Yet an economist who wanders into the wrong seminar and ends up listening to presentations on some unfamiliar topic is nonetheless likely to hear much that is familiar. The reason is that all economic analysis is based on a set of common principles that apply to many different issues.

Some of these principles involve *individual choice*—for economics is, first of all, about the choices that individuals make. Do you choose to work over the summer or take a backpacking trip? Do you buy a new CD or go to a movie? These decisions involve *making a choice* from among a limited number of alternatives—limited because no one can have everything that he or she wants. Every question in economics at its most basic level involves individuals making choices.

But to understand how an economy works, you need to understand more than how individuals make choices. None of us are Robinson Crusoe, alone on an island—we must make decisions in an environment that is shaped by the decisions of others. Indeed, in a modern economy even the simplest decisions you make—say, what to have for breakfast—are shaped by the decisions of thousands of

other people, from the banana grower in Costa Rica who decided to grow the fruit you eat to the farmer in Iowa who provided the corn in your cornflakes. And because each of us in a market economy depends on so many others—and they, in turn, depend on us—our choices interact. So although all economics at a basic level is about individual choice, in order to understand how market economies behave we must also understand economic *interaction*—how my choices affect your choices, and vice versa.



One must choose.

Many important economic interactions can be understood by looking at the markets for individual goods, like the market for corn. But an economy as a whole has its ups and downs—and we therefore need to understand economy-wide interactions as well as the more limited interactions that occur in individual markets.

In this chapter, we will look at twelve basic principles of economics—four principles involving individual choice, five involving the way individual choices interact, and three more involving economy-wide interactions.

WHAT YOU WILL LEARN IN THIS CHAPTER:

- A set of principles for understanding the economics of how individuals make choices
- A set of principles for understanding how individual choices interact
- A set of principles for understanding economy-wide interactions

Individual Choice: The Core of Economics

Every economic issue involves, at its most basic level, **individual choice**—decisions by an individual about what to do and what *not* to do. In fact, you might say that it isn't economics if it isn't about choice.

Step into a big store like a Wal-Mart or Target. There are thousands of different products available, and it is extremely unlikely that you—or anyone else—could afford to buy everything you might want to have. And anyway, there's only so much space in your dorm room or apartment. So will you buy another bookcase or a mini-refrigerator? Given limitations on your budget and your living space, you must choose which products to buy and which to leave on the shelf.

The fact that those products are on the shelf in the first place involves choice—the store manager chose to put them there, and the manufacturers of the products chose to produce them. All economic activities involve individual choice.

Four economic principles underlie the economics of individual choice, as shown in Table 1-1. We'll now examine each of these principles in more detail.

TABLE 1-1

Principles That Underlie the Economics of Individual Choice

1. Resources are scarce.
2. The real cost of something is what you must give up to get it.
3. "How much?" is a decision at the margin.
4. People usually exploit opportunities to make themselves better off.

Resources Are Scarce

You can't always get what you want. Everyone would like to have a beautiful house in a great location (and help with the housecleaning), two or three luxury cars, and frequent vacations in fancy hotels. But even in a rich country like the United States, not many families can afford all that. So they must make choices—whether to go to Disney World this year or buy a better car, whether to make do with a small backyard or accept a longer commute in order to live where land is cheaper.

Limited income isn't the only thing that keeps people from having everything they want. Time is also in limited supply: there are only 24 hours in a day. And because the time we have is limited, choosing to spend time on one activity also means choosing not to spend time on a different activity—spending time studying for an exam means forgoing a night at the movies. Indeed, many people are so limited by the number of hours in the day that they are willing to trade money for time. For example, convenience stores normally charge higher prices than a regular supermarket. But they fulfill a valuable role by catering to time-pressured customers who would rather pay more than travel farther to the supermarket.

Why do individuals have to make choices? The ultimate reason is that *resources are scarce*. A **resource** is anything that can be used to produce something else. Lists of the economy's resources usually begin with land, labor (the time of workers), capital (machinery, buildings, and other man-made productive assets), and human capital (the educational achievements and skills of workers). A resource is **scarce** when there's not enough of the resource available to satisfy all the various ways a society wants to use it. There are many scarce resources. These include natural resources—resources that come from the physical environment, such as minerals, lumber, and petroleum. There is also a limited quantity of human resources—labor, skill, and intelligence. And in a growing world economy with a rapidly increasing human population, even clean air and water have become scarce resources.

Just as individuals must make choices, the scarcity of resources means that society as a whole must make choices. One way for a society to make choices is simply to allow them to emerge as the result of many individual choices, which is what usually happens in a market economy. For example, Americans as a group have only so many

Individual choice is the decision by an individual of what to do, which necessarily involves a decision of what not to do.

A **resource** is anything that can be used to produce something else.

Resources are **scarce**—there is not enough of the resources available to satisfy all the various ways a society wants to use them.

hours in a week: how many of those hours will they spend going to supermarkets to get lower prices, rather than saving time by shopping at convenience stores? The answer is the sum of individual decisions: each of the millions of individuals in the economy makes his or her own choice about where to shop, and the overall choice is simply the sum of those individual decisions.

But for various reasons, there are some decisions that a society decides are best not left to individual choice. For example, the authors live in an area that until recently was mainly farmland but is now being rapidly built up. Most local residents feel that the community would be a more pleasant place to live if some of the land were left undeveloped. But no individual has an incentive to keep his or her land as open space, rather than sell it to a developer. So a trend has emerged in many communities across the United States of local governments purchasing undeveloped land and preserving it as open space. We'll see in later chapters why decisions about how to use scarce resources are often best left to individuals but sometimes should be made at a higher, community-wide, level.

The real cost of an item is its **opportunity cost**: what you must give up in order to get it.

The Real Cost of Something Is What You Must Give Up to Get It

It is the last term before you graduate, and your class schedule allows you to take only one elective. There are two, however, that you would really like to take: History of Jazz and Beginning Tennis.

Suppose you decide to take the History of Jazz course. What's the cost of that decision? It is the fact that you can't take Beginning Tennis, your next best alternative choice. Economists call that kind of cost—what you must give up in order to get an item you want—the **opportunity cost** of that item. So the opportunity cost of taking the History of Jazz class is the enjoyment you would have derived from the Beginning Tennis class.

The concept of opportunity cost is crucial to understanding individual choice because, in the end, all costs are opportunity costs. That's because every choice you make means forgoing some other alternative. Sometimes critics claim that economists are concerned only with costs and benefits that can be measured in dollars and cents. But that is not true. Much economic analysis involves cases like our elective course example, where it costs no extra tuition to take one elective course—that is, there is no direct monetary cost. Nonetheless, the elective you choose has an opportunity cost—the other desirable elective course that you must forgo because your limited time permits taking only one. More specifically, the opportunity cost of a choice is what you forgo by not choosing your next best alternative.

You might think that opportunity cost is an add-on—that is, something *additional* to the monetary cost of an item. Suppose that an elective class costs additional tuition of \$750; now there is a monetary cost to taking History of Jazz. Is the opportunity cost of taking that course something separate from that monetary cost?

Well, consider two cases. First, suppose that taking Beginning Tennis also costs \$750. In this case, you would have to spend that \$750 no matter which class you take. So what you give up to take the History of Jazz class is still the Beginning Tennis class, period—you would have to spend that \$750 either way. But suppose there isn't any fee for the tennis class. In that case, what you give up to take the jazz class is the enjoyment from the tennis class *plus* the enjoyment that you could have gained from spending the \$750 on other things.

Either way, the real cost of taking your preferred class is what you must give up to get it. As you expand the set of decisions that underlie each choice—whether to take an elective or not, whether to finish this term or not, whether to drop out or not—you'll realize that *all* costs are ultimately opportunity costs.

Sometimes the money you have to pay for something is a good indication of its opportunity cost. But many times it is not. One very important example of how poorly monetary cost can indicate opportunity cost is the cost of attending college. Tuition

FOR INQUIRING MINDS

Got a Penny?

At many cash registers—for example, the one downstairs in our college cafeteria—there is a little basket full of pennies. People are encouraged to use the basket to round their purchases up or down: if it costs \$5.02, you give the cashier \$5 and take two pennies from the basket; if it costs \$4.99, you pay \$5 and the cashier throws in a penny. It makes everyone's life a bit easier. Of course, it would be easier still if we just abolished the penny, a step that some economists have urged.

But then why do we have pennies in the first place? If it's too small a sum to worry about, why calculate prices that exactly?

The answer is that a penny wasn't always such a negligible sum: the purchasing power of a penny has been greatly reduced by inflation, a general rise in the prices of all goods and services over time. Forty years ago, a penny had more purchasing power than a nickel does today.

Why does this matter? Well, remember the saying: "A penny saved is a penny earned." But there are other ways to earn money, so you must decide whether saving a penny is a productive use of your time. Could you earn more by devoting that time to other uses?

Sixty years ago, the average wage was about \$1.20 an hour. A penny was equivalent to 30 seconds' worth of work—it was worth saving a penny if doing so took less than 30 seconds. But wages have risen along with overall prices, so that the average worker is now paid more than \$17 per hour. A penny is therefore equivalent to just over 2 seconds of work—and so it's not worth the opportunity cost of the time it takes to worry about a penny more or less.

In short, the rising opportunity cost of time in terms of money has turned a penny from a useful coin into a nuisance.



Photo by David Liam Kyle/NBAE via Getty Images

LeBron James understood the concept of opportunity cost.

and housing are major monetary expenses for most students; but even if these things were free, attending college would still be an expensive proposition because most college students, if they were not in college, would have a job. That is, by going to college, students *forgo* the income they could have made if they had worked instead. This means that the opportunity cost of attending college is what you pay for tuition and housing *plus* the forgone income you would have earned in a job.

It's easy to see that the opportunity cost of going to college is especially high for people who could be earning a lot during what would otherwise have been their college years. That is why star athletes like LeBron James often skip college. Some, like Tiger Woods, leave before graduating.

"How Much?" Is a Decision at the Margin

Some important decisions involve an "either-or" choice—for example, you decide either to go to college or to begin working; you decide either to take economics or to take something else. But other important decisions involve "how much" choices—for example, if you are taking both economics and chemistry this semester, you must decide how much time to spend studying for each. When it comes to understanding "how much" decisions, economics has an important insight to offer: "how much" is a decision made *at the margin*.

Suppose you are taking both economics and chemistry. And suppose you are a pre-med student, so that your grade in chemistry matters more to you than your grade in economics. Does that therefore imply that you should spend *all* your study time on chemistry and wing it on the economics exam? Probably not; even if you think your chemistry grade is more important, you should put some effort into studying for economics.

Spending more time studying for economics involves a benefit (a higher expected grade in that course) and a cost (you could have spent that time doing something else, such as studying to get a higher grade in chemistry). That is, your decision involves a **trade-off**—a comparison of costs and benefits.

How do you decide this kind of "how much" question? The typical answer is that you make the decision a bit at a time, by asking how you should spend the next hour. Say both exams are on the same day, and the night before you spend time reviewing your notes for both courses. At 6:00 P.M., you decide that it's a good idea to spend at least an hour on each course. At 8:00 P.M., you decide you'd better spend another

You make a **trade-off** when you compare the costs with the benefits of doing something.

hour on each course. At 10:00 P.M., you are getting tired and figure you have one more hour to study before bed—chemistry or economics? If you are pre-med, it's likely to be chemistry; if you are pre-MBA, it's likely to be economics.

Note how you've made the decision to allocate your time: at each point the question is whether or not to spend *one more hour* on either course. And in deciding whether to spend another hour studying for chemistry, you weigh the costs (an hour forgone of studying for economics or an hour forgone of sleeping) versus the benefits (a likely increase in your chemistry grade). As long as the benefit of studying one more hour for chemistry outweighs the cost, you should choose to study for that additional hour.

Decisions of this type—what to do with your next hour, what to do with your next dollar, and so on—are **marginal decisions**. They involve making trade-offs *at the margin*: comparing the costs and benefits of doing a little bit more of an activity versus doing a little bit less. The study of such decisions is known as **marginal analysis**.

Many of the questions that we face in economics—as well as in real life—involve marginal analysis: How many workers should I hire in my shop? At what mileage should I change the oil in my car? What is an acceptable rate of negative side effects from a new medicine? Marginal analysis plays a central role in economics because it is the key to deciding “how much” of an activity to do.

Decisions about whether to do a bit more or a bit less of an activity are **marginal decisions**. The study of such decisions is known as **marginal analysis**.

An **incentive** is anything that offers rewards to people who change their behavior.

People Usually Exploit Opportunities to Make Themselves Better Off

One day, while listening to the morning financial news, the authors heard a great tip about how to park cheaply in Manhattan. Garages in the Wall Street area charge as much as \$30 per day. But according to the newscaster, some people had found a better way: instead of parking in a garage, they had their oil changed at the Manhattan Jiffy Lube, where it costs \$19.95 to change your oil—and they keep your car all day!

It's a great story, but unfortunately it turned out not to be true—in fact, there is no Jiffy Lube in Manhattan. But if there were, you can be sure there would be a lot of oil changes there. Why? Because when people are offered opportunities to make themselves better off, they normally take them—and if they could find a way to park their car all day for \$19.95 rather than \$30, they would.

When you try to predict how individuals will behave in an economic situation, it is a very good bet that they will exploit opportunities to make themselves better off. Furthermore, individuals will *continue* to exploit these opportunities until they have been fully exhausted—that is, people will exploit opportunities until those opportunities have been fully exploited.

If there really was a Manhattan Jiffy Lube and an oil change really was a cheap way to park your car, we can safely predict that before long the waiting list for oil changes would be weeks, if not months.

In fact, the principle that people will exploit opportunities to make themselves better off is the basis of *all* predictions by economists about individual behavior. If the earnings of those who get MBAs soar while the earnings of those who get law degrees decline, we can expect more students to go to business school and fewer to go to law school. If the price of gasoline rises and stays high for an extended period of time, we can expect people to buy smaller cars with higher gas mileage—making themselves better off in the presence of higher gas prices by driving more fuel-efficient cars.

When changes in the available opportunities offer rewards to those who change their behavior, we say that people face new **incentives**. If the price of parking in Manhattan rises, those who can find alternative ways to get to their Wall Street jobs will save money by doing so—and so we can expect fewer people to drive to work.

One last point: economists tend to be skeptical of any attempt to change people's behavior that *doesn't* change their incentives. For example, a plan that calls on manufacturers to reduce pollution voluntarily probably won't be effective; a plan that gives them a financial incentive to reduce pollution is a lot more likely to work.

FOR INQUIRING MINDS

Pay for Grades?

The true reward for learning is, of course, the learning itself. But teachers and schools often feel that it's worth throwing in a few extras. Elementary school students who do well get gold stars; at higher levels, students who score well on tests may receive trophies, plaques, or even gift certificates.

But what about cash?

A few years ago, some Florida schools stirred widespread debate by offering actual cash bonuses to students who scored high on the state's standardized exams. At Parrott Middle School, which offered the highest amounts, an eighth-grader with a top score on an exam received a \$50 savings bond.

Many people questioned the monetary awards. In fact, the great majority of teachers feel that cash rewards for learning are a bad idea—the dollar amounts can't be made large enough to give students a real sense of how important their education is, and they make learning seem like work-for-pay. So why did the schools engage in the practice?

The answer, it turns out, is that the previous year the state government had introduced a pay-for-performance scheme for schools: schools whose students earned high marks on the state exams received extra state funds. The problem arose of how to motivate the students to take the exams as seriously as the school

administrators did. Parrott's principal defended the pay-for-grades practice by pointing out that good students would often "Christmas tree" their exams—ignore the questions and fill out the bubble sheets in the shape of Christmas trees. With large sums of money for the school at stake, he decided to set aside his misgivings and pay students to do well on the exams.

Does paying students for grades lead to higher grades? Interviews with students suggest that it does spur at least some students to try harder on state exams. And some Florida schools that have introduced rewards for good grades on state exams report substantial improvements in student performance.

Individual Choice: Summing It Up

We have just seen that there are four basic principles of individual choice:

- *Resources are scarce.* It is always necessary to make choices.
- *The real cost of something is what you must give up to get it.* All costs are opportunity costs.
- *"How much?" is a decision at the margin.* Usually the question is not "whether" but "how much." And that is a question whose answer hinges on the costs and benefits of doing a bit more or a bit less.
- *People usually exploit opportunities to make themselves better off.* As a result, people will respond to incentives.

So are we ready to do economics? Not yet—because most of the interesting things that happen in the economy are the result not merely of individual choices but of the way in which individual choices *interact*.

►ECONOMICS IN ACTION

A Woman's Work

One of the great social transformations of the twentieth century was the change in the nature of women's work. In 1900, only 6 percent of married women worked for pay outside the home. By 2005, the number was about 60 percent.

What caused this transformation? Changing attitudes toward work outside the home certainly played a role: in the first half of the twentieth century, it was often considered improper for a married woman to work outside the home if she could afford not to, whereas today it is considered normal. But an important driving force was the invention and growing availability of home appliances, especially washing machines. Before these appliances became available, housework was an extremely laborious task—much more so than a full-time job. In 1945, government researchers clocked a farm wife as she did the weekly wash by hand; she spent 4 hours washing clothes and 4½ hours ironing, and she walked more than a mile. Then she was

equipped with a washing machine; the same wash took 41 minutes, ironing was reduced to $1\frac{3}{4}$ hours, and the distance walked was reduced by 90 percent.

The point is that in pre-appliance days, the opportunity cost of working outside the home was very high: it was something women typically did only in the face of dire financial necessity. With modern appliances, the opportunities available to women changed—and the rest is history. ▲

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▶ CHECK YOUR UNDERSTANDING 1-1

- Explain how each of the following situations illustrates one of the four principles of individual choice.
 - You are on your third trip to a restaurant's all-you-can-eat dessert buffet and are feeling very full. Although it would cost you no additional money, you forgo a slice of coconut cream pie but have a slice of chocolate cake.
 - Even if there were more resources in the world, there would still be scarcity.
 - Different teaching assistants teach several Economics 101 tutorials. Those taught by the teaching assistants with the best reputations fill up quickly, with spaces left unfilled in the ones taught by assistants with poor reputations.
 - To decide how many hours per week to exercise, you compare the health benefits of one more hour of exercise to the effect on your grades of one less hour spent studying.
- You make \$45,000 per year at your current job with Whiz Kids Consultants. You are considering a job offer from Brainiacs, Inc., which will pay you \$50,000 per year. Which of the following are elements of the opportunity cost of accepting the new job at Brainiacs, Inc.?
 - The increased time spent commuting to your new job
 - The \$45,000 salary from your old job
 - The more spacious office at your new job

Solutions appear at back of book.

▶ QUICK REVIEW

- ▶ All economic activities involve **individual choice**.
- ▶ People must make choices because **resources are scarce**.
- ▶ The real cost of something is what you must give up to get it—specifically, giving up your next best alternative. All costs are **opportunity costs**. Monetary costs are sometimes a good indicator of opportunity costs, but not always.
- ▶ Many choices are not *whether* to do something but *how much*. “How much” choices are made by making a **trade-off** at the margin. The study of **marginal decisions** is known as **marginal analysis**.
- ▶ Because people usually exploit opportunities to make themselves better off, **incentives** can change people's behavior.

Interaction: How Economies Work

As we learned in the Introduction, an economy is a system for coordinating the productive activities of many people. In a market economy, such as the one we live in, that coordination takes place without any coordinator: each individual makes his or her own choices. Yet those choices are by no means independent of each other: each individual's opportunities, and hence choices, depend to a large extent on the choices made by other people. So to understand how a market economy behaves, we have to examine this **interaction** in which my choices affect your choices, and vice versa.

When studying economic interaction, we quickly learn that the end result of individual choices may be quite different from what any one individual intends.

For example, over the past century farmers in the United States have eagerly adopted new farming techniques and crop strains that have reduced their costs and increased their yields. Clearly, it's in the interest of each farmer to keep up with the latest farming techniques. But the end result of each farmer trying to increase his or her own income has actually been to drive many farmers out of business. Because American farmers have been so successful at producing larger yields, agricultural prices have steadily fallen. These falling prices have reduced the incomes of many farmers, and as a result fewer and fewer people find farming worth doing. That is, an individual farmer who plants a better variety of corn is better off; but when many farmers plant a better variety of corn, the result may be to make farmers as a group worse off.

A farmer who plants a new, more productive corn variety doesn't just grow more corn. Such a farmer also affects the market for corn through the increased yields attained, with consequences that will be felt by other farmers, consumers, and beyond.

Just as there are four economic principles that fall under the theme of choice, there are five principles that fall under the theme of interaction. These five principles are summarized in Table 1-2. We will now examine each of these principles more closely.

Interaction of choices—my choices affect your choices, and vice versa—is a feature of most economic situations. The results of this interaction are often quite different from what the individuals intend.

TABLE 1-2

Principles That Underlie the Interaction of Individual Choices

- There are gains from trade.
- Markets move toward equilibrium.
- Resources should be used as efficiently as possible to achieve society's goals.
- Markets usually lead to efficiency.
- When markets don't achieve efficiency, government intervention can improve society's welfare.

In a market economy, individuals engage in **trade**: they provide goods and services to others and receive goods and services in return.

There are **gains from trade**: people can get more of what they want through trade than they could if they tried to be self-sufficient. This increase in output is due to **specialization**: each person specializes in the task that he or she is good at performing.

There Are Gains from Trade

Why do the choices I make interact with the choices you make? A family could try to take care of all its own needs—growing its own food, sewing its own clothing, providing itself with entertainment, writing its own economics textbooks. But trying to live that way would be very hard. The key to a much better standard of living for everyone is **trade**, in which people divide tasks among themselves and each person provides a good or service that other people want in return for different goods and services that he or she wants.

The reason we have an economy, not many self-sufficient individuals, is that there are **gains from trade**: by dividing tasks and trading, two people (or 6 billion people) can each get more of what they want than they could get by being self-sufficient. Gains from trade arise, in particular, from this division of tasks, which economists call **specialization**—a situation in which different people each engage in a different task.

The advantages of specialization, and the resulting gains from trade, were the starting point for Adam Smith's 1776 book *The Wealth of Nations*, which many regard as the beginning of economics as a discipline. Smith's book begins with a description of an eighteenth-century pin factory where, rather than each of the 10 workers making a pin from start to finish, each worker specialized in one of the many steps in pin-making:

One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on, is a particular business, to whiten the pins is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner, divided into about eighteen distinct operations. . . . Those ten persons, therefore, could make among them upwards of forty-eight thousand pins in a day. But if they had all wrought separately and independently, and without any of them having been educated to this particular business, they certainly could not each of them have made twenty, perhaps not one pin a day. . . .

The same principle applies when we look at how people divide tasks among themselves and trade in an economy. *The economy, as a whole, can produce more when each person specializes in a task and trades with others.*

The benefits of specialization are the reason a person typically chooses only one career. It takes many years of study and experience to become a doctor; it also takes many years of study and experience to become a commercial airline pilot. Many doctors might well have had the potential to become excellent pilots, and vice versa; but it is very unlikely that anyone who decided to pursue both careers would be as good a pilot or as good a doctor as someone who decided at the beginning to specialize in that field. So it is to everyone's advantage that individuals specialize in their career choices.

Markets are what allow a doctor and a pilot to specialize in their own fields. Because markets for commercial flights and for doctors' services exist, a doctor is assured that she can find a flight and a pilot is assured that he can find a doctor. As long as individuals know that they can find the goods and services that they want in the market, they are willing to forgo self-sufficiency and are willing to specialize. But what assures people that markets will deliver what they want? The answer to that question leads us to our second principle of how individual choices interact.

Markets Move Toward Equilibrium

It's a busy afternoon at the supermarket; there are long lines at the checkout counters. Then one of the previously closed cash registers opens. What happens?

The first thing that happens, of course, is a rush to that register. After a couple of minutes, however, things will have settled down; shoppers will have rearranged



"I hunt and she gathers—otherwise we couldn't make ends meet."

themselves so that the line at the newly opened register is about the same length as the lines at all the other registers.

How do we know that? We know from our fourth principle of individual choice that people will exploit opportunities to make themselves better off. This means that people will rush to the newly opened register in order to save time standing in line. And things will settle down when shoppers can no longer improve their position by switching lines—that is, when the opportunities to make themselves better off have all been exploited.

A story about supermarket checkout lines may seem to have little to do with how individual choices interact, but in fact it illustrates an important principle. A situation in which individuals cannot make themselves better off by doing something different—the situation in which all the checkout lines are the same length—is what economists call an **equilibrium**. An economic situation is in equilibrium when no individual would be better off doing something different.

Recall the story about the mythical Jiffy Lube, where it was supposedly cheaper to leave your car for an oil change than to pay for parking. If that opportunity had really existed and people were still paying \$30 to park in garages, the situation would *not* have been an equilibrium. And that should have been a giveaway that the story couldn't be true. In reality, people would have seized an opportunity to park cheaply, just as they seize opportunities to save time at the checkout line. And in so doing they would have eliminated the opportunity! Either it would have become very hard to get an appointment for an oil change or the price of a lube job would have increased to the point that it was no longer an attractive option (unless you really needed a lube job).

As we will see, markets usually reach equilibrium via changes in prices, which rise or fall until no opportunities for individuals to make themselves better off remain.

The concept of equilibrium is extremely helpful in understanding economic interactions because it provides a way of cutting through the sometimes complex details of those interactions. To understand what happens when a new line is opened at a supermarket, you don't need to worry about exactly how shoppers rearrange themselves, who moves ahead of whom, which register just opened, and so on. What you need to know is that any time there is a change, the situation will move to an equilibrium.



Rhoda Sydney/Photo Edit

Witness equilibrium in action at the checkout lines in your neighborhood supermarket.

An economic situation is in **equilibrium** when no individual would be better off doing something different.

FOR INQUIRING MINDS

Choosing Sides

Why do people in America drive on the right side of the road? Of course, it's the law. But long before it was the law, it was an equilibrium.

Before there were formal traffic laws, there were informal "rules of the road," practices that everyone expected everyone else to follow. These rules included an understanding that people would normally keep to one side of the road. In some places, such as England, the rule was to keep to the left; in others, such as France, it was to keep to the right.

Why would some places choose the right and others, the left? That's not completely clear, although it may have

depended on the dominant form of traffic. Men riding horses and carrying swords on their left hip preferred to ride on the left (think about getting on or off the horse, and you'll see why). On the other hand, right-handed people walking but leading horses apparently preferred to walk on the right.

In any case, once a rule of the road was established, there were strong incentives for each individual to stay on the "usual" side of the road: those who didn't would keep colliding with oncoming traffic. So once established, the rule of the road would be self-enforcing—that is, it would be an equilibrium. Nowadays, of

course, which side you drive on is determined by law; some countries have even changed sides (Sweden went from left to right in 1967). But what about pedestrians? There are no laws—but there are informal rules. In the United States, urban pedestrians normally keep to the right. But if you should happen to visit a country where people drive on the left, watch out: people who drive on the left also typically walk on the left. So when in a foreign country, do as the locals do. You won't be arrested if you walk on the right, but you will be worse off than if you accept the equilibrium and walk on the left.



An economy is **efficient** if it takes all opportunities to make some people better off without making other people worse off.

Equity means that everyone gets his or her fair share. Since people can disagree about what's "fair," equity isn't as well defined a concept as efficiency.

The fact that markets move toward equilibrium is why we can depend on them to work in a predictable way. In fact, we can trust markets to supply us with the essentials of life. For example, people who live in big cities can be sure that the supermarket shelves will always be fully stocked. Why? Because if some merchants who distribute food *didn't* make deliveries, a big profit opportunity would be created for any merchant who did—and there would be a rush to supply food, just like the rush to a newly opened cash register. So the market ensures that food will always be available for city dwellers. And, returning to our previous principle, this allows city dwellers to be city dwellers—to specialize in doing city jobs rather than living on farms and growing their own food.

A market economy also allows people to achieve gains from trade. But how do we know how well such an economy is doing? The next principle gives us a standard to use in evaluating an economy's performance.

Resources Should Be Used as Efficiently as Possible to Achieve Society's Goals

Suppose you are taking a course in which the classroom is too small for the number of students—many people are forced to stand or sit on the floor—despite the fact that large, empty classrooms are available nearby. You would say, correctly, that this is no way to run a college. Economists would call this an *inefficient* use of resources.

But if an inefficient use of resources is undesirable, just what does it mean to use resources *efficiently*? You might imagine that the efficient use of resources has something to do with money, maybe that it is measured in dollars-and-cents terms. But in economics, as in life, money is only a means to other ends. The measure that economists really care about is not money but people's happiness or welfare. Economists say that *an economy's resources are used efficiently when they are used in a way that has fully exploited all opportunities to make everyone better off*. To put it another way, an economy is **efficient** if it takes all opportunities to make some people better off without making other people worse off.

In our classroom example, there clearly was a way to make everyone better off—moving the class to a larger room would make people in the class better off without hurting anyone else in the college. Assigning the course to the smaller classroom was an inefficient use of the college's resources, whereas assigning the course to the larger classroom would have been an efficient use of the college's resources.

When an economy is efficient, it is producing the maximum gains from trade possible given the resources available. Why? Because there is no way to rearrange how resources are used in a way that can make everyone better off. When an economy is efficient, one person can be made better off by rearranging how resources are used *only* by making someone else worse off. In our classroom example, if all larger classrooms were already occupied, the college would have been run in an efficient way: your class could be made better off by moving to a larger classroom only by making people in the larger classroom worse off by making them move to a smaller classroom.

Should economic policy makers always strive to achieve economic efficiency? Well, not quite, because efficiency is not the only criterion by which to evaluate an economy. People also care about issues of fairness, or **equity**. And there is typically a trade-off between equity and efficiency: policies that promote equity often come at a cost of decreased efficiency in the economy, and vice versa.

To see this, consider the case of disabled-designated parking spaces in public parking lots. Many people have great difficulty walking due to age or disability, so it seems only fair to assign closer parking spaces specifically for their use. You may have noticed, however, that a certain amount of inefficiency is involved. To make sure that there is always an appropriate space available should a disabled person want one, there are typically quite a number of disabled-designated spaces. So at any one time there are typically more such spaces available than there are disabled people who want one. As a result, desirable parking spaces are unused. (And the

temptation for nondisabled people to use them is so great that we must be dissuaded by fear of getting a ticket.) So, short of hiring parking valets to allocate spaces, there is a conflict between *equity*, making life “fairer” for disabled people, and *efficiency*, making sure that all opportunities to make people better off have been fully exploited by never letting close-in parking spaces go unused.

Exactly how far policy makers should go in promoting equity over efficiency is a difficult question that goes to the heart of the political process. As such, it is not a question that economists can answer. What is important for economists, however, is always to seek to use the economy’s resources as efficiently as possible in the pursuit of society’s goals, whatever those goals may be.

Markets Usually Lead to Efficiency

No branch of the U.S. government is entrusted with ensuring the general economic efficiency of our market economy—we don’t have agents who go around making sure that brain surgeons aren’t plowing fields, that Minnesota farmers aren’t trying to grow oranges, that prime beachfront property isn’t taken up by used-car dealerships, that colleges aren’t wasting valuable classroom space. The government doesn’t need to enforce efficiency because in most cases the invisible hand does the job.

In other words, the incentives built into a market economy already ensure that resources are usually put to good use, that opportunities to make people better off are not wasted. If a college were known for its habit of crowding students into small classrooms while large classrooms go unused, it would soon find its enrollment dropping, putting the jobs of its administrators at risk. The “market” for college students would respond in a way that induces administrators to run the college efficiently.

A detailed explanation of why markets are usually very good at making sure that resources are used well will have to wait until we have studied how markets actually work. But the most basic reason is that in a market economy, in which individuals are free to choose what to consume and what to produce, opportunities for mutual gain are normally taken. If there is a way in which some people can be made better off, people will usually be able to take advantage of that opportunity. And that is exactly what defines efficiency: all the opportunities to make some people better off without making other people worse off have been exploited.

As we learned in the Introduction, however, there are exceptions to this principle that markets are generally efficient. In cases of *market failure*, the individual pursuit of self-interest found in markets makes society worse off—that is, the market outcome is inefficient. And, as we will see in examining the next principle, when markets fail, government intervention can help. But short of instances of market failure, the general rule is that markets are a remarkably good way of organizing an economy.

When Markets Don’t Achieve Efficiency, Government Intervention Can Improve Society’s Welfare

Let’s recall from the Introduction the nature of the market failure caused by traffic congestion—a commuter driving to work has no incentive to take into account the cost that his or her action inflicts on other drivers in the form of increased traffic congestion. There are several possible remedies to this situation; examples include charging road tolls, subsidizing the cost of public transportation, and taxing sales of gasoline to individual drivers. All these remedies work by changing the incentives of would-be drivers—motivating them to drive less and use alternative transportation. But they also share another feature: each relies on government intervention in the market.

This brings us to our fifth and last principle of interaction: *When markets don’t achieve efficiency, government intervention can improve society’s welfare*. That is, when markets go wrong, an appropriately designed government policy can sometimes move society closer to an efficient outcome by changing how society’s resources are used.

A very important branch of economics is devoted to studying why markets fail and what policies should be adopted to improve social welfare. We will study these problems and their remedies in depth in later chapters, but here we give a brief overview of three principal ways in which they fail:

- Individual actions have *side effects* that are not properly taken into account by the market. An example is an action that causes pollution.
- One party prevents mutually beneficial trades from occurring in an attempt to capture a greater share of resources for itself. An example is a drug company that keeps its prices so high that some people who would benefit from their drugs cannot afford to buy them.
- Some goods, by their very nature, are unsuited for efficient management by markets. An example of such a good is air traffic control.

An important part of your education in economics is learning to identify not just when markets work but also when they don't work—and to judge what government policies are appropriate in each situation.

► **ECONOMICS IN ACTION**

Restoring Equilibrium on the Freeways

Back in 1994 a powerful earthquake struck the Los Angeles area, causing several freeway bridges to collapse and thereby disrupting the normal commuting routes of hundreds of thousands of drivers. The events that followed offer a particularly clear example of interdependent decision making—in this case, the decisions of commuters about how to get to work.

In the immediate aftermath of the earthquake, there was great concern about the impact on traffic, since motorists would now have to crowd onto alternative routes or detour around the blockages by using city streets. Public officials and news programs warned commuters to expect massive delays and urged them to avoid unnecessary travel, reschedule their work to commute before or after the rush, or use mass transit. These warnings were unexpectedly effective. In fact, so many people heeded them that in the first few days following the quake, those who maintained their regular commuting routine actually found the drive to and from work faster than before.

Of course, this situation could not last. As word spread that traffic was actually not bad at all, people abandoned their less convenient new commuting methods and reverted to their cars—and traffic got steadily worse. Within a few weeks after the quake, serious traffic jams had appeared. After a few more weeks, however, the situation stabilized: the reality of worse-than-usual congestion discouraged enough drivers to prevent the nightmare of citywide gridlock from materializing. Los Angeles traffic, in short, had settled into a new equilibrium, in which each commuter was making the best choice he or she could, given what everyone else was doing.

This was not, by the way, the end of the story: fears that the city would strangle on traffic led local authorities to repair the roads with record speed. Within only 18 months after the quake, all the freeways were back to normal, ready for the next one. ▲

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► **QUICK REVIEW**

- A feature of most economic situations is the **interaction** of choices made by individuals, the end result of which may be quite different from what was intended. In a market economy, interaction takes the form of **trade** between individuals.
- Individuals interact because there are **gains from trade**. Gains from trade arise from **specialization**.
- Economic situations normally move toward **equilibrium**.
- As far as possible, there should be an **efficient** use of resources to achieve society's goals. But efficiency is not the only way to evaluate an economy; **equity** may also be desirable, and there is often a trade-off between equity and efficiency.
- Markets normally *are* efficient, except for certain well-defined exceptions.
- When markets fail to achieve efficiency, government intervention can improve society's welfare.

► **CHECK YOUR UNDERSTANDING** 1-2

1. Explain how each of the following situations illustrates one of the five principles of interaction.
 - a. Using the college website, any student who wants to sell a used textbook for at least \$30 is able to sell it to someone who is willing to pay \$30.
 - b. At a college tutoring co-op, students can arrange to provide tutoring in subjects they are good in (like economics) in return for receiving tutoring in subjects they are poor in (like philosophy).

- c. The local municipality imposes a law that requires bars and nightclubs near residential areas to keep their noise levels below a certain threshold.
 - d. To provide better care for low-income patients, the local municipality has decided to close some underutilized neighborhood clinics and shift funds to the main hospital.
 - e. On the college website, books of a given title with approximately the same level of wear and tear sell for about the same price.
2. Which of the following describes an equilibrium situation? Which does not? Explain your answer.
- a. The restaurants across the street from the university dining hall serve better-tasting and cheaper meals than those served at the university dining hall. The vast majority of students continue to eat at the dining hall.
 - b. You currently take the subway to work. Although taking the bus is cheaper, the ride takes longer. So you are willing to pay the higher subway fare in order to save time.

Solutions appear at back of book.

Economy-Wide Interactions

As we mentioned in the Introduction, the economy as a whole has its ups and downs. For example, business in America's shopping malls was somewhat depressed in 2002, because the economy hadn't fully recovered from the 2001 recession. To understand recessions, we need to understand economy-wide interactions, and understanding the big picture of the economy requires understanding three more important economic principles. Those three economy-wide principles are summarized in Table 1-3.

One Person's Spending Is Another Person's Income

In 2001, corporations that had been buying a lot of computers, software, and other high-tech supplies in the late 1990s suddenly decided to cut back on their purchases. The result, economists agree, was a recession caused mainly by these cuts in business investment spending. As we mentioned in the previous chapter, this was followed by a sharp drop-off in spending at the nation's retail stores.

But why should a cut in spending by businesses mean empty stores in the shopping malls? After all, malls are places where families, not businesses, do their shopping. The answer is that lower business spending led to lower incomes throughout the economy, because people who had been making those computers or designing that software either lost their jobs or were forced to take pay cuts. And as incomes fell, so did spending by consumers.

This story illustrates a general principle: *One person's spending is another person's income*. In a market economy, people make a living selling things—including their labor—to other people. If some group in the economy decides, for whatever reason, to spend more, the income of other groups will rise. If some group decides to spend less, the income of other groups will fall.

Because one person's spending is another person's income, a chain reaction of changes in spending behavior tends to have repercussions that spread through the economy. For example, a cut in business investment spending, like the one that happened in 2001, leads to reduced family incomes; families respond by reducing consumer spending; this leads to another round of income cuts; and so on. These repercussions play an important role in our understanding of recessions and recoveries.

Overall Spending Sometimes Gets Out of Line With the Economy's Productive Capacity

Macroeconomics emerged as a separate branch of economics in the 1930s, when a collapse of consumer and business spending, a crisis in the banking industry, and other factors led to a plunge in overall spending. This plunge in spending, in turn, led to a period of very high unemployment known as the Great Depression.

TABLE 1-3

Principles That Underlie Economy-Wide Interactions

1. One person's spending is another person's income.
2. Overall spending sometimes gets out of line with the economy's productive capacity.
3. Government policies can change spending.

The lesson economists learned from the troubles of the 1930s is that overall spending—the amount of goods and services that consumers and businesses want to buy—sometimes doesn’t match the amount of goods and services the economy is capable of producing. In the 1930s, spending fell far short of what was needed to keep American workers employed, and the result was a severe economic slump. In fact, shortfalls in spending are responsible for most, though not all, recessions—although nothing like the Great Depression has happened since the 1930s.

It’s also possible for overall spending to be too high. In that case, the economy experiences *inflation*, a rise in prices throughout the economy. This rise in prices occurs because when the amount that people want to buy outstrips the supply, producers can raise their prices and still find willing customers.

Government Policies Can Change Spending

Overall spending sometimes gets out of line with the economy’s productive capacity. But can anything be done about that? Yes, a lot. Government policies can have strong effects on spending.

For one thing, the government itself does a lot of spending on everything from military equipment to education—and it can choose to do more or less. The government can also vary how much it collects from the public in taxes, which in turn affects how much income consumers and businesses have left to spend. And the government’s control of the quantity of money in circulation, it turns out, gives it another powerful tool with which to affect total spending. Government spending, taxes, and control of money are the tools of *macroeconomic policy*.

Modern governments deploy these tools of macroeconomic policy in an effort to manage overall spending in the economy, trying to steer it between the perils of recession and inflation. These efforts aren’t always successful—recessions still happen, and so do periods of inflation. But it’s widely believed that the growing sophistication of macroeconomic policy is an important reason why the United States and other major economies seem to be more stable today than they were in the past.

►ECONOMICS IN ACTION

Adventures in Babysitting

The website myarmylifetoo.com, which offers advice to army families, suggests that parents join a babysitting cooperative—an arrangement that is common in many walks of life. In a babysitting cooperative, a number of parents exchange babysitting services rather than hire someone to babysit. But how do these organizations make sure that everyone does their fair share of the work? As myarmylifetoo.com explains, “Instead of money, most co-ops exchange tickets or points. When you need a sitter, you call a friend on the list, and you pay them with tickets. You earn tickets by babysitting other children within the co-op.”

In other words, a babysitting co-op is a miniature economy in which people buy and sell babysitting services. And it happens to be a type of economy that can have macroeconomic problems! A famous article titled “Monetary Theory and the Great Capitol Hill Babysitting Co-Op Crisis,” published in 1977, described the troubles of a babysitting cooperative that issued too few tickets. Bear in mind that, on average, people in a babysitting co-op want to have a reserve of tickets stashed away in case they need to go out several times before they can replenish their stash by doing some more babysitting.

In this case, because there weren’t that many tickets out there to begin with, most parents were anxious to add to their reserves by babysitting but reluctant to run them down by going out. But one parent’s decision to go out was another’s chance to babysit, so it became difficult to earn tickets. Knowing this, parents became even more reluctant to use their reserves except on special occasions.

In short, the co-op had fallen into a recession.

Recessions in the larger, nonbabysitting economy are a bit more complicated than this, but the troubles of the Capitol Hill babysitting co-op demonstrate two of our three principles of economy-wide interactions. One person's spending is another person's income: opportunities to babysit arose only to the extent that other people went out. And an economy can suffer from too little spending: when not enough people were willing to go out, everyone was frustrated at the lack of babysitting opportunities.

And what about government policies to change spending? Actually, the Capitol Hill co-op did that, too. Eventually, it solved its problem by handing out more tickets, and with increased reserves, people were willing to go out more. ▲

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► CHECK YOUR UNDERSTANDING 1-3

1. Explain how each of the following examples illustrates one of the three principles of economy-wide interactions.
 - a. The White House urged Congress to pass major tax cuts in the spring of 2001, when it became clear that the U.S. economy was experiencing a slump.
 - b. Oil companies are investing heavily in projects that will extract oil from the "oil sands" of Canada. In Edmonton, Alberta, near the projects, restaurants and other consumer businesses are booming.
 - c. In the mid-2000s, Spain, which was experiencing a big housing boom, also had the highest inflation rate in Europe.

Solutions appear at back of book.

►► QUICK REVIEW

- Because individuals in a market economy derive their income from selling things, including their labor, to other people, one person's spending is another person's income. As a result, changes in spending behavior tend to have repercussions that spread through the economy.
- Overall spending sometimes gets out of line with the economy's capacity to produce goods and services. When spending is too low, the result is a recession. When spending is too high, it causes inflation.
- Governments have a number of tools at their disposal that can strongly affect the overall level of spending. Modern governments use these tools in an effort to steer the economy between the perils of recession and inflation.

►► A LOOK AHEAD...

The twelve basic principles we have described lie behind almost all economic analysis. Although they can be immediately helpful in understanding many situations, they are usually not enough. Applying the principles to real economic issues takes one more step.

That step is the creation of *models*—simplified representations of economic situations. Models must be realistic enough to provide real-world guidance but simple enough to allow us to clearly see the implications of the principles described in this chapter. So our next step is to show how models are used to actually do economic analysis.]

SUMMARY

1. All economic analysis is based on a list of basic principles. These principles apply to three levels of economic understanding. First, we must understand how individuals make choices; second, we must understand how these choices interact; and third, we must understand how the economy functions overall.
2. Everyone has to make choices about what to do and what *not* to do. **Individual choice** is the basis of economics—if it doesn't involve choice, it isn't economics.
3. The reason choices must be made is that **resources**—anything that can be used to produce something else—are **scarce**. Individuals are limited in their choices by money and time; economies are limited by their supplies of human and natural resources.
4. Because you must choose among limited alternatives, the true cost of anything is what you must give up to get it—all costs are **opportunity costs**.
5. Many economic decisions involve questions not of "whether" but of "how much"—how much to spend on some good, how much to produce, and so on. Such decisions must be taken by performing a **trade-off at the margin**—by comparing the costs and benefits of doing a bit more or a bit less. Decisions of this type are called **marginal decisions**, and the study of them, **marginal analysis**, plays a central role in economics.
6. The study of how people *should* make decisions is also a good way to understand actual behavior. Individuals usually exploit opportunities to make themselves better off.

If opportunities change, so does behavior: people respond to **incentives**.

7. **Interaction**—my choices depend on your choices, and vice versa—adds another level to economic understanding. When individuals interact, the end result may be different from what anyone intends.
8. The reason for interaction is that there are **gains from trade**: by engaging in the **trade** of goods and services with one another, the members of an economy can all be made better off. Underlying gains from trade are the advantages of **specialization**, of having individuals specialize in the tasks they are good at.
9. Economies normally move toward **equilibrium**—a situation in which no individual can make himself or herself better off by taking a different action.
10. An economy is **efficient** if all opportunities to make some people better off without making other people

worse off are taken. Resources should be used as efficiently as possible to achieve society's goals. But efficiency is not the sole way to evaluate an economy: **equity**, or fairness, is also desirable, and there is often a trade-off between equity and efficiency.

11. Markets usually lead to efficiency, with some well-defined exceptions.
12. When markets fail and do not achieve efficiency, government intervention can improve society's welfare.
13. One person's spending is another person's income.
14. Overall spending in the economy can get out of line with the economy's productive capacity, leading to recession or inflation.
15. Governments have the ability to strongly affect overall spending, an ability they use in an effort to steer the economy between recession and inflation.

KEY TERMS

Individual choice, p. 6
Resource, p. 6
Scarce, p. 6
Opportunity cost, p. 7
Trade-off, p. 8

Marginal decisions, p. 9
Marginal analysis, p. 9
Incentive, p. 9
Interaction, p. 11
Trade, p. 12

Gains from trade, p. 12
Specialization, p. 12
Equilibrium, p. 13
Efficient, p. 14
Equity, p. 14

PROBLEMS

1. In each of the following situations, identify which of the twelve principles is at work.
 - a. You choose to shop at the local discount store rather than paying a higher price for the same merchandise at the local department store.
 - b. On your spring break trip, your budget is limited to \$35 a day.
 - c. The student union provides a website on which departing students can sell items such as used books, appliances, and furniture rather than giving them away to their roommates as they formerly did.
 - d. After a hurricane did extensive damage to homes on the island of St. Crispin, homeowners wanted to purchase many more building materials and hire many more workers than were available on the island. As a result, prices for goods and services rose dramatically across the board.
 - e. You buy a used textbook from your roommate. Your roommate uses the money to buy songs from iTunes.
 - f. You decide how many cups of coffee to have when studying the night before an exam by considering how much more work you can do by having another cup versus how jittery it will make you feel.
 - g. There is limited lab space available to do the project required in Chemistry 101. The lab supervisor assigns lab time to each student based on when that student is able to come.
 - h. You realize that you can graduate a semester early by forgoing a semester of study abroad.
 - i. At the student union, there is a bulletin board on which people advertise used items for sale, such as bicycles. Once you have adjusted for differences in quality, all the bikes sell for about the same price.
 - j. You are better at performing lab experiments, and your lab partner is better at writing lab reports. So the two of you agree that you will do all the experiments, and she will write up all the reports.
 - k. State governments mandate that it is illegal to drive without passing a driving exam.
 - l. Your parents' after-tax income has increased because of a tax cut passed by Congress. They therefore increase your allowance, which you spend on a spring break vacation.
2. Describe some of the opportunity costs when you decide to do the following.
 - a. Attend college instead of taking a job

- b. Watch a movie instead of studying for an exam
 - c. Ride the bus instead of driving your car
3. Liza needs to buy a textbook for the next economics class. The price at the college bookstore is \$65. One online site offers it for \$55 and another site, for \$57. All prices include sales tax. The accompanying table indicates the typical shipping and handling charges for the textbook ordered online.

Shipping method	Delivery time	Charge
Standard shipping	3–7 days	\$3.99
Second-day air	2 business days	8.98
Next-day air	1 business day	13.98

- a. What is the opportunity cost of buying online instead of at the bookstore? Note that if you buy the book online, you must wait to get it.
 - b. Show the relevant choices for this student. What determines which of these options the student will choose?
4. Use the concept of opportunity cost to explain the following.
- a. More people choose to get graduate degrees when the job market is poor.
 - b. More people choose to do their own home repairs when the economy is slow and hourly wages are down.
 - c. There are more parks in suburban than in urban areas.
 - d. Convenience stores, which have higher prices than supermarkets, cater to busy people.
 - e. Fewer students enroll in classes that meet before 10:00 A.M.
5. In the following examples, state how you would use the principle of marginal analysis to make a decision.
- a. Deciding how many days to wait before doing your laundry
 - b. Deciding how much library research to do before writing your term paper
 - c. Deciding how many bags of chips to eat
 - d. Deciding how many lectures of a class to skip
6. This morning you made the following individual choices: you bought a bagel and coffee at the local café, you drove to school in your car during rush hour, and you typed your roommate's term paper because you are a fast typist—in return for which she will do your laundry for a month. For each of these actions, describe how your individual choices interacted with the individual choices made by others. Were other people left better off or worse off by your choices in each case?
7. The Hatfield family lives on the east side of the Hatatoochie River, and the McCoy family lives on the west side. Each family's diet consists of fried chicken and corn-on-the-cob, and each is self-sufficient, raising their own chickens and growing their own corn. Explain the conditions under which each of the following would be true.

- a. The two families are made better off when the Hatfields specialize in raising chickens, the McCoy's specialize in growing corn, and the two families trade.
 - b. The two families are made better off when the McCoy's specialize in raising chickens, the Hatfields specialize in growing corn, and the two families trade.
8. Which of the following situations describes an equilibrium? Which does not? If the situation does not describe an equilibrium, what would an equilibrium look like?
- a. Many people regularly commute from the suburbs to downtown Pleasantville. Due to traffic congestion, the trip takes 30 minutes when you travel by highway but only 15 minutes when you go by side streets.
 - b. At the intersection of Main and Broadway are two gas stations. One station charges \$3.00 per gallon for regular gas and the other charges \$2.85 per gallon. Customers can get service immediately at the first station but must wait in a long line at the second.
 - c. Every student enrolled in Economics 101 must also attend a weekly tutorial. This year there are two sections offered: section A and section B, which meet at the same time in adjoining classrooms and are taught by equally competent instructors. Section A is overcrowded, with people sitting on the floor and often unable to see the chalkboard. Section B has many empty seats.
9. In each of the following cases, explain whether you think the situation is efficient or not. If it is not efficient, why not? What actions would make the situation efficient?
- a. Electricity is included in the rent at your dorm. Some residents in your dorm leave lights, computers, and appliances on when they are not in their rooms.
 - b. Although they cost the same amount to prepare, the cafeteria in your dorm consistently provides too many dishes that diners don't like, such as tofu casserole, and too few dishes that diners do like, such as roast turkey with dressing.
 - c. The enrollment for a particular course exceeds the spaces available. Some students who need to take this course to complete their major are unable to get a space even though others who are taking it as an elective do get a space.
10. Discuss the efficiency and equity implications of each of the following policies. How would you go about balancing the concerns of equity and efficiency in these areas?
- a. The government pays the full tuition for every college student to study whatever subject he or she wishes.
 - b. When people lose their jobs, the government provides unemployment benefits until they find new ones.
11. Governments often adopt certain policies in order to promote desired behavior among their citizens. For each of the following policies, determine what the incentive is and what behavior the government wishes to promote. In each case, why do you think that the government might wish to change people's behavior, rather than allow their actions to be solely determined by individual choice?
- a. A tax of \$5 per pack is imposed on cigarettes.

- b. The government pays parents \$100 when their child is vaccinated for measles.
 - c. The government pays college students to tutor children from low-income families.
 - d. The government imposes a tax on the amount of air pollution that a company discharges.
12. In each of the following situations, explain how government intervention could improve society's welfare by changing people's incentives. In what sense is the market going wrong?
- a. Pollution from auto emissions has reached unhealthy levels.
 - b. Everyone in Woodville would be better off if streetlights were installed in the town. But no individual resident is willing to pay for installation of a streetlight in front of his or her house because it is impossible to recoup the cost by charging other residents for the benefit they receive from it.
13. In his January 31, 2007, speech on the state of the economy, President George W. Bush said that "Since we enacted major tax relief into law in 2003, our economy has created nearly 7.2 million new jobs. Our economy has expanded by more than 13 percent." Which two of the three principles of economy-wide interaction are at work in this statement?
14. In August 2007, a sharp downturn in the U.S. housing market reduced the income of many who worked in the home construction industry. A *Wall Street Journal* news article reported that Wal-Mart's wire-transfer business was likely to suffer because many construction workers are Hispanics who regularly send part of their wages back to relatives in their home countries via Wal-Mart. With this information, use one of the principles of economy-wide interaction to trace a chain of links that explains how reduced spending for U.S. home purchases is likely to affect the performance of the Mexican economy.
15. In 2005, Hurricane Katrina caused massive destruction to the U.S. Gulf Coast. Tens of thousands of people lost their homes and possessions. Even those who weren't directly affected by the destruction were hurt because businesses and jobs dried up. Using one of the principles of economy-wide interaction, explain how government intervention can help in this situation.
16. During the Great Depression, food was left to rot in the fields or fields that had once been actively cultivated were left fallow. Use one of the principles of economy-wide interaction to explain how this could have occurred.



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