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PRINCIPLES OF  
**ECONOMICS**

*Eighth Edition*

CHAPTER  
**1**

Ten Principles of  
Economics



# Look for the answers to these questions:

- What kinds of questions does economics address?
- What are the principles of how people make decisions?
- What are the principles of how people interact?
- What are the principles of how the economy as a whole works?



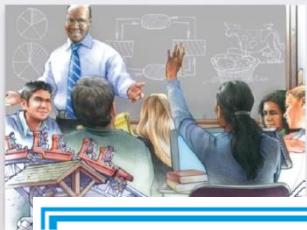
# Ten Principles of Economics

- Resources are scarce
- Scarcity: the limited nature of society's resources
  - Society has limited resources
    - Cannot produce all the goods and services people wish to have
- Economics
  - The study of how society manages its scarce resources



# Ten Principles of Economics

- Economists study:
  - How people decide what to buy, how much to work, save, and spend
  - How firms decide how much to produce, how many workers to hire
  - How society decides how to divide its resources between national defense, consumer goods, protecting the environment, and other needs



# How People Make Decisions

Principle 1: People face trade-offs

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

Principle 3: Rational people think at the margin

Principle 4: People respond to incentives



# Principle 1: People Face Trade-offs

- To get something that we like, we have to give up something else that we also like
  - Going to a party the night before an exam
    - Less time for studying
  - Having more money to buy stuff
    - Working longer hours, less time for leisure
  - Protecting the environment
    - Resources could be used to produce consumer goods



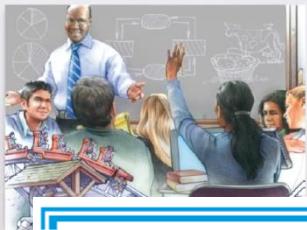
# Principle 1: People Face Trade-offs

- Society faces trade-offs:
  - The more it spends on national defense (guns) to protect its shores
    - The less it can spend on consumer goods (butter) to raise the standard of living at home
  - Pollution regulations: cleaner environment and improved health
    - But at the cost of reducing the incomes of the firms' owners, workers, and customers



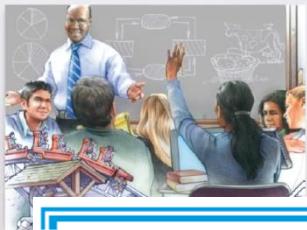
# Principle 1: People Face Trade-offs

- **Efficiency:** society gets the most from its scarce resources
- **Equality:** prosperity is distributed uniformly among society's members
- **Tradeoff:**
  - To achieve greater equality, could redistribute income from wealthy to poor
  - But this reduces incentive to work and produce, shrinks the size of economic “pie”



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

- Making decisions:
  - Compare costs and benefits of alternatives
  - Need to include opportunity costs
- Opportunity cost
  - Whatever must be given up to obtain some item



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

- The opportunity cost of:
  - Going to college for a year
    - Tuition, books, and fees
    - PLUS foregone wages
  - Going to the movies
    - The price of the movie ticket
    - PLUS the value of the time you spend in the theater



## Principle 3: Rational People Think at the Margin

- Rational people
  - Systematically and purposefully do the best they can to achieve their objectives
  - Given the available opportunities
  - Make decisions by evaluating costs and benefits of marginal changes
    - Small incremental adjustments to a plan of action



# Principle 3: Rational People Think at the Margin

- Examples:
  - Cell phone users with unlimited minutes (the minutes are free at the margin)
    - Are often prone to making long/frivolous calls
    - Marginal benefit of the call  $> 0$
  - A manager considers whether to increase output
    - Compares the cost of the needed labor and materials to the extra revenue



# Principle 4: People Respond to Incentives

- Incentive
  - Something that induces a person to act
- Examples:
  - When gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUVs
  - When cigarette taxes increase, teen smoking falls

You are selling your 2007 Mustang. You have already spent \$1,000 on repairs. At the last minute, the transmission dies. You can pay \$900 to have it repaired, or sell the car “as is.”

In each of the following scenarios, should you have the transmission repaired? Explain.

- A. Blue book value (what you could get for the car) is \$7,500 if transmission works, \$6,200 if it doesn’t.
- B. Blue book value is \$6,300 if transmission works, \$5,500 if it doesn’t.

Cost of fixing the transmission = \$900

A. Blue book value is \$7,500 if transmission works,  
\$6,200 if it doesn't

– Benefit of fixing transmission = \$1,300

$$(= 7500 - 6200)$$

– Get the transmission fixed

B. Blue book value is \$6,300 if transmission works,  
\$5,500 if it doesn't

– Benefit of fixing the transmission = \$800

$$(= 6300 - 5500)$$

– Do not pay \$900 to fix it



# How People Interact

**Principle 5:** Trade can make everyone better off

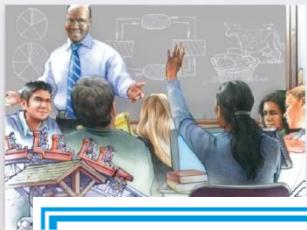
**Principle 6:** Markets are usually a good way to organize economic activity

**Principle 7:** Governments can sometimes improve market outcomes



## Principle 5: Trade Can Make Everyone Better Off

- People benefit from trade:
  - People can buy a greater variety of goods and services at lower cost
- Countries benefit from trade and specialization
  - Get a better price abroad for goods they produce
  - Buy other goods more cheaply from abroad than could be produced at home



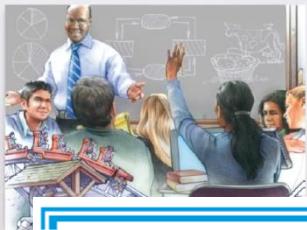
# Principle 6: Markets Are Usually a Good Way to Organize Economic Activity

- Market
  - A group of buyers and sellers (need not be in a single location)
- “Organize economic activity” means determining
  - What goods and services to produce
  - How much of each to produce
  - Who produced and consumed these



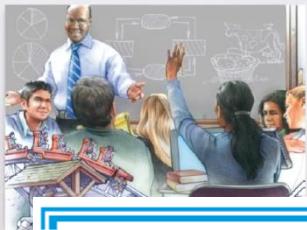
## Principle 6: Markets Are Usually a Good Way to Organize Economic Activity

- A market economy allocates resources
  - Decentralized decisions of many firms and households – as they interact in markets
- Famous insight by Adam Smith in *The Wealth of Nations* (1776):
  - Each of these households and firms acts as if “led by an invisible hand” to promote general economic well-being



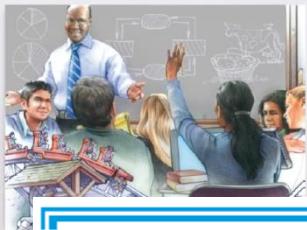
# Principle 6: Markets Are Usually a Good Way to Organize Economic Activity

- Prices:
  - Determined: interaction of buyers and sellers
  - Reflect the good's value to buyers
  - Reflect the cost of producing the good
- Invisible hand:
  - Prices guide self-interested households and firms to make decisions that maximize society's economic well-being



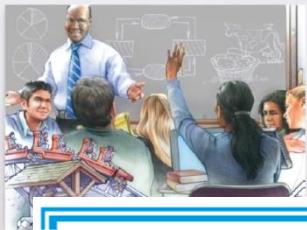
## Principle 7: Governments Can Sometimes Improve Market Outcomes

- Government - enforce property rights
  - Enforce rules and maintain institutions that are key to a market economy
    - People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen



## Principle 7: Governments Can Sometimes Improve Market Outcomes

- Government - promote efficiency
  - Avoid market failures: market left on its own fails to allocate resources efficiently
  - Externality – source of market failure
    - Production or consumption of a good affects bystanders (e.g. pollution)
  - Market power – source of market failure
    - A single buyer or seller has substantial influence on market price (e.g. monopoly)



## Principle 7: Governments Can Sometimes Improve Market Outcomes

- Government - promote equality
  - Avoid disparities in economic wellbeing
  - Use tax or welfare policies to change how the economic “pie” is divided



# How the economy as a whole works

**Principle 8:** A country's standard of living depends on its ability to produce goods and services

**Principle 9:** Prices rise when the government prints too much money

**Principle 10:** Society faces a short-run trade-off between inflation and unemployment



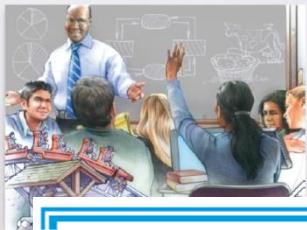
## Principle 8: Country's Standard of Living Depends on Its Ability to Produce Goods and Services

- Huge variation in living standards
  - Across countries and over time
  - Average income in rich countries
    - Is more than ten times average income in poor countries
  - The U.S. standard of living today
    - Is about eight times larger than 100 years ago



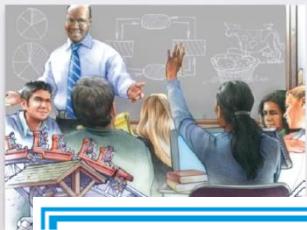
## Principle 8: Country's Standard of Living Depends on Its Ability to Produce Goods and Services

- Productivity: most important determinant of living standards
  - Quantity of goods and services produced from each unit of labor input
  - Depends on the equipment, skills, and technology available to workers
    - Other factors (e.g., labor unions, competition from abroad) have far less impact on living standards



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

- Inflation
  - An increase in the overall level of prices in the economy
- In the long run
  - Inflation is almost always caused by excessive growth in the quantity of money, which causes the value of money to fall
  - The faster the government creates money, the greater the inflation rate



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

- Short-run trade-off between unemployment and inflation
  - Over a period of a year or two, many economic policies push inflation and unemployment in opposite directions
  - Other factors can make this tradeoff more or less favorable, but the tradeoff is always present

# Summary

- Fundamental lessons about individual decision making:
  - People face trade-offs among alternative goals
  - The cost of any action is measured in terms of forgone opportunities
  - Rational people make decisions by comparing marginal costs and marginal benefits
  - People change their behavior in response to the incentives they face

# Summary

- Fundamental lessons about interactions among people:
  - Trade and interdependence can be mutually beneficial
  - Markets are usually a good way of coordinating economic activity among people
  - The government can potentially improve market outcomes by remedying a market failure or by promoting greater economic equality

# Summary

- Fundamental lessons about the economy as a whole:
  - Productivity is the ultimate source of living standards
  - Growth in the quantity of money is the ultimate source of inflation
  - Society faces a short-run trade-off between inflation and unemployment