

CHAPTER 1

Ten Principles of Economics

The word *economy* comes from the Greek word *oikonomos*, which means “one who manages a household.” At first, this origin might seem peculiar. But in fact, households and economies have much in common.

A household faces many decisions. It must decide which household members do which tasks and what each member receives in return: Who cooks dinner? Who does the laundry? Who gets the extra dessert at dinner? Who gets to drive the car? In short, a household must allocate its scarce resources (time, dessert, car mileage) among its various members, taking into account each member’s abilities, efforts, and desires.

Like a household, a society faces many decisions. It must find some way to decide what jobs will be done and who will do them. It needs some people to grow food, other people to make clothing, and still others to design computer software. Once society has allocated people (as well as land, buildings, and machines) to various jobs, it must also allocate the goods and services 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

economics

the study of how society
manages its scarce
resources

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

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 choices 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 many 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 the 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 explore these ideas more fully in later chapters. The ten principles are introduced here to give you a sense of what economics is all about. Consider this chapter a "preview of coming attractions."

1-1 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, our first four principles concern individual decision making.

1-1a 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 something that we like, we usually have to give up something else that we also 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 of 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 she could have spent napping, bike riding, playing video games, or working at her part-time job for some extra spending money.

Consider parents deciding how to spend their family income. They can buy food, clothing, or a family vacation. Or they can save some of their income for retirement or their 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 itself from foreign aggressors, the less it can spend on consumer goods (butter) to raise its standard of living. 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 these higher costs, the firms end up earning smaller profits, paying lower wages, charging higher prices, or doing some combination of these three. Thus, while pollution regulations yield a cleaner environment and the improved health that comes with it, this benefit comes at the cost of reducing the well-being 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.

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. Though these policies achieve greater equality, they 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 shrinks.

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 would reduce our material standard of living. The government should not ignore the poor just because helping them would distort work incentives. Nonetheless, people are likely to make good decisions only if they understand the options available to them. Our study of economics, therefore, starts by acknowledging life's trade-offs.

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

1-1b 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.

This calculation has two problems. 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 exceed the cost of living and eating at home or in your own apartment. 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 and earning money. For most students, the earnings they give up to attend school are the largest cost of their education.

opportunity cost

whatever must be given up to obtain some item

rational people

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

marginal change

a small incremental adjustment to a plan of action

The **opportunity cost** of an item is what you give up to get that item. When making any decision, decision makers should take into account the opportunity costs of each possible action. In fact, they usually do. College athletes who can earn millions dropping out of school and playing professional sports are well aware that their opportunity cost of attending college is very high. Not surprisingly, they often decide that the benefit of a college education is not worth the cost.

1-1c Principle 3: Rational People Think at the Margin

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 product to make 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 often involve shades of gray. At dinnertime, you don't ask yourself "Should I fast or eat like a pig?" More likely, the question you face is "Should I take that extra spoonful of mashed potatoes?" When exams roll around, your decision is not between blowing them off and studying 24 hours a day but whether to spend an extra hour reviewing your notes instead of playing video games. 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 make decisions by comparing *marginal benefits* and *marginal costs*.

For example, suppose you are considering watching a movie tonight. You pay \$40 a month for a movie streaming service that gives you unlimited access to its film library, and you typically watch 8 movies a month. What cost should you take into account when deciding whether to stream another movie? You might at first think the answer is $\$40/8$, or \$5, which is the *average* cost of a movie. More relevant for your decision, however, is the *marginal* cost—the extra cost that you would incur by streaming another film. Here, the marginal cost is zero because you pay the same \$40 for the service regardless of how many movies you stream. In other words, at the margin, streaming a movie is free. The only cost of watching a movie tonight is the time it takes away from other activities, such as working at a job or (better yet) reading this textbook.

Thinking at the margin also works for business decisions. 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. The average cost of each seat is \$500 ($\$100,000/200$). One might be tempted to conclude that the airline should never sell a ticket for less than \$500. But imagine that a plane is about to take off with 10 empty seats and a standby passenger waiting at the gate is willing to 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. The *average* cost of flying a passenger is \$500, but the *marginal* cost is merely the cost of the can of soda that the extra passenger will consume and the small bit of jet fuel needed to carry the extra passenger's weight. As long as the standby passenger pays more than the marginal cost, selling the ticket is profitable. Thus, a rational airline can increase profits by thinking at the margin.

Marginal decision making can explain some otherwise puzzling 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. Yet 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, the marginal benefit of an extra diamond is large.

A rational decision maker takes an action if and only if the action's marginal benefit exceeds its marginal cost. This principle explains why people use their movie streaming services as much as they do, why airlines are willing to sell tickets below average cost, and why people 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.



Many movie streaming services set the marginal cost of a movie equal to zero.

1-1d Principle 4: People Respond to Incentives

An **incentive** is something that induces a person to act, such as the prospect of a punishment or 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 as simply "People respond to incentives. The rest is commentary."

Incentives are key to analyzing how markets work. For example, when the price of apples 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 to 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, as a result, 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 higher gasoline tax also encourages people to carpool, take public transportation, live closer to where they work, or switch to hybrid or electric cars.

When policymakers fail to consider how their policies affect incentives, they often face unintended consequences. For example, consider public policy regarding auto safety. Today, all cars have seat belts, but this was not true 60 years ago. In 1965, 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 likelihood of surviving an auto accident rises. But that's not the end of the story. 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

incentive

something that induces a person to act

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 by reducing the risk 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 give rise not only to fewer deaths per accident but also to 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.

QuickQuiz

1. Economics is best defined as the study of
 - a. how society manages its scarce resources.
 - b. how to run a business most profitably.
 - c. how to predict inflation, unemployment, and stock prices.
 - d. how the government can stop the harm from unchecked self-interest.
2. Your opportunity cost of going to a movie is
 - a. the price of the ticket.
 - b. the price of the ticket plus the cost of any soda and popcorn you buy at the theater.
 - c. the total cash expenditure needed to go to the movie plus the value of your time.
 - d. zero, as long as you enjoy the movie and consider it a worthwhile use of time and money.
3. A marginal change is one that
 - a. is not important for public policy.
 - b. incrementally alters an existing plan.
 - c. makes an outcome inefficient.
 - d. does not influence incentives.
4. Because people respond to incentives,
 - a. policymakers can alter outcomes by changing punishments or rewards.
 - b. policies can have unintended consequences.
 - c. society faces a trade-off between efficiency and equality.
 - d. All of the above.

Answers at end of chapter.

1-2 How People Interact

The first four principles discussed how individuals make decisions. As we go about our lives, many of our decisions affect not only ourselves but other people as well. The next three principles concern how people interact with one another.

1-2a Principle 5: Trade Can Make Everyone Better Off

You may have heard on the news that the Chinese are our competitors in the world economy. In some ways, this is true because American firms and Chinese firms produce many of the same goods. Companies in the United States and China compete for the same customers in the markets for clothing, toys, solar panels, automobile tires, and many other items.

Yet it is easy to be misled when thinking about competition among countries. Trade between the United States and China is not like a sports contest in which one side wins and the other side loses. The opposite is true: Trade between two countries can make each country better off.

To see why, consider how trade affects your family. When a member of your family looks for a job, she competes against members of other families who are looking for jobs. Families also compete against one another when they go shopping because each family wants to buy the best goods at the lowest prices. In a sense, each family in an economy competes with all other families.

Despite this competition, your family would not be better off isolating itself from all other families. If it did, your family would need to grow its own food, sew its own clothes, and build its own home. Clearly, your family gains much from being able to trade with others. Trade allows each person to specialize in the activities she does best, whether it is farming, sewing, or home building. By trading with others, people can buy a greater variety of goods and services at lower cost.

Like families, countries also benefit from being able to trade with one another. Trade allows countries to specialize in what they do best and to enjoy a greater variety of goods and services. The Chinese, as well as the French, Egyptians, and Brazilians, are as much our partners in the world economy as they are our competitors.

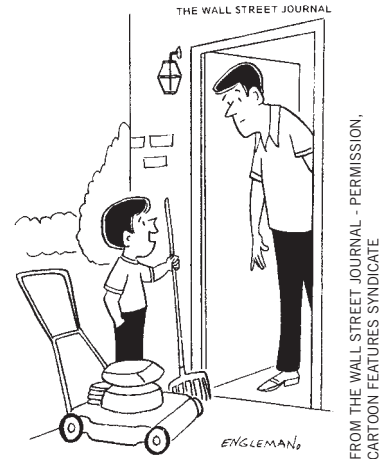
1-2b Principle 6: Markets Are Usually a Good Way to Organize Economic Activity

The collapse of communism in the Soviet Union and Eastern Europe in the late 1980s and early 1990s was one of the last century's most transformative events. Communist countries operated on the premise that government officials were in the best position to allocate the economy's scarce resources. These central planners decided what goods and services were produced, how much was produced, and who produced and consumed these goods and services. The theory behind central planning was that only the government could organize economic activity in a way that promoted well-being for the country as a whole.

Most countries that once had centrally planned economies have abandoned the system and instead have adopted market economies. In a **market economy**, the decisions of a central planner are replaced by the decisions of millions of firms and households. Firms decide whom to hire and what to make. Households decide which firms to work for and what to buy with their incomes. These firms and households interact in the marketplace, where prices and self-interest guide their decisions.

At first glance, the success of market economies is puzzling. In a market economy, no one is looking out for the well-being of society as a whole. Free markets contain many buyers and sellers of numerous goods and services, and all of them are interested primarily in their own well-being. Yet despite decentralized decision making and self-interested decision makers, market economies have proven remarkably successful in organizing economic activity to promote overall prosperity.

In his 1776 book *An Inquiry into the Nature and Causes of the Wealth of Nations*, economist Adam Smith made the most famous observation in all of economics:



"For \$5 a week you can watch baseball without being nagged to cut the grass!"

market economy

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

Households and firms interacting in markets act as if they are guided by an “invisible hand” that leads them to desirable market outcomes. One of our goals in this book is to understand how this invisible hand works its magic.

As you study economics, you will learn that prices are the instrument with which the invisible hand directs economic activity. In any market, buyers look at the price when deciding how much to demand, and sellers look at the price when deciding how much to supply. As a result of these decisions, market prices reflect both the value of a good to society and the cost to society of making the good. Smith’s great insight was that prices adjust to guide buyers and sellers to reach outcomes that, in many cases, maximize the well-being of society as a whole.

Smith’s insight has an important corollary: When a government prevents prices from adjusting naturally to supply and demand, it impedes the invisible hand’s ability to coordinate the decisions of the households and firms that make up an economy. This corollary explains why taxes adversely affect the allocation of resources: They distort prices and thus the decisions of households and firms. It also explains the problems caused by policies that control prices, such as rent control. And it explains the failure of communism. In communist countries, prices were not determined in the marketplace but were dictated by central planners. These planners lacked the necessary information about consumers’ tastes and producers’ costs, which in a market economy is reflected in prices. Central planners failed because they tried to run the economy with one hand tied behind their backs—the invisible hand of the marketplace.

FYI

Adam Smith and the Invisible Hand

It may be only a coincidence that Adam Smith’s great book *The Wealth of Nations* was published in 1776, the exact year in which American revolutionaries signed the Declaration of Independence. But the two documents share a point of view that was prevalent at the time: Individuals are usually best left to their own devices, without the heavy hand of government directing their actions. This political philosophy provides the intellectual foundation for the market economy and for a free society more generally.

Why do decentralized market economies work well? Is it because people can be counted on to treat one another with love and kindness? Not at all. Here is Adam Smith’s description of how people interact in a market economy:



Adam Smith.

Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their own advantage to do for him what he requires of them. . . . Give me that which I want, and you shall have this which you want, is

the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of.

It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens. . . .

Every individual . . . neither intends to promote the public interest, nor knows how much he is promoting it. . . . He 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. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.

Smith is saying that participants in the economy are motivated by self-interest and that the “invisible hand” of the marketplace guides this self-interest into promoting general economic well-being.

Many of Smith’s insights remain at the center of modern economics. Our analysis in the coming chapters will allow us to express Smith’s conclusions more precisely and to analyze more fully the strengths and weaknesses of the market’s invisible hand. ■

CASE STUDY

ADAM SMITH WOULD HAVE LOVED UBER

You have probably never lived in a centrally planned economy, but if you have ever tried to hail a cab in a major city, you have likely experienced a highly regulated market. In many cities, the local government imposes strict controls in the market for taxis. The rules usually go well beyond regulation of insurance and safety. For example, the government may limit entry into the market by approving only a certain number of taxi medallions or permits. It may determine the prices that taxis are allowed to charge. The government uses its police powers—that is, the threat of fines or jail time—to keep unauthorized drivers off the streets and prevent drivers from charging unauthorized prices.

In 2009, however, this highly controlled market was invaded by a disruptive force: Uber, a company that provides a smartphone app to connect passengers and drivers. Because Uber cars do not roam the streets looking for taxi-hailing pedestrians, they are technically not taxis and so are not subject to the same regulations. But they offer much the same service. Indeed, rides from Uber cars are often more convenient. On a cold and rainy day, who wants to stand on the side of the road waiting for an empty cab to drive by? It is more pleasant to remain inside, use your smartphone to arrange a ride, and stay warm and dry until the car arrives.

Uber cars often charge less than taxis, but not always. Uber's prices rise significantly when there is a surge in demand, such as during a sudden rainstorm or late on New Year's Eve, when numerous tipsy partiers are looking for a safe way to get home. By contrast, regulated taxis are typically prevented from surge pricing.

Not everyone is fond of Uber. Drivers of traditional taxis complain that this new competition cuts into their source of income. This is hardly a surprise: Suppliers of goods and services often dislike new competitors. But vigorous competition among producers makes a market work well for consumers.

That is why economists love Uber. A 2014 survey of several dozen prominent economists asked whether car services such as Uber increased consumer well-being. Every single economist said "Yes." The economists were also asked whether surge pricing increased consumer well-being. "Yes," said 85 percent of them. Surge pricing makes consumers pay more at times, but because Uber drivers respond to incentives, it also increases the quantity of car services supplied when they are most needed. Surge pricing also helps allocate the services to those consumers who value them most highly and reduces the costs of searching and waiting for a car.

If Adam Smith were alive today, he would surely have the Uber app on his phone. ●

1-2c Principle 7: Governments Can Sometimes Improve Market Outcomes

If the invisible hand of the market is so great, why do we need government? One purpose of studying economics is to refine your view about the proper role and scope of government policy.

One reason we need government is that the invisible hand can work its magic only if the government enforces the rules and maintains the institutions that are key to a market economy. Most important, market economies need institutions to enforce **property rights** so individuals can own and control scarce resources. A farmer won't grow food if she expects her crop to be stolen; a restaurant won't serve meals unless it is assured that customers will pay before they leave; and a film company won't produce movies if too many potential customers avoid paying by making illegal copies. We all rely on government-provided police and courts to enforce our rights over the things we produce—and the invisible hand counts on our ability to enforce those rights.

Another reason we need government is that, although the invisible hand is powerful, it is not omnipotent. There are two broad rationales for a government to



RICHARD LEVINE/ALAMY STOCK PHOTO

Technology can improve this market.

property rights

the ability of an individual to own and exercise control over scarce resources

intervene in the economy and change the allocation of resources that people would choose on their own: to promote efficiency or to promote equality. That is, most policies aim either to enlarge the economic pie or to change how the pie is divided.

Consider first the goal of efficiency. Although the invisible hand usually leads markets to allocate resources to maximize the size of the economic pie, this is not always the case. Economists use the term **market failure** to refer to a situation in which the market on its own fails to produce an efficient allocation of resources. As we will see, one possible cause of market failure is an **externality**, which is the impact of one person's actions on the well-being of a bystander. The classic example of an externality is pollution. When the production of a good pollutes the air and creates health problems for those who live near the factories, the market on its own may fail to take this cost into account. Another possible cause of market failure is **market power**, which refers to the ability of a single person or firm (or a small group of them) to unduly influence market prices. For example, if everyone in town needs water but there is only one well, the owner of the well does not face the rigorous competition with which the invisible hand normally keeps self-interest in check; she may take advantage of this opportunity by restricting the output of water so she can charge a higher price. In the presence of externalities or market power, well-designed public policy can enhance economic efficiency.

Now consider the goal of equality. Even when the invisible hand yields efficient outcomes, it can nonetheless leave sizable disparities in economic well-being. A market economy rewards people according to their ability to produce things that other people are willing to pay for. The world's best basketball player earns more than the world's best chess player simply because people are willing to pay more to watch basketball than chess. The invisible hand does not ensure that everyone has sufficient food, decent clothing, and adequate healthcare. This inequality may, depending on one's political philosophy, call for government intervention. In practice, many public policies, such as the income tax and the welfare system, aim to achieve a more equal distribution of economic well-being.

To say that the government *can* improve market outcomes does not mean that it always *will*. Public policy is made not by angels but by a political process that is far from perfect. Sometimes policies are designed to reward the politically powerful. Sometimes they are made by well-intentioned leaders who are not fully informed. As you study economics, you will become a better judge of when a government policy is justifiable because it promotes efficiency or equality and when it is not.

market failure

a situation in which a market left on its own fails to allocate resources efficiently

externality

the impact of one person's actions on the well-being of a bystander

market power

the ability of a single economic actor (or small group of actors) to have a substantial influence on market prices

QuickQuiz

5. International trade benefits a nation when
 - a. its revenue from selling abroad exceeds its outlays from buying abroad.
 - b. its trading partners experience reduced economic well-being.
 - c. all nations are specializing in producing what they do best.
 - d. no domestic jobs are lost because of trade.
6. Adam Smith's "invisible hand" refers to
 - a. the subtle and often hidden methods that businesses use to profit at consumers' expense.
 - b. the ability of free markets to reach desirable outcomes, despite the self-interest of market participants.
 - c. the ability of government regulation to benefit consumers even if the consumers are unaware of the regulations.
 - d. the way in which producers or consumers in unregulated markets impose costs on innocent bystanders.
7. Governments may intervene in a market economy in order to
 - a. protect property rights.
 - b. correct a market failure due to externalities.
 - c. achieve a more equal distribution of income.
 - d. All of the above.

Answers at end of chapter.

1-3 How the Economy as a Whole Works

We started by discussing how individuals make decisions and then looked at how people interact with one another. All these decisions and interactions together make up “the economy.” The last three principles concern the workings of the economy as a whole.

1-3a Principle 8: A Country’s Standard of Living Depends on Its Ability to Produce Goods and Services

The differences in living standards around the world are staggering. In 2017, the average American earned about \$60,000. In the same year, the average German earned about \$51,000, the average Chinese about \$17,000, and the average Nigerian only \$6,000. Not surprisingly, this large variation in average income is reflected in various measures of quality of life. Citizens of high-income countries have more computers, more cars, better nutrition, better healthcare, and a longer life expectancy than do citizens of low-income countries.

Changes in living standards over time are also large. In the United States, incomes have historically grown about 2 percent per year (after adjusting for changes in the cost of living). At this rate, average income doubles every 35 years. Over the past century, average U.S. income has risen about eightfold.

What explains these large differences in living standards among countries and over time? The answer is surprisingly simple. Almost all variation in living standards is attributable to differences in countries’ **productivity**—that is, the amount of goods and services produced by each unit of labor input. In nations where workers can produce a large quantity of goods and services per hour, most people enjoy a high standard of living; in nations where workers are less productive, most people endure a more meager existence. Similarly, the growth rate of a nation’s productivity determines the growth rate of its average income.

productivity

the quantity of goods and services produced from each unit of labor input

The relationship between productivity and living standards is simple, but its implications are far-reaching. If productivity is the primary determinant of living standards, other explanations must be less important. For example, it might be tempting to credit labor unions or minimum-wage laws for the rise in living standards of American workers over the past century. Yet the real hero of American workers is their rising productivity. As another example, some commentators have claimed that increased competition from Japan and other countries explained the slow growth in U.S. incomes during the 1970s and 1980s. Yet the real villain was flagging productivity growth in the United States.

The relationship between productivity and living standards also has profound implications for public policy. When thinking about how any policy will affect living standards, the key question is how it will affect our ability to produce goods and services. To boost living standards, policymakers need to raise productivity by ensuring that workers are well educated, have the tools they need to produce goods and services, and have access to the best available technology.

1-3b Principle 9: Prices Rise When the Government Prints Too Much Money

In January 1921, a daily newspaper in Germany cost 0.30 marks. Less than 2 years later, in November 1922, the same newspaper cost 70,000,000 marks. All other prices in the economy rose by similar amounts. This episode is one of history’s most spectacular examples of **inflation**, an increase in the overall level of prices in the economy.

inflation

an increase in the overall level of prices in the economy



"Well it may have been 68 cents when you got in line, but it's 74 cents now!"

Although the United States has never experienced inflation even close to that of Germany in the 1920s, inflation has at times been a problem. During the 1970s, the overall level of prices more than doubled, and President Gerald Ford called inflation "public enemy number one." By contrast, inflation in the two decades of the 21st century has run about 2 percent per year; at this rate, it takes 35 years for prices to double. Because high inflation imposes various costs on society, keeping inflation at a reasonable rate is a goal of economic policymakers around the world.

What causes inflation? In almost all cases of large or persistent inflation, the culprit is growth in the quantity of money. When a government creates large quantities of the nation's money, the value of the money falls. In Germany in the early 1920s, when prices were on average tripling every month, the quantity of money was also tripling every month. Although less dramatic, the economic history of the United States points to a similar conclusion: The high inflation of the 1970s was associated with rapid growth in the quantity of money, and the return of low inflation in the 1980s was associated with slower growth in the quantity of money.

1-3c Principle 10: Society Faces a Short-Run Trade-Off between Inflation and Unemployment

While an increase in the quantity of money primarily raises prices in the long run, the short-run story is more complex. Most economists describe the short-run effects of money growth as follows:

- Increasing the amount of money in the economy stimulates the overall level of spending and thus the demand for goods and services.
- Higher demand may over time cause firms to raise their prices, but in the meantime, it also encourages them to hire more workers and produce a larger quantity of goods and services.
- More hiring means lower unemployment.

This line of reasoning leads to one final economy-wide trade-off: a short-run trade-off between inflation and unemployment.

Although some economists still question these ideas, most accept that society faces a short-run trade-off between inflation and unemployment. This simply means that, over a period of a year or two, many economic policies push inflation and unemployment in opposite directions. Policymakers face this trade-off regardless of whether inflation and unemployment both start out at high levels (as they did in the early 1980s), at low levels (as they did in the late 1990s), or someplace in between. This short-run trade-off plays a key role in the analysis of the **business cycle**—the irregular and largely unpredictable fluctuations in economic activity, as measured by the production of goods and services or the number of people employed.

Policymakers can exploit the short-run trade-off between inflation and unemployment using various policy instruments. By changing the amount that the government spends, the amount it taxes, and the amount of money it prints, policymakers can influence the overall demand for goods and services. Changes in demand in turn influence the combination of inflation and unemployment that the economy experiences in the short run. Because these instruments of economic policy are so powerful, how policymakers should use them to control the economy, if at all, is a subject of continuing debate.

business cycle
fluctuations in economic activity, such as employment and production

QuickQuiz

8. The main reason that some nations have higher average living standards than others is that
 - a. the richer nations have exploited the poorer ones.
 - b. the central banks of some nations have created more money.
 - c. some nations have stronger laws protecting worker rights.
 - d. some nations have higher levels of productivity.
9. If a nation has high and persistent inflation, the most likely explanation is
 - a. the central bank creating excessive amounts of money.
 - b. unions bargaining for excessively high wages.
 - c. the government imposing excessive levels of taxation.
 - d. firms using their market power to enforce excessive price hikes.
10. If a central bank uses the tools of monetary policy to reduce the demand for goods and services, the likely result is _____ inflation and _____ unemployment in the short run.
 - a. lower; lower
 - b. lower; higher
 - c. higher; higher
 - d. higher; lower

Answers at end of chapter.

1-4 Conclusion

You now have a taste of what economics is all about. In the coming chapters, we develop many specific insights about people, markets, and economies. Mastering these insights will take some effort, but the task is not overwhelming. The field of economics is based on a few big ideas that can be applied in many different situations.

Throughout this book, we will refer back to the *Ten Principles of Economics* introduced in this chapter and summarized in Table 1. Keep these building blocks in mind. Even the most sophisticated economic analysis is founded on these ten principles.

How People Make Decisions

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

How People Interact

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

How the Economy as a Whole Works

8. A country's standard of living depends on its ability to produce goods and services.
9. Prices rise when the government prints too much money.
10. Society faces a short-run trade-off between inflation and unemployment.

TABLE 1

Ten Principles of Economics

CHAPTER IN A NUTSHELL

- The fundamental lessons about individual decision making are that people face trade-offs among alternative goals, that the cost of any action is measured in terms of forgone opportunities, that rational people make decisions by comparing marginal costs and marginal benefits, and that people change their behavior in response to the incentives they face.
- The fundamental lessons about interactions among people are that trade and interdependence can be mutually beneficial, that markets are usually a good way of coordinating economic activity among people, and that governments can potentially improve market outcomes by remedying a market failure or by promoting greater economic equality.
- The fundamental lessons about the economy as a whole are that productivity is the ultimate source of living standards, that growth in the quantity of money is the ultimate source of inflation, and that society faces a short-run trade-off between inflation and unemployment.

KEY CONCEPTS

scarcity, *p. 2*
 economics, *p. 2*
 efficiency, *p. 3*
 equality, *p. 3*
 opportunity cost, *p. 4*
 rational people, *p. 4*

marginal change, *p. 4*
 incentive, *p. 5*
 market economy, *p. 7*
 property rights, *p. 9*
 market failure, *p. 10*

externality, *p. 10*
 market power, *p. 10*
 productivity, *p. 11*
 inflation, *p. 11*
 business cycle, *p. 12*

QUESTIONS FOR REVIEW

1. Give three examples of important trade-offs that you face in your life.
2. What items would you include to figure out the opportunity cost of a vacation to Disney World?
3. Water is necessary for life. Is the marginal benefit of a glass of water large or small?
4. Why should policymakers think about incentives?
5. Why isn't trade between two countries like a game in which one country wins and the other loses?
6. What does the "invisible hand" of the marketplace do?
7. What are the two main causes of market failure? Give an example of each.
8. Why is productivity important?
9. What is inflation and what causes it?
10. How are inflation and unemployment related in the short run?

PROBLEMS AND APPLICATIONS

1. Describe some of the trade-offs faced by each of the following:
 - a. a family deciding whether to buy a new car
 - b. a member of Congress deciding how much to spend on national parks
 - c. a company president deciding whether to open a new factory
 - d. a professor deciding how much to prepare for class
 - e. a recent college graduate deciding whether to go to graduate school
2. You are trying to decide whether to take a vacation. Most of the costs of the vacation (airfare, hotel, and forgone wages) are measured in dollars, but the benefits of the vacation are psychological. How can you compare the benefits to the costs?
3. You were planning to spend Saturday working at your part-time job, but a friend asks you to go skiing. What is the true cost of going skiing? Now suppose you had been planning to spend the day studying at the library. What is the cost of going skiing in this case? Explain.

4. You win \$100 in a basketball pool. You have a choice between spending the money now and putting it away for a year in a bank account that pays 5 percent interest. What is the opportunity cost of spending the \$100 now?
5. The company that you manage has invested \$5 million in developing a new product, but the development is not quite finished. At a recent meeting, your salespeople report that the introduction of competing products has reduced the expected sales of your new product to \$3 million. If it would cost \$1 million to finish development and make the product, should you go ahead and do so? What is the most that you should pay to complete development?
6. A 1996 bill reforming the federal government's antipoverty programs limited many welfare recipients to only 2 years of benefits.
 - a. How does this change affect the incentives for working?
 - b. How might this change represent a trade-off between equality and efficiency?
7. Explain whether each of the following government activities is motivated by a concern about equality or a concern about efficiency. In the case of efficiency, discuss the type of market failure involved.
 - a. regulating cable TV prices
 - b. providing some poor people with vouchers that can be used to buy food
 - c. prohibiting smoking in public places
 - d. breaking up Standard Oil (which once owned 90 percent of all U.S. oil refineries) into several smaller companies
 - e. imposing higher personal income tax rates on people with higher incomes
 - f. enacting laws against driving while intoxicated
8. Discuss each of the following statements from the standpoints of equality and efficiency.
 - a. "Everyone in society should be guaranteed the best healthcare possible."
 - b. "When workers are laid off, they should be able to collect unemployment benefits until they find a new job."
9. In what ways is your standard of living different from that of your parents or grandparents when they were your age? Why have these changes occurred?
10. Suppose Americans decide to save more of their incomes. If banks lend this extra saving to businesses that use the funds to build new factories, how might this lead to faster growth in productivity? Who do you suppose benefits from the higher productivity? Is society getting a free lunch?
11. During the Revolutionary War, the American colonies could not raise enough tax revenue to fully fund the war effort. To make up the difference, the colonies decided to print more money. Printing money to cover expenditures is sometimes referred to as an "inflation tax." Who do you think is being "taxed" when more money is printed? Why?

QuickQuiz Answers

1. a 2. c 3. b 4. d 5. c 6. b 7. d 8. d 9. a 10. b

CHAPTER 2

Thinking Like an Economist

Every field of study has its own language and way of thinking. Mathematicians talk about axioms, integrals, and vector spaces. Psychologists talk about ego, id, and cognitive dissonance. Lawyers talk about venue, torts, and promissory estoppel.

Economics is no different. Supply, demand, elasticity, comparative advantage, consumer surplus, deadweight loss—these terms are part of the economist's language. In the coming chapters, you will encounter many new terms and some familiar words that economists use in specialized ways. At first, this new language may seem needlessly arcane. But as you will see, its value lies in its ability to provide you with a new and useful way of thinking about the world in which you live.

The purpose of this book is to help you learn the economist's way of thinking. Just as you cannot become a mathematician, psychologist, or lawyer overnight, learning to think like an economist will take some time. Yet with a combination of theory, case studies, and examples of economics in the news, this book will give you ample opportunity to develop and practice this skill.

Before delving into the substance and details of economics, it is helpful to have an overview of how economists approach the world. This chapter discusses the field's methodology. What is distinctive about how economists confront a question? What does it mean to think like an economist?

2-1 The Economist as Scientist



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"I'm a social scientist, Michael. That means I can't explain electricity or anything like that, but if you ever want to know about people, I'm your man."

Economists try to address their subject with a scientist's objectivity. They approach the study of the economy in much the same way a physicist approaches the study of matter and a biologist approaches the study of life: They devise theories, collect data, and then analyze these data to verify or refute their theories.

To beginners, the claim that economics is a science can seem odd. After all, economists do not work with test tubes or telescopes. The essence of science, however, is the *scientific method*—the dispassionate development and testing of theories about how the world works. This method of inquiry is as applicable to studying a nation's economy as it is to studying the earth's gravity or a species' evolution. As Albert Einstein once put it, "The whole of science is nothing more than the refinement of everyday thinking."

Although Einstein's comment is as true for social sciences such as economics as it is for natural sciences such as physics, most people are not accustomed to looking at society through a scientific lens. Let's discuss some of the ways economists apply the logic of science to examine how an economy works.

2-1a The Scientific Method: Observation, Theory, and More Observation

Isaac Newton, the famous 17th-century scientist and mathematician, allegedly became intrigued one day when he saw an apple fall from a tree. This observation motivated Newton to develop a theory of gravity that applies not only to an apple falling to the earth but to any two objects in the universe. Subsequent testing of Newton's theory has shown that it works well in many circumstances (but not all, as Einstein would later show). Because Newton's theory has been so successful at explaining what we observe around us, it is still taught in undergraduate physics courses around the world.

This interplay between theory and observation also occurs in economics. An economist might live in a country experiencing rapidly increasing prices and be moved by this observation to develop a theory of inflation. The theory might assert that high inflation arises when the government prints too much money. To test this theory, the economist could collect and analyze data on prices and money from many different countries. If growth in the quantity of money were unrelated to the rate of price increase, the economist would start to doubt the validity of this theory of inflation. If money growth and inflation were correlated in international data, as in fact they are, the economist would become more confident in the theory.

Although economists use theory and observation like other scientists, they face an obstacle that makes their task especially challenging: In economics, conducting experiments is often impractical. Physicists studying gravity can drop objects in their laboratories to generate data to test their theories. By contrast, economists studying inflation are not allowed to manipulate a nation's monetary policy simply to generate useful data. Economists, like astronomers and evolutionary biologists, usually have to make do with whatever data the world gives them.

To find a substitute for laboratory experiments, economists pay close attention to the natural experiments offered by history. When a war in the Middle East interrupts the supply of crude oil, for instance, oil prices skyrocket around the world. For consumers of oil and oil products, such an event depresses living standards. For economic policymakers, it poses a difficult choice about how best to respond. But for economic scientists, the event provides an opportunity to study the effects of a key natural resource on the world's economies. Throughout this book, we consider

many historical episodes. Studying these episodes is valuable because they give us insight into the economy of the past and allow us to illustrate and evaluate economic theories of the present.

2-1b The Role of Assumptions

If you ask a physicist how long it would take a marble to fall from the top of a ten-story building, he will likely answer the question by assuming that the marble falls in a vacuum. Of course, this assumption is false. In fact, the building is surrounded by air, which exerts friction on the falling marble and slows it down. Yet the physicist will point out that the friction on the marble is so small that its effect is negligible. Assuming the marble falls in a vacuum simplifies the problem without substantially affecting the answer.

Economists make assumptions for the same reason: Assumptions can simplify the complex world and make it easier to understand. To study the effects of international trade, for example, we might assume that the world consists of only two countries and that each country produces only two goods. In reality, there are many countries, each of which produces thousands of different types of goods. But by considering a world with only two countries and two goods, we can focus our thinking on the essence of the problem. Once we understand international trade in this simplified imaginary world, we are in a better position to understand international trade in the more complex world in which we live.

The art in scientific thinking—whether in physics, biology, or economics—is deciding which assumptions to make. Suppose, for instance, that instead of dropping a marble from the top of the building, we were dropping a beach ball of the same weight. Our physicist would realize that the assumption of no friction is less accurate in this case: Friction exerts a greater force on the beach ball because it is much larger than a marble. The assumption that gravity works in a vacuum is reasonable when studying a falling marble but not when studying a falling beach ball.

Similarly, economists use different assumptions to answer different questions. Suppose that we want to study what happens to the economy when the government changes the number of dollars in circulation. An important piece of this analysis, it turns out, is how prices respond. Many prices in the economy change infrequently: The newsstand prices of magazines, for instance, change only once every few years. Knowing this fact may lead us to make different assumptions when studying the effects of the policy change over different time horizons. For studying the short-run effects of the policy, we may assume that prices do not change much. We may even make the extreme assumption that all prices are completely fixed. For studying the long-run effects of the policy, however, we may assume that all prices are completely flexible. Just as a physicist uses different assumptions when studying falling marbles and falling beach balls, economists use different assumptions when studying the short-run and long-run effects of a change in the quantity of money.

2-1c Economic Models

High school biology teachers teach basic anatomy with plastic replicas of the human body. These models have all the major organs—the heart, liver, kidneys, and so on—and allow teachers to show their students very simply how the important parts of the body fit together. Because these plastic models are stylized and omit many details, no one would mistake one of them for a real person. Despite this lack of realism—indeed, because of this lack of realism—studying these models is useful for learning how the human body works.

Economists also use models to learn about the world, but unlike plastic manikins, their models mostly consist of diagrams and equations. Like a biology teacher's plastic model, economic models omit many details to allow us to see what is truly important. Just as the biology teacher's model does not include all the body's muscles and blood vessels, an economist's model does not include every feature of the economy.

As we use models to examine various economic issues throughout this book, you will see that all the models are built with assumptions. Just as a physicist begins the analysis of a falling marble by assuming away the existence of friction, economists assume away many details of the economy that are irrelevant to the question at hand. All models—in physics, biology, and economics—simplify reality to improve our understanding of it.

2-1d Our First Model: The Circular-Flow Diagram

The economy consists of millions of people engaged in many activities—buying, selling, working, hiring, manufacturing, and so on. To understand how the economy works, we must find some way to simplify our thinking about all these activities. In other words, we need a model that explains, in general terms, how the economy is organized and how participants in the economy interact with one another.

Figure 1 presents a visual model of the economy called the **circular-flow diagram**. In this model, the economy is simplified to include only two types of decision makers—firms and households. Firms produce goods and services using inputs, such as labor, land, and capital (buildings and machines). These inputs are called the *factors of production*. Households own the factors of production and consume all the goods and services that the firms produce.

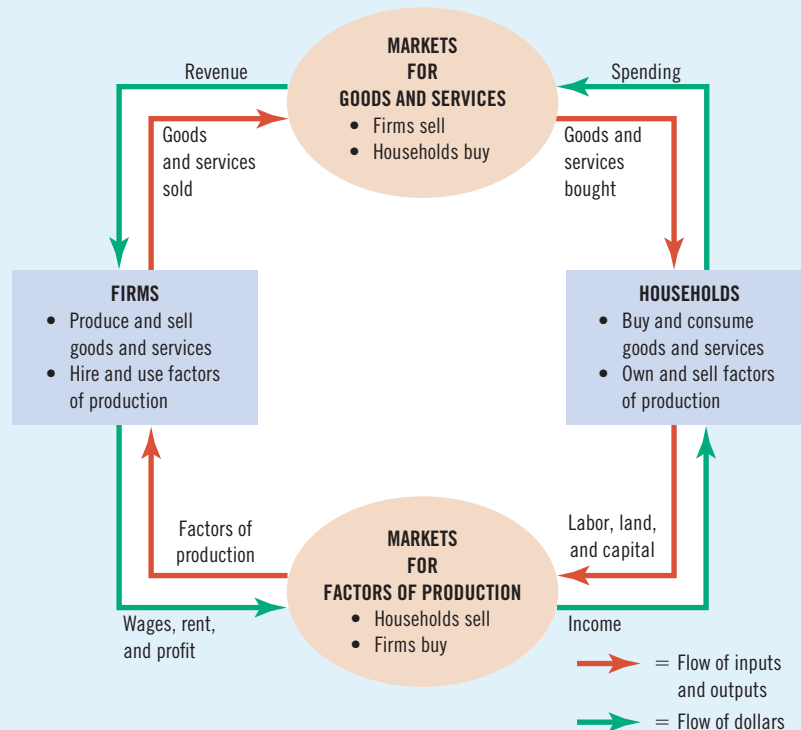
circular-flow diagram

a visual model of the economy that shows how dollars flow through markets among households and firms

FIGURE 1

The Circular Flow

This diagram is a schematic representation of the organization of the economy. Decisions are made by households and firms. Households and firms interact in the markets for goods and services (where households are buyers and firms are sellers) and in the markets for the factors of production (where firms are buyers and households are sellers). The outer set of arrows shows the flow of dollars, and the inner set of arrows shows the corresponding flow of inputs and outputs.



Households and firms interact in two types of markets. In the *markets for goods and services*, households are buyers, and firms are sellers. In particular, households buy the output of goods and services that firms produce. In the *markets for the factors of production*, households are sellers, and firms are buyers. In these markets, households provide the inputs that firms use to produce goods and services. The circular-flow diagram offers a simple way of organizing all the transactions that occur between households and firms in an economy.

The two loops of the circular-flow diagram are distinct but related. The inner loop represents the flows of inputs and outputs. Households sell the use of their labor, land, and capital to firms in the markets for the factors of production. Firms then use these factors to produce goods and services, which in turn are sold to households in the markets for goods and services. The outer loop of the diagram represents the corresponding flow of dollars. Households spend money to buy goods and services from firms. The firms use some of the revenue from these sales for payments to the factors of production, such as workers' wages. What's left is the profit for the firm owners, who are themselves members of households.

Let's take a tour of the circular flow by following a dollar bill as it makes its way from person to person through the economy. Imagine that the dollar begins at a household—say, in your wallet. If you want a cup of coffee, you take the dollar (along with a few of its brothers and sisters) to the market for coffee, which is one of the many markets for goods and services. When you buy your favorite drink at your local Starbucks, the dollar moves into the shop's cash register, becoming revenue for the firm. The dollar doesn't stay at Starbucks for long, however, because the firm spends it on inputs in the markets for the factors of production. Starbucks might use the dollar to pay rent to its landlord for the space it occupies or to pay the wages of its workers. In either case, the dollar enters the income of some household and, once again, is back in someone's wallet. At that point, the story of the economy's circular flow starts once again.

The circular-flow diagram in Figure 1 is a simple model of the economy. A more complex and realistic circular-flow model would include, for instance, the roles of government and international trade. (A portion of that dollar you gave to Starbucks might be used to pay taxes or to buy coffee beans from a farmer in Brazil.) Yet these details are not crucial for a basic understanding of how the economy is organized. Because of its simplicity, this circular-flow diagram is useful to keep in mind when thinking about how the pieces of the economy fit together.

2-1e Our Second Model: The Production Possibilities Frontier

Most economic models, unlike the circular-flow diagram, are built using the tools of mathematics. Here we use one of the simplest such models, called the production possibilities frontier, to illustrate some basic economic ideas.

Although real economies produce thousands of goods and services, let's consider an economy that produces only two goods—cars and computers. Together, the car industry and the computer industry use all of the economy's factors of production. The **production possibilities frontier** is a graph that shows the various combinations of output—in this case, cars and computers—that the economy can possibly produce given the available factors of production and the available production technology that firms use to turn these factors into output.

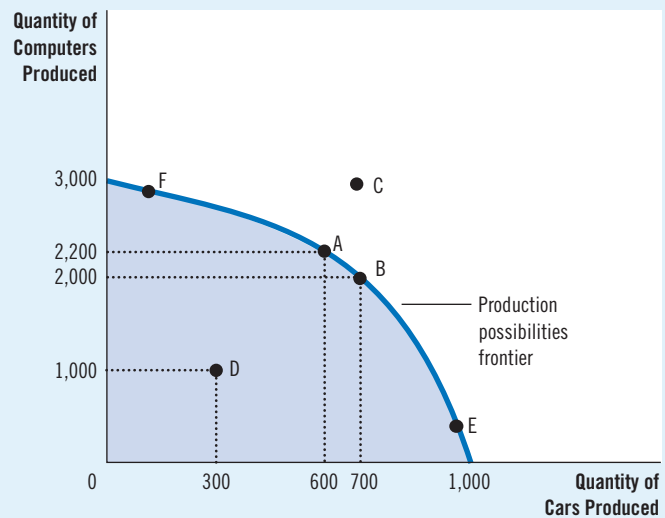
Figure 2 shows this economy's production possibilities frontier. If the economy uses all its resources in the car industry, it produces 1,000 cars and no computers. If it uses all its resources in the computer industry, it produces 3,000 computers and no cars. The two endpoints of the production possibilities frontier represent these extreme possibilities.

production possibilities frontier

a graph that shows the combinations of output that the economy can possibly produce given the available factors of production and the available production technology

FIGURE 2**The Production Possibilities Frontier**

The production possibilities frontier shows the combinations of output—in this case, cars and computers—that the economy can possibly produce. The economy can produce any combination on or inside the frontier. Points outside the frontier are not feasible given the economy's resources. The slope of the production possibilities frontier measures the opportunity cost of a car in terms of computers. This opportunity cost varies, depending on how much of the two goods the economy is producing.



More likely, the economy divides its resources between the two industries, producing some cars and some computers. For example, it can produce 600 cars and 2,200 computers, shown in the figure by point A. Or, by moving some of the factors of production to the car industry from the computer industry, the economy can produce 700 cars and 2,000 computers, represented by point B.

Because resources are scarce, not every conceivable outcome is feasible. For example, no matter how resources are allocated between the two industries, the economy cannot produce the amount of cars and computers represented by point C. Given the technology available for making cars and computers, the economy does not have enough of the factors of production to support that level of output. With the resources it has, the economy can produce at any point on or inside the production possibilities frontier, but it cannot produce at points outside the frontier.

An outcome is said to be *efficient* if the economy is getting all it can from the scarce resources it has available. Points on (rather than inside) the production possibilities frontier represent efficient levels of production. When the economy is producing at such a point, say point A, there is no way to produce more of one good without producing less of the other. Point D represents an *inefficient* outcome. For some reason, perhaps widespread unemployment, the economy is producing less than it could from the resources it has available: It is producing only 300 cars and 1,000 computers. If the source of the inefficiency is eliminated, the economy can increase its production of both goods. For example, if the economy moves from point D to point A, its production of cars increases from 300 to 600, and its production of computers increases from 1,000 to 2,200.

One of the *Ten Principles of Economics* in Chapter 1 is that people face trade-offs. The production possibilities frontier shows one trade-off that society faces. Once we have reached an efficient point on the frontier, the only way of producing more

of one good is to produce less of the other. When the economy moves from point A to point B, for instance, society produces 100 more cars at the expense of producing 200 fewer computers.

This trade-off helps us understand another of the *Ten Principles of Economics*: The cost of something is what you give up to get it. This is called the *opportunity cost*. The production possibilities frontier shows the opportunity cost of one good as measured in terms of the other good. When society moves from point A to point B, it gives up 200 computers to get 100 additional cars. That is, at point A, the opportunity cost of 100 cars is 200 computers. Put another way, the opportunity cost of each car is two computers. Notice that the opportunity cost of a car equals the slope of the production possibilities frontier. (Slope is discussed in the graphing appendix to this chapter.)

The opportunity cost of a car in terms of the number of computers is not constant in this economy but depends on how many cars and computers the economy is producing. This is reflected in the shape of the production possibilities frontier. Because the production possibilities frontier in Figure 2 is bowed outward, the opportunity cost of a car is highest when the economy is producing many cars and few computers, such as at point E, where the frontier is steep. When the economy is producing few cars and many computers, such as at point F, the frontier is flatter, and the opportunity cost of a car is lower.

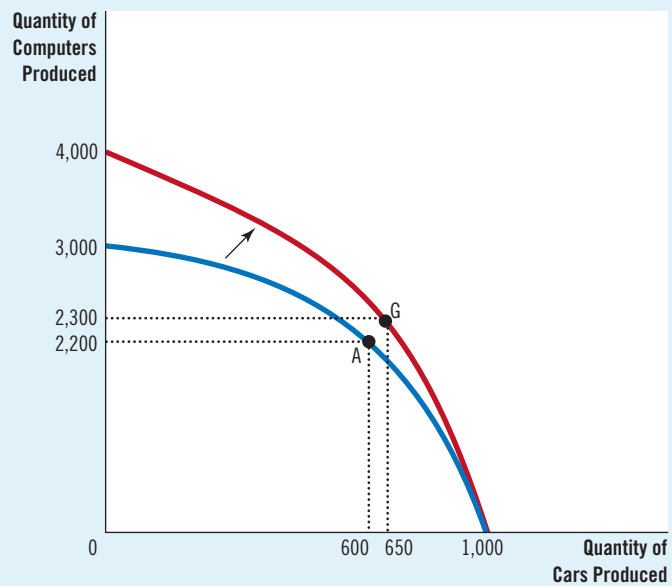
Economists believe that production possibilities frontiers often have this bowed-out shape. When the economy is using most of its resources to make computers, the resources best suited to car production, such as skilled autoworkers, are being used in the computer industry. Because these workers probably aren't very good at making computers, increasing car production by one unit will cause only a slight reduction in the number of computers produced. Thus, at point F, the opportunity cost of a car in terms of computers is small, and the frontier is relatively flat. By contrast, when the economy is using most of its resources to make cars, such as at point E, the resources best suited to making cars are already at work in the car industry. Producing an additional car now requires moving some of the best computer technicians out of the computer industry and turning them into autoworkers. As a result, producing an additional car requires a substantial loss of computer output. The opportunity cost of a car is high, and the frontier is steep.

The production possibilities frontier shows the trade-off between the outputs of different goods at a given time, but the trade-off can change over time. For example, suppose a technological advance in the computer industry raises the number of computers that a worker can produce per week. This advance expands society's set of opportunities. For any given number of cars, the economy can now make more computers. If the economy does not produce any computers, it can still produce 1,000 cars, so one endpoint of the frontier stays the same. But if the economy devotes some of its resources to the computer industry, it will produce more computers from those resources. As a result, the production possibilities frontier shifts outward, as in Figure 3.

This figure shows what happens when an economy grows. Society can move production from a point on the old frontier to a point on the new frontier. Which point it chooses depends on its preferences for the two goods. In this example, society moves from point A to point G, enjoying more computers (2,300 instead of 2,200) and more cars (650 instead of 600).

FIGURE 3**A Shift in the Production Possibilities Frontier**

A technological advance in the computer industry enables the economy to produce more computers for any given number of cars. As a result, the production possibilities frontier shifts outward. If the economy moves from point A to point G, then the production of both cars and computers increases.



The production possibilities frontier simplifies a complex economy to highlight some basic but powerful ideas: scarcity, efficiency, trade-offs, opportunity cost, and economic growth. As you study economics, these ideas will recur in various forms. The production possibilities frontier offers one simple way of thinking about them.

2-1f Microeconomics and Macroeconomics

Many subjects are studied on various levels. Consider biology, for example. Molecular biologists study the chemical compounds that make up living things. Cellular biologists study cells, which are made up of many chemical compounds and, at the same time, are themselves the building blocks of living organisms. Evolutionary biologists study the many varieties of animals and plants and how species gradually change over the centuries.

Economics is also studied on various levels. We can study the decisions of individual households and firms. We can study the interaction of households and firms in markets for specific goods and services. Or we can study the operation of the economy as a whole, which is the sum of the activities of all these decision makers in all these markets.

The field of economics is traditionally divided into two broad subfields. **Microeconomics** is the study of how households and firms make decisions and how they interact in specific markets. **Macroeconomics** is the study of economy-wide phenomena. A microeconomist might study the effects of rent control on housing in New York City, the impact of foreign competition on the U.S. auto industry, or the effects of education on workers' earnings. A macroeconomist might study the effects of borrowing by the federal government, the changes over time in the economy's unemployment rate, or alternative policies to promote growth in national living standards.

microeconomics

the study of how households and firms make decisions and how they interact in markets

macroeconomics

the study of economy-wide phenomena, including inflation, unemployment, and economic growth

Microeconomics and macroeconomics are closely intertwined. Because changes in the overall economy arise from the decisions of millions of individuals, it is impossible to understand macroeconomic developments without considering the underlying microeconomic decisions. For example, a macroeconomist might study the effect of a federal income tax cut on the overall production of goods and services. But to analyze this issue, he must consider how the tax cut affects households' decisions about how much to spend on goods and services.

Despite the inherent link between microeconomics and macroeconomics, the two fields are distinct. Because they address different questions, each field has its own set of models, which are often taught in separate courses.

QuickQuiz

1. An economic model is
 - a. a mechanical machine that replicates the functioning of the economy.
 - b. a fully detailed, realistic description of the economy.
 - c. a simplified representation of some aspect of the economy.
 - d. a computer program that predicts the future of the economy.
2. The circular-flow diagram illustrates that, in markets for the factors of production,
 - a. households are sellers, and firms are buyers.
 - b. households are buyers, and firms are sellers.
 - c. households and firms are both buyers.
 - d. households and firms are both sellers.
3. A point inside the production possibilities frontier is
 - a. efficient but not feasible.
 - b. feasible but not efficient.
 - c. both efficient and feasible.
 - d. neither efficient nor feasible.
4. All of the following topics fall within the study of microeconomics EXCEPT
 - a. the impact of cigarette taxes on the smoking behavior of teenagers.
 - b. the role of Microsoft's market power in the pricing of software.
 - c. the effectiveness of antipoverty programs in reducing homelessness.
 - d. the influence of the government budget deficit on economic growth.

Answers at end of chapter.

2-2 The Economist as Policy Adviser

Often, economists are asked to explain the causes of economic events. Why, for example, is unemployment higher for teenagers than for older workers? Sometimes, economists are asked to recommend policies to improve economic outcomes. What, for instance, should the government do to improve the well-being of teenagers? When economists are trying to explain the world, they are scientists. When they are helping improve it, they are policy advisers.

2-2a Positive versus Normative Analysis

To clarify the two roles that economists play, let's examine the use of language. Because scientists and policy advisers have different goals, they use language in different ways.

For example, suppose that two people are discussing minimum-wage laws. Here are two statements you might hear:

- PRISHA: Minimum-wage laws cause unemployment.
 NOAH: The government should raise the minimum wage.

IN THE NEWS

Why Tech Companies Hire Economists

Many high-tech companies find expertise in economics a useful input into their decision making.

Goodbye, Ivory Tower. Hello, Silicon Valley Candy Store

By Steve Lohr

For eight years, Jack Coles had an economist's dream job at Harvard Business School.

His research focused on the design of efficient markets, an important and growing field that has influenced such things as Treasury bill auctions and decisions on who receives organ transplants. He even got to work with Alvin E. Roth, who won a Nobel in economic science in 2012.

But prestige was not enough to keep Mr. Coles at Harvard. In 2013, he moved to the San Francisco Bay Area. He now works at Airbnb, the online lodging marketplace, one of a number of tech companies luring economists with the promise of big sets of data and big salaries.

Silicon Valley is turning to the dismal science in its never-ending quest to squeeze more money out of old markets and build new ones. In turn, the economists say they are eager to explore the digital world for fresh insights into timeless economic questions of pricing, incentives and behavior.

"It's an absolute candy store for economists," Mr. Coles said. . . .

Businesses have been hiring economists for years. Usually, they are asked to study macroeconomic trends—topics like recessions and currency exchange rates—and help their employers deal with them.

But what the tech economists are doing is different: Instead of thinking about national or global trends, they are studying the data trails of consumer behavior to help digital companies make smart decisions that strengthen their online marketplaces in areas like advertising, movies, music, travel and lodging.

Tech outfits including giants like Amazon, Facebook, Google and Microsoft and up-and-comers like Airbnb and Uber hope that sort of improved efficiency means more profit.

At Netflix, Randall Lewis, an economic research scientist, is finely measuring the effectiveness of advertising. His work also gets at the correlation-or-causation conundrum in economic behavior: What consumer actions occur coincidentally after people see ads, and what actions are most likely caused by the ads?

At Airbnb, Mr. Coles is researching the company's marketplace of hosts and guests

positive statements

claims that attempt to describe the world as it is

normative statements

claims that attempt to prescribe how the world should be

Ignoring for now whether you agree with these statements, notice that Prisha and Noah differ in what they are trying to do. Prisha is speaking like a scientist: She is making a claim about how the world works. Noah is speaking like a policy adviser: He is making a claim about how he would like to change the world.

In general, statements about the world come in two types. One type, such as Prisha's, is positive. **Positive statements** are descriptive. They make a claim about how the world *is*. A second type of statement, such as Noah's, is normative. **Normative statements** are prescriptive. They make a claim about how the world *ought to be*.

A key difference between positive and normative statements is how we judge their validity. We can, in principle, confirm or refute positive statements by examining evidence. An economist might evaluate Prisha's statement by analyzing data on changes in minimum wages and changes in unemployment over time. By contrast, evaluating normative statements involves values as well as facts. Noah's statement cannot be judged using data alone. Deciding what is good or bad policy is not just a matter of science. It also involves our views on ethics, religion, and political philosophy.

Positive and normative statements are fundamentally different, but within a person's set of beliefs, they are often intertwined. In particular, positive views about how the world works affect normative views about what policies are desirable.

for insights, both to help build the business and to understand behavior. One study focuses on procrastination—a subject of great interest to behavioral economists—by looking at bookings. Are they last-minute? Made weeks or months in advance? Do booking habits change by age, gender or country of origin?

“They are microeconomic experts, heavy on data and computing tools like machine learning and writing algorithms,” said Tom Beers, executive director of the National Association for Business Economics.

Understanding how digital markets work is getting a lot of attention now, said Hal Varian, Google’s chief economist. But, he said, “I thought it was fascinating years ago.”

Mr. Varian, 69, is the godfather of the tech industry’s in-house economists. Once a well-known professor at the University of California, Berkeley, Mr. Varian showed up at Google in 2002, part time at first, but soon became an employee. He helped refine Google’s AdWords

marketplace, where advertisers bid to have their ads shown on search pages. . . .

For the moment, Amazon seems to be the most aggressive recruiter of economists. It even has an Amazon Economists website for soliciting résumés. In a video on the site, Patrick Bajari, the company’s chief economist, says the economics team has contributed to decisions that have had “multibillion-dollar impacts” for the company. . . .

A current market-design challenge for Amazon and Microsoft is their big cloud computing services. These digital services, for example, face a peak-load problem, much as electric utilities do.

How do you sell service at times when there is a risk some customers may be bumped off? Run an auction for what customers are willing to pay for interruptible service? Or offer set discounts for different levels of risk? Both Amazon and Microsoft are working on that now.

To answer such questions, economists work in teams with computer scientists and people in business. In tech companies, market design involves not only economics but also engineering and marketing. How hard is a certain approach technically? How easy is it to explain to customers?

“Economics influences rather than determines decisions,” said Preston McAfee, Microsoft’s chief economist, who previously worked at Google and Yahoo. ■

Questions to Discuss

1. Think of some firms that you often interact with. How might the input of economists improve their businesses?
2. After studying economics in college, what kind of businesses would be most fun to work for?

Source: *New York Times*, September 4, 2016.

Prisha’s claim that the minimum wage causes unemployment, if true, might lead her to reject Noah’s conclusion that the government should raise the minimum wage. Yet normative conclusions cannot come from positive analysis alone; they involve value judgments as well.

As you study economics, keep in mind the distinction between positive and normative statements because it will help you stay focused on the task at hand. Much of economics is positive: It just tries to explain how the economy works. Yet those who use economics often have normative goals: They want to learn how to improve the economy. When you hear economists making normative statements, you know they are speaking not as scientists but as policy advisers.

2-2b Economists in Washington

President Harry Truman once said that he wanted to find a one-armed economist. When he asked his economists for advice, they always answered, “On the one hand, . . . On the other hand, . . .”

Truman was right that economists’ advice is not always straightforward. This tendency is rooted in one of the *Ten Principles of Economics*: People face trade-offs. Economists are aware that trade-offs are involved in most policy decisions. A policy might increase efficiency at the cost of equality. It might help future generations but hurt the current generation. An economist who says that all policy decisions are easy is an economist not to be trusted.



*"Let's switch.
I'll make the policy, you
implement it, and he'll
explain it."*

Truman was not the only president who relied on economists' advice. Since 1946, the president of the United States has received guidance from the Council of Economic Advisers, which consists of three members and a staff of a few dozen economists. The council, whose offices are just a few steps from the White House, has no duty other than to advise the president and to write the annual *Economic Report of the President*, which discusses recent developments in the economy and presents the council's analysis of current policy issues.

The president also receives input from economists in many administrative departments. Economists at the Office of Management and Budget help formulate spending plans and regulatory policies. Economists at the Department of the Treasury help design tax policy. Economists at the Department of Labor analyze data on workers and those looking for work to help formulate labor-market policies. Economists at the Department of Justice help enforce the nation's antitrust laws.

Economists are also found outside the executive branch of government. To obtain independent evaluations of policy proposals, Congress relies on the advice of the Congressional Budget Office, which is staffed by economists. The Federal Reserve, the institution that sets the nation's monetary policy, employs hundreds of economists to analyze developments in the United States and throughout the world.

The influence of economists on policy goes beyond their role as advisers: Their research and writings can affect policy indirectly. Economist John Maynard Keynes offered this observation:

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.

These words were written in 1935, but they remain true today. Indeed, the "academic scribbler" now influencing public policy is often Keynes himself.

2-2c Why Economists' Advice Is Not Always Followed

Economists who advise presidents and other elected leaders know that their recommendations are not always heeded. Frustrating as this can be, it is easy to understand. The process by which economic policy is actually made differs in many ways from the idealized policy process assumed in economics textbooks.

Throughout this text, whenever we discuss policy, we often focus on one question: What is the best policy for the government to pursue? We act as if policy were set by a benevolent king. Once the king figures out the right policy, he has no trouble putting his ideas into action.

In the real world, figuring out the right policy is only part of a leader's job, sometimes the easiest part. After a president hears from his economic advisers what policy they deem best, he turns to other advisers for related input. His communications advisers will tell him how best to explain the proposed policy to the public, and they will try to anticipate any misunderstandings that might make the challenge more difficult. His press advisers will tell him how the news media will report on his proposal and what opinions will likely be expressed on the nation's editorial pages. His legislative affairs advisers will tell him how Congress will

view the proposal, what amendments members of Congress will suggest, and the likelihood that Congress will pass some version of the president's proposal into law. His political advisers will tell him which groups will organize to support or oppose the proposed policy, how this proposal will affect his standing among different groups in the electorate, and whether it will change support for any of the president's other policy initiatives. After weighing all this advice, the president then decides how to proceed.

Making economic policy in a representative democracy is a messy affair, and there are often good reasons why presidents (and other politicians) do not advance the policies that economists advocate. Economists offer crucial input to the policy process, but their advice is only one ingredient of a complex recipe.

QuickQuiz

5. Which of the following is a positive, rather than a normative, statement?
 - a. Law X will reduce national income.
 - b. Law X is a good piece of legislation.
 - c. Congress ought to pass law X.
 - d. The president should veto law X.
6. The following parts of government regularly rely on the advice of economists:
 - a. Department of Treasury.
 - b. Office of Management and Budget.
 - c. Department of Justice.
 - d. All of the above.

Answers at end of chapter.

2-3 Why Economists Disagree

"If all the economists were laid end to end, they would not reach a conclusion." This quip from George Bernard Shaw is revealing. Economists as a group are often criticized for giving conflicting advice to policymakers. President Ronald Reagan once joked that if the game Trivial Pursuit were designed for economists, it would have 100 questions and 3,000 answers.

Why do economists so often appear to give conflicting advice to policymakers? There are two basic reasons:

- Economists may disagree about the validity of alternative positive theories of how the world works.
- Economists may have different values and therefore different normative views about what government policy should aim to accomplish.

Let's discuss each of these reasons.

2-3a Differences in Scientific Judgments

Several centuries ago, astronomers debated whether the earth or the sun was at the center of the solar system. More recently, climatologists have debated whether the earth is experiencing global warming and, if so, why. Science is an ongoing search to understand the world around us. It is not surprising that as the search continues, scientists sometimes disagree about the direction in which truth lies.

Economists often disagree for the same reason. Although the field of economics sheds light on much about the world (as you will see throughout this book),

there is still much to be learned. Sometimes economists disagree because they have different hunches about the validity of alternative theories. Sometimes they disagree because of different judgments about the size of the parameters that measure how economic variables are related.

For example, economists debate whether the government should tax a household's income or its consumption (spending). Advocates of a switch from the current income tax to a consumption tax believe that the change would encourage households to save more because income that is saved would not be taxed. Higher saving, in turn, would free resources for capital accumulation, leading to more rapid growth in productivity and living standards. Advocates of the current income tax system believe that household saving would not respond much to a change in the tax laws. These two groups of economists hold different normative views about the tax system because they have different positive views about saving's responsiveness to tax incentives.

2-3b Differences in Values

Suppose that Jack and Jill both take the same amount of water from the town well. To pay for maintaining the well, the town taxes its residents. Jill has income of \$150,000 and is taxed \$15,000, or 10 percent of her income. Jack has income of \$40,000 and is taxed \$6,000, or 15 percent of his income.

Is this policy fair? If not, who pays too much and who pays too little? Does it matter whether Jack's low income is due to a medical disability or to his decision to pursue an acting career? Does it matter whether Jill's high income is due to a large inheritance or to her willingness to work long hours at a dreary job?

These are difficult questions about which people are likely to disagree. If the town hired two experts to study how it should tax its residents to pay for the well, it would not be surprising if they offered conflicting advice.

This simple example shows why economists sometimes disagree about public policy. As we know from our discussion of normative and positive analysis, policies cannot be judged on scientific grounds alone. Sometimes, economists give conflicting advice because they have different values or political philosophies. Perfecting the science of economics will not tell us whether Jack or Jill pays too much.

2-3c Perception versus Reality

Because of differences in scientific judgments and differences in values, some disagreement among economists is inevitable. Yet one should not overstate the amount of disagreement. Economists agree with one another more often than is sometimes understood.

Table 1 contains twenty propositions about economic policy. In surveys of professional economists, these propositions were endorsed by an overwhelming majority of respondents. Most of these propositions would fail to command a similar consensus among the public.

The first proposition in the table is about rent control, a policy that sets a legal maximum on the amount landlords can charge for their apartments. Almost all economists believe that rent control adversely affects the availability and quality of housing and is a costly way of helping the neediest members of society. Nonetheless, many city governments ignore the advice of economists and place ceilings on the rents that landlords may charge their tenants.

The second proposition in the table concerns policies that restrict trade among nations: tariffs (taxes on imports) and import quotas (limits on how much of a good can be purchased from abroad). For reasons we discuss more fully in later chapters,

Proposition (and percentage of economists who agree)

1. A ceiling on rents reduces the quantity and quality of housing available. (93%)
2. Tariffs and import quotas usually reduce general economic welfare. (93%)
3. Flexible and floating exchange rates offer an effective international monetary arrangement. (90%)
4. Fiscal policy (e.g., tax cut and/or government expenditure increase) has a significant stimulative impact on a less than fully employed economy. (90%)
5. The United States should not restrict employers from outsourcing work to foreign countries. (90%)
6. Economic growth in developed countries like the United States leads to greater levels of well-being. (88%)
7. The United States should eliminate agricultural subsidies. (85%)
8. An appropriately designed fiscal policy can increase the long-run rate of capital formation. (85%)
9. Local and state governments should eliminate subsidies to professional sports franchises. (85%)
10. If the federal budget is to be balanced, it should be done over the business cycle rather than yearly. (85%)
11. The gap between Social Security funds and expenditures will become unsustainably large within the next 50 years if current policies remain unchanged. (85%)
12. Cash payments increase the welfare of recipients to a greater degree than do transfers-in-kind of equal cash value. (84%)
13. A large federal budget deficit has an adverse effect on the economy. (83%)
14. The redistribution of income in the United States is a legitimate role for the government. (83%)
15. Inflation is caused primarily by too much growth in the money supply. (83%)
16. The United States should not ban genetically modified crops. (82%)
17. A minimum wage increases unemployment among young and unskilled workers. (79%)
18. The government should restructure the welfare system along the lines of a “negative income tax.” (79%)
19. Effluent taxes and marketable pollution permits represent a better approach to pollution control than the imposition of pollution ceilings. (78%)
20. Government subsidies on ethanol in the United States should be reduced or eliminated. (78%)

Source: Richard M. Alston, J. R. Kearl, and Michael B. Vaughn, “Is There Consensus among Economists in the 1990s?” *American Economic Review* (May 1992): 203–209; Dan Fuller and Doris Geide-Stevenson, “Consensus among Economists Revisited,” *Journal of Economics Education* (Fall 2003): 369–387; Robert Whaples, “Do Economists Agree on Anything? Yes!” *Economists’ Voice* (November 2006): 1–6; Robert Whaples, “The Policy Views of American Economic Association Members: The Results of a New Survey,” *Econ Journal Watch* (September 2009): 337–348.

TABLE 1

**Propositions
about Which Most
Economists Agree**

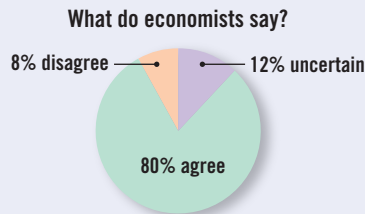
almost all economists oppose such barriers to free trade. Nonetheless, over the years, presidents and Congress have often chosen to restrict the import of certain goods. The policies of the Trump administration are a vivid example.

Why do policies such as rent control and trade barriers persist if the experts are united in their opposition? It may be that the realities of the political process stand

ASK THE EXPERTS

Ticket Resale

“Laws that limit the resale of tickets for entertainment and sports events make potential audience members for those events worse off on average.”



Source: IGM Economic Experts Panel, April 16, 2012.

as immovable obstacles. But it also may be that economists have not yet convinced enough of the public that these policies are undesirable. One purpose of this book is to help you understand the economist's view on these and other subjects and, perhaps, to persuade you that it is the right one.

As you read the book, you will occasionally see small boxes called “Ask the Experts.” These are based on the IGM Economics Experts Panel, an ongoing survey of several dozen prominent economists. Every few weeks, these experts are offered a proposition and then asked whether they agree with it, disagree with it, or are uncertain. The results in these boxes will give you a sense of when economists are united, when they are divided, and when they just don't know what to think.

You can see an example here regarding the resale of tickets to entertainment and sporting events. Lawmakers sometimes try to prohibit reselling tickets, or “scalping” as it is sometimes called. The survey results show that many economists side with the scalpers rather than the lawmakers.

QuickQuiz

7. Economists may disagree because they have different
 - a. hunches about the validity of alternative theories.
 - b. judgments about the size of key parameters.
 - c. political philosophies about the goals of public policy.
 - d. All of the above.
8. Most economists believe that tariffs are
 - a. a good way to promote domestic economic growth.
 - b. a poor way to raise general economic well-being.
 - c. an often necessary response to foreign competition.
 - d. an efficient way for the government to raise revenue.

Answers at end of chapter.

2-4 Let's Get Going

The first two chapters of this book have introduced you to the ideas and methods of economics. We are now ready to get to work. In the next chapter, we start learning in more detail the principles of economic behavior and economic policy.

As you proceed through this book, you will be asked to draw on many intellectual skills. You might find it helpful to keep in mind some advice from the great economist John Maynard Keynes:

The study of economics does not seem to require any specialized gifts of an unusually high order. Is it not . . . a very easy subject compared with the higher branches of philosophy or pure science? An easy subject, at which very few excel! The paradox finds its explanation, perhaps, in that the master-economist must possess a rare *combination* of gifts. He must be mathematician, historian, statesman, philosopher—in some degree. He must understand symbols and speak in words. He must contemplate the particular in terms of the general, and touch abstract and concrete in the same flight of thought. He must study the present

in the light of the past for the purposes of the future. No part of man's nature or his institutions must lie entirely outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician.

This is a tall order. But with practice, you will become more and more accustomed to thinking like an economist.

CHAPTER IN A NUTSHELL

- Economists try to address their subject with a scientist's objectivity. Like all scientists, they make appropriate assumptions and build simplified models to understand the world around them. Two simple economic models are the circular-flow diagram and the production possibilities frontier. The circular-flow diagram shows how households and firms interact in markets for goods and services and in markets for the factors of production. The production possibilities frontier shows how society faces a trade-off between producing different goods.
- The field of economics is divided into two subfields: microeconomics and macroeconomics. Microeconomists study decision making by households and firms and the interactions among households and firms in the marketplace. Macroeconomists study the forces and trends that affect the economy as a whole.
- A positive statement is an assertion about how the world *is*. A normative statement is an assertion about how the world *ought to be*. While positive statements can be judged based on facts and the scientific method, normative statements entail value judgments as well. When economists make normative statements, they are acting more as policy advisers than as scientists.
- Economists who advise policymakers sometimes offer conflicting advice either because of differences in scientific judgments or because of differences in values. At other times, economists are united in the advice they offer, but policymakers may choose to ignore the advice because of the many forces and constraints imposed on them by the political process.

KEY CONCEPTS

| | | |
|---|------------------------------|------------------------------------|
| circular-flow diagram, <i>p. 20</i> | microeconomics, <i>p. 24</i> | positive statements, <i>p. 26</i> |
| production possibilities frontier, <i>p. 21</i> | macroeconomics, <i>p. 24</i> | normative statements, <i>p. 26</i> |

QUESTIONS FOR REVIEW

1. In what ways is economics a science?
2. Why do economists make assumptions?
3. Should an economic model describe reality exactly?
4. Name a way that your family interacts in the markets for the factors of production and a way that it interacts in the markets for goods and services.
5. Name one economic interaction that isn't covered by the simplified circular-flow diagram.
6. Draw and explain a production possibilities frontier for an economy that produces milk and cookies.
7. Use a production possibilities frontier to describe the idea of *efficiency*.
8. What are the two subfields of economics? Explain what each subfield studies.
9. What is the difference between a positive and a normative statement? Give an example of each.
10. Why do economists sometimes offer conflicting advice to policymakers?

PROBLEMS AND APPLICATIONS

1. Draw a circular-flow diagram. Identify the parts of the model that correspond to the flow of goods and services and the flow of dollars for each of the following activities.
 - a. Selena pays a storekeeper \$1 for a quart of milk.
 - b. Stuart earns \$8 per hour working at a fast-food restaurant.
 - c. Shanna spends \$40 to get a haircut.
 - d. Salma earns \$20,000 from her 10 percent ownership of Acme Industrial.
2. Imagine a society that produces military goods and consumer goods, which we'll call "guns" and "butter."
 - a. Draw a production possibilities frontier for guns and butter. Using the concept of opportunity cost, explain why it most likely has a bowed-out shape.
 - b. Show a point on the graph that is impossible for the economy to achieve. Show a point on the graph that is feasible but inefficient.
 - c. Imagine that the society has two political parties, called the Hawks (who want a strong military) and the Doves (who want a smaller military). Show a point on your production possibilities frontier that the Hawks might choose and a point that the Doves might choose.
 - d. Imagine that an aggressive neighboring country reduces the size of its military. As a result, both the Hawks and the Doves reduce their desired production of guns by the same amount. Which party would get the bigger "peace dividend," measured by the increase in butter production? Explain.
3. The first principle of economics in Chapter 1 is that people face trade-offs. Use a production possibilities frontier to illustrate society's trade-off between two "goods"—a clean environment and the quantity of industrial output. What do you suppose determines the shape and position of the frontier? Show what happens to the frontier if engineers develop a new way of producing electricity that emits fewer pollutants.
4. An economy consists of three workers: Larry, Moe, and Curly. Each works 10 hours a day and can produce two services: mowing lawns and washing cars. In an hour, Larry can either mow one lawn or wash one car; Moe can either mow one lawn or wash two cars; and Curly can either mow two lawns or wash one car.
 - a. Calculate how much of each service is produced in the following scenarios, which we label A, B, C, and D:
 - All three spend all their time mowing lawns. (A)
 - All three spend all their time washing cars. (B)
 - All three spend half their time on each activity. (C)
 - Larry spends half his time on each activity, while Moe only washes cars and Curly only mows lawns. (D)
 - b. Graph the production possibilities frontier for this economy. Using your answers to part *a*, identify points A, B, C, and D on your graph.
 - c. Explain why the production possibilities frontier has the shape it does.
 - d. Are any of the allocations calculated in part *a* inefficient? Explain.
5. Classify each of the following topics as relating to microeconomics or macroeconomics.
 - a. a family's decision about how much income to save
 - b. the effect of government regulations on auto emissions
 - c. the impact of higher national saving on economic growth
 - d. a firm's decision about how many workers to hire
 - e. the relationship between the inflation rate and changes in the quantity of money
6. Classify each of the following statements as positive or normative. Explain.
 - a. Society faces a short-run trade-off between inflation and unemployment.
 - b. A reduction in the growth rate of the money supply will reduce the rate of inflation.
 - c. The Federal Reserve should reduce the growth rate of the money supply.
 - d. Society ought to require welfare recipients to look for jobs.
 - e. Lower tax rates encourage more work and more saving.

QuickQuiz Answers

1. c 2. a 3. b 4. d 5. a 6. d 7. d 8. b