they produce. It must decide who will eat caviar and who will eat potatoes. It must decide who will drive a Ferrari and who will take the bus.

scarcity
the limited nature of society's resources

The management of society's resources is important because resources are scarce. **Scarcity** means that society has limited resources and therefore cannot produce all the goods and services people wish to have. Just as each member of a household cannot get everything he or she wants, each individual in a society cannot attain the highest standard of living to which he or she might aspire.

economics
the study of how society manages its scarce resources

Economics is the study of how society manages its scarce resources. In most societies, resources are allocated not by an all-powerful dictator but through the combined actions of millions of households and firms. Economists therefore study how people make decisions: how much they work, what they buy, how much they save, and how they invest their savings. Economists also study how people interact with one another. For instance, they examine how the multitude of buyers and sellers of a good together determine the price at which the good is sold and the quantity that is sold. Finally, economists analyze forces and trends that affect the economy as a whole, including the growth in average income, the fraction of the population that cannot find work, and the rate at which prices are rising.

The study of economics has many facets, but it is unified by several central ideas. In this chapter, we look at *Ten Principles of Economics*. Don't worry if you don't understand them all at first or if you aren't completely convinced. We will explore these ideas more fully in later chapters. The ten principles are introduced here to give you an overview of what economics is all about. Consider this chapter a "preview of coming attractions."

How People Make Decisions

There is no mystery to what an economy is. Whether we are talking about the economy of Los Angeles, the United States, or the whole world, an economy is just a group of people dealing with one another as they go about their lives. Because the behavior of an economy reflects the behavior of the individuals who make up the economy, we begin our study of economics with four principles of individual decision making.

Principle 1: People Face Trade-offs

You may have heard the old saying, "There ain't no such thing as a free lunch." Grammar aside, there is much truth to this adage. To get one thing that we like, we usually have to give up another thing that we like. Making decisions requires trading off one goal against another.

Consider a student who must decide how to allocate her most valuable resource—her time. She can spend all her time studying economics, spend all of it studying psychology, or divide it between the two fields. For every hour she studies one subject, she gives up an hour she could have used studying the other. And for every hour she spends studying, she gives up an hour that she could have spent napping, bike riding, watching TV, or working at her part-time job for some extra spending money.

Or consider parents deciding how to spend their family income. They can buy food, clothing, or a family vacation. Or they can save some of the family income for retirement or the children's college education. When they choose to spend an extra dollar on one of these goods, they have one less dollar to spend on some other good.

When people are grouped into societies, they face different kinds of trade-offs. One classic trade-off is between "guns and butter." The more a society spends on national defense (guns) to protect its shores from foreign aggressors, the less it can spend on consumer goods (butter) to raise the standard of living at home. Also important in modern society is the trade-off between a clean environment and a high level of income. Laws that require firms to reduce pollution raise the cost of producing goods and services. Because of the higher costs, these firms end up earning smaller profits, paying lower wages, charging higher prices, or some combination of these three. Thus, while pollution regulations yield the benefit of a cleaner environment and the improved health that comes with it, the regulations come at the cost of reducing the incomes of the regulated firms' owners, workers, and customers.

Another trade-off society faces is between efficiency and equality. **Efficiency** means that society is getting the maximum benefits from its scarce resources. **Equality** means that those benefits are distributed uniformly among society's members. In other words, efficiency refers to the size of the economic pie, and equality refers to how the pie is divided into individual slices.

efficiency
the property of society getting the most it can from its scarce resources

equality
the property of distributing economic prosperity uniformly among the members of society

When government policies are designed, these two goals often conflict. Consider, for instance, policies aimed at equalizing the distribution of economic well-being. Some of these policies, such as the welfare system or unemployment insurance, try to help the members of society who are most in need. Others, such as the individual income tax, ask the financially successful to contribute more than others to support the government. While achieving greater equality, these policies reduce efficiency. When the government redistributes income from the rich to the poor, it reduces the reward for working hard; as a result, people work less and produce fewer goods and services. In other words, when the government tries to cut the economic pie into more equal slices, the pie gets smaller.

Recognizing that people face trade-offs does not by itself tell us what decisions they will or should make. A student should not abandon the study of psychology just because doing so would increase the time available for the study of economics. Society should not stop protecting the environment just because environmental regulations reduce our material standard of living. The poor should not be ignored just because helping them distorts work incentives. Nonetheless, people are likely to make good decisions only if they understand the options they have available. Our study of economics, therefore, starts by acknowledging life's trade-offs.

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

Because people face trade-offs, making decisions requires comparing the costs and benefits of alternative courses of action. In many cases, however, the cost of an action is not as obvious as it might first appear.

Consider the decision to go to college. The main benefits are intellectual enrichment and a lifetime of better job opportunities. But what are the costs? To answer this question, you might be tempted to add up the money you spend on tuition, books, room, and board. Yet this total does not truly represent what you give up to spend a year in college.

There are two problems with this calculation. First, it includes some things that are not really costs of going to college. Even if you quit school, you need a place to sleep and food to eat. Room and board are costs of going to college only to the extent that they are more expensive at college than elsewhere. Second, this

calculation ignores the largest cost of going to college—your time. When you spend a year listening to lectures, reading textbooks, and writing papers, you cannot spend that time working at a job. For most students, the earnings given up to attend school are the largest single cost of their education.

opportunity cost
whatever must be given up to obtain some item

The **opportunity cost** of an item is what you give up to get that item. When making any decision, decision makers should be aware of the opportunity costs that accompany each possible action. In fact, they usually are. College athletes who can earn millions if they drop out of school and play professional sports are well aware that their opportunity cost of college is very high. It is not surprising that they often decide that the benefit of a college education is not worth the cost.

Principle 3: Rational People Think at the Margin

rational people
people who systematically and purposefully do the best they can to achieve their objectives

Economists normally assume that people are rational. **Rational people** systematically and purposefully do the best they can to achieve their objectives, given the available opportunities. As you study economics, you will encounter firms that decide how many workers to hire and how much of their product to manufacture and sell to maximize profits. You will also encounter individuals who decide how much time to spend working and what goods and services to buy with the resulting income to achieve the highest possible level of satisfaction.

Rational people know that decisions in life are rarely black and white but usually involve shades of gray. At dinnertime, the decision you face is not between fasting or eating like a pig but whether to take that extra spoonful of mashed potatoes. When exams roll around, your decision is not between blowing them off or studying 24 hours a day but whether to spend an extra hour reviewing your notes instead of watching TV. Economists use the term **marginal change** to describe a small incremental adjustment to an existing plan of action. Keep in mind that *margin* means "edge," so marginal changes are adjustments around the edges of what you are doing. Rational people often make decisions by comparing *marginal benefits* and *marginal costs*.

marginal change
a small incremental adjustment to a plan of action

For example, consider an airline deciding how much to charge passengers who fly standby. Suppose that flying a 200-seat plane across the United States costs the airline $100,000. In this case, the average cost of each seat is $100,000/200, which is $500. One might be tempted to conclude that the airline should never sell a ticket for less than $500. Actually, a rational airline can often find ways to raise its profits by thinking at the margin. Imagine that a plane is about to take off with ten empty seats, and a standby passenger waiting at the gate will pay $300 for a seat. Should the airline sell the ticket? Of course it should. If the plane has empty seats, the cost of adding one more passenger is tiny. Although the *average* cost of flying a passenger is $500, the *marginal* cost is merely the cost of the bag of peanuts and can of soda that the extra passenger will consume. As long as the standby passenger pays more than the marginal cost, selling the ticket is profitable.

Marginal decision making can help explain some otherwise puzzling economic phenomena. Here is a classic question: Why is water so cheap, while diamonds are so expensive? Humans need water to survive, while diamonds are unnecessary; but for some reason, people are willing to pay much more for a diamond than for a cup of water. The reason is that a person's willingness to pay for a good is based on the marginal benefit that an extra unit of the good would yield. The marginal benefit, in turn, depends on how many units a person already has. Water is essential, but the marginal benefit of an extra cup is small because water is plentiful. By contrast, no one needs diamonds to survive, but because diamonds are so rare, people consider the marginal benefit of an extra diamond to be large.

A rational decision maker takes an action if and only if the marginal benefit of the action exceeds the marginal cost. This principle can explain why airlines are willing to sell a ticket below average cost and why people are willing to pay more for diamonds than for water. It can take some time to get used to the logic of marginal thinking, but the study of economics will give you ample opportunity to practice.

Principle 4: People Respond to Incentives

incentive
something that induces a person to act

An **incentive** is something that induces a person to act, such as the prospect of a punishment or a reward. Because rational people make decisions by comparing costs and benefits, they respond to incentives. You will see that incentives play a central role in the study of economics. One economist went so far as to suggest that the entire field could be summarized simply: "People respond to incentives. The rest is commentary."

Incentives are crucial to analyzing how markets work. For example, when the price of an apple rises, people decide to eat fewer apples. At the same time, apple orchards decide to hire more workers and harvest more apples. In other words, a higher price in a market provides an incentive for buyers to consume less and an incentive for sellers to produce more. As we will see, the influence of prices on the behavior of consumers and producers is crucial for how a market economy allocates scarce resources.

Public policymakers should never forget about incentives: Many policies change the costs or benefits that people face and, therefore, alter their behavior. A tax on gasoline, for instance, encourages people to drive smaller, more fuel-efficient cars. That is one reason people drive smaller cars in Europe, where gasoline taxes are high, than in the United States, where gasoline taxes are low. A gasoline tax also encourages people to carpool, take public transportation, and live closer to where they work. If the tax were larger, more people would be driving hybrid cars, and if it were large enough, they would switch to electric cars.

When policymakers fail to consider how their policies affect incentives, they often end up with unintended consequences. For example, consider public policy regarding auto safety. Today, all cars have seat belts, but this was not true 50 years ago. In the 1960s, Ralph Nader's book *Unsafe at Any Speed* generated much public concern over auto safety. Congress responded with laws requiring seat belts as standard equipment on new cars.

How does a seat belt law affect auto safety? The direct effect is obvious: When a person wears a seat belt, the probability of surviving an auto accident rises. But that's not the end of the story because the law also affects behavior by altering incentives. The relevant behavior here is the speed and care with which drivers operate their cars. Driving slowly and carefully is costly because it uses the driver's time and energy. When deciding how safely to drive, rational people compare, perhaps unconsciously, the marginal benefit from safer driving to the marginal cost. As a result, they drive more slowly and carefully when the benefit of increased safety is high. For example, when road conditions are icy, people drive more attentively and at lower speeds than they do when road conditions are clear.

Consider how a seat belt law alters a driver's cost–benefit calculation. Seat belts make accidents less costly because they reduce the likelihood of injury or death. In other words, seat belts reduce the benefits of slow and careful driving. People respond to seat belts as they would to an improvement in road conditions—by driving faster and less carefully. The result of a seat belt law, therefore, is a larger number of accidents. The decline in safe driving has a clear, adverse impact on pedestrians, who are more likely to find themselves in an accident but (unlike the drivers) don't have the benefit of added protection.

At first, this discussion of incentives and seat belts might seem like idle speculation. Yet in a classic 1975 study, economist Sam Peltzman argued that auto-safety laws have had many of these effects. According to Peltzman's evidence, these laws produce both fewer deaths per accident and more accidents. He concluded that the net result is little change in the number of driver deaths and an increase in the number of pedestrian deaths.

Peltzman's analysis of auto safety is an offbeat and controversial example of the general principle that people respond to incentives. When analyzing any policy, we must consider not only the direct effects but also the less obvious indirect effects that work through incentives. If the policy changes incentives, it will cause people to alter their behavior.

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Hip-hop mogul Sean "Diddy" Combs responds to incentives.

CASE STUDY The Incentive Effects of Gasoline Prices

From 2005 to 2008 the price of oil in world oil markets skyrocketed, the result of limited supplies together with surging demand from robust world growth, especially in China. The price of gasoline in the United States rose from about $2 to about $4 a gallon. At the time, the news was filled with stories about how people responded to the increased incentive to conserve, sometimes in obvious ways, sometimes in less obvious ways.

Here is a sampling of various stories:

- "As Gas Prices Soar, Buyers Are Flocking to Small Cars"
- "As Gas Prices Climb, So Do Scooter Sales"
- "Gas Prices Knock Bicycles Sales, Repairs into Higher Gear"
- "Gas Prices Send Surge of Riders to Mass Transit"
- "Camel Demand Up as Oil Price Soars": Farmers in the Indian state of Rajasthan are rediscovering the humble camel. As the cost of running gas-guzzling tractors soars, even-toed ungulates are making a comeback.
- "The Airlines Are Suffering, But the Order Books of Boeing and Airbus Are Bulging": Demand for new, more fuel-efficient aircraft has never been greater. The latest versions of the Airbus A320 and Boeing 737, the single-aisle workhorses for which demand is strongest, are up to 40% cheaper to run than the vintage planes some American airlines still use.
- "Home Buying Practices Adjust to High Gas Prices": In his hunt for a new home, Demetrius Stroud crunched the numbers to find out that, with gas prices climbing, moving near an Amtrak station is the best thing for his wallet.
- "Gas Prices Drive Students to Online Courses": For Christy LaBadie, a sophomore at Northampton Community College, the 30-minute drive from her home to the Bethlehem, Pa., campus has become a financial hardship now that gasoline prices have soared to more than $4 a gallon. So this semester she decided to take an online course to save herself the trip—and the money.
- "Diddy Halts Private Jet Flights Over Fuel Prices": Fuel prices have grounded an unexpected frequent-flyer: Sean "Diddy" Combs. . . . The hip-hop mogul said he is now flying on commercial airlines instead of in private jets, which Combs said had previously cost him $200,000 and up for a roundtrip between New York and Los Angeles. "I'm actually flying commercial," Diddy said before walking onto an airplane, sitting in a first-class seat and flashing his boarding pass to the camera. "That's how high gas prices are."