In this Lecture,

look for the answers to these questions:

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

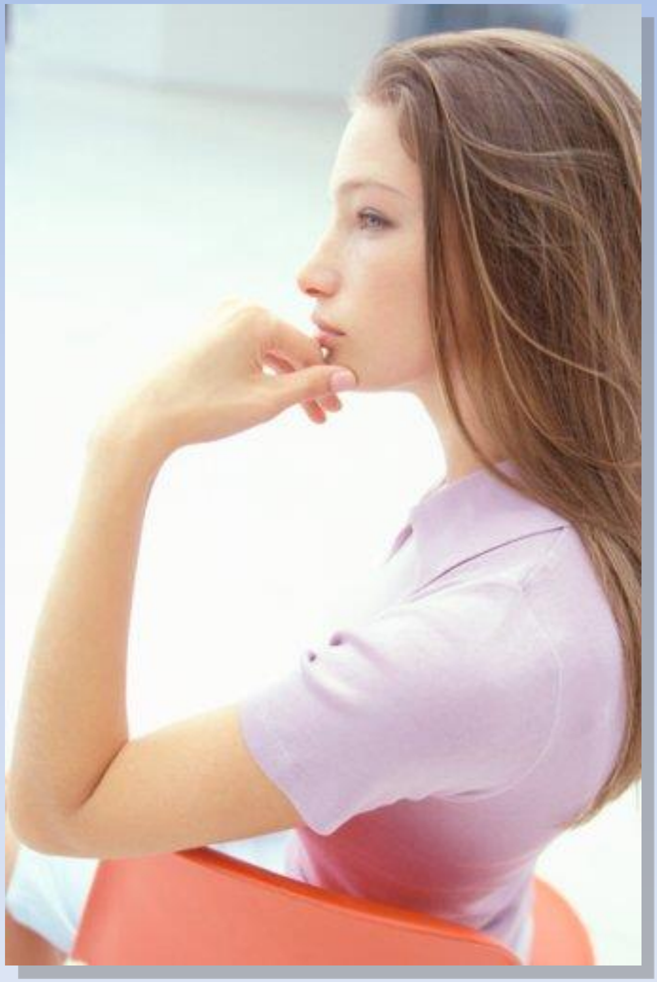
What Economics Is All About

- Economy – “oikonomos” (Greek)
  - “One who manages a household”
- Household - many decisions
  - Allocate scarce resources
    - Ability, effort, and desire
- Society - many decisions
  - Allocate resources
  - Allocate output

What Economics Is All About

- **Scarcity**: the limited nature of society's resources
- **Economics**: the study of how society manages its scarce resources, e.g.
  - how people decide what to buy, how much to work, save, and spend
  - how firms decide how much to produce, how many workers to hire
  - how society decides how to divide its resources between national defense, consumer goods, protecting the environment, and other needs

The principles of
HOW PEOPLE MAKE DECISIONS



PRINCIPLE #1:

People Face Tradeoffs

All decisions involve tradeoffs. Examples:

- Going to a party the night before your midterm leaves less time for studying.
- Having more money to buy stuff requires working longer hours, which leaves less time for leisure.
- Protecting the environment requires resources that could otherwise be used to produce consumer goods.

PRINCIPLE #1:

People Face Tradeoffs

- Society faces an important tradeoff:

  efficiency vs. equality

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

PRINCIPLE #2:

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

- Making decisions requires comparing the costs and benefits of alternative choices.
- The **opportunity cost** of any item is whatever must be given up to obtain it.
- It is the relevant cost for decision making.

PRINCIPLE #2:

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

Examples:

The opportunity cost of…

…going to college for a year is not just the tuition, books, and fees, but also the foregone wages.

…seeing a movie is not just the price of the ticket, but the value of the time you spend in the theater.

PRINCIPLE #3:

Rational People Think at the Margin

Rational people

– systematically and purposefully do the best they can to achieve their objectives.

– make decisions by evaluating costs and benefits of **marginal changes**, incremental adjustments to an existing plan.

PRINCIPLE #3:

Rational People Think at the Margin

Examples:

- When a student considers whether to go to college for an additional year, he compares the fees & foregone wages to the extra income he could earn with the extra year of education.
- When a manager considers whether to increase output, she compares the cost of the needed labor and materials to the extra revenue.

PRINCIPLE #4:

People Respond to Incentives

- **Incentive**: something that induces a person to act, i.e. the prospect of a reward or punishment.
- Rational people respond to incentives.

  Examples:
  - When gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUVs.
  - When cigarette taxes increase, teen smoking falls.

The principles of

HOW PEOPLE INTERACT

PRINCIPLE #5:

Trade Can Make Everyone Better Off

- Rather than being self-sufficient, people can specialize in producing one good or service and exchange it for other goods.
- Countries also benefit from trade and specialization:
  - Get a better price abroad for goods they produce
  - Buy other goods more cheaply from abroad than could be produced at home

PRINCIPLE #6:

Markets Are Usually A Good Way to Organize Economic Activity

- **Market**: a group of buyers and sellers (need not be in a single location)
- "Organize economic activity" means determining
  - <u>what</u> goods to produce
  - <u>how</u> to produce them
  - <u>how much</u> of each to produce
  - <u>who</u> gets them

PRINCIPLE #6:

Markets Are Usually A Good Way to Organize Economic Activity

- A **market economy** allocates resources through the decentralized decisions of many households and firms as they interact in markets.
- Famous insight by Adam Smith in *The Wealth of Nations* (1776):

  Each of these households and firms
  acts as if "led by **an invisible hand**"
  to promote general economic well-being.

How People Interact

- Adam Smith's "invisible hand"
  - Households and firms interacting in markets
    - Act as if they are guided by an "invisible hand"
    - Leads them to desirable market outcomes
  - Corollary: Government intervention
    - Prevents the invisible hand's ability to coordinate the decisions of the households and firms that make up the economy

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

- Communist countries – central planning
  - Government officials (central planners)
    - Allocate economy's scarce resources
      - What goods & services were produced
      - How much was produced
      - Who produced & consumed these goods & services

Principle 7: Governments can sometimes improve market outcomes

- We need government
  - Enforce rules and maintain institutions
    - Enforce property rights
  - Promote efficiency
    - Avoid market failure
  - Promote equality
    - Avoid disparities in economic wellbeing

How People Interact

- Property rights
  - Ability of an individual to own and exercise control over scarce resources
- Market failure
  - Situation in which the market on its own fails to produce an efficient allocation of resources

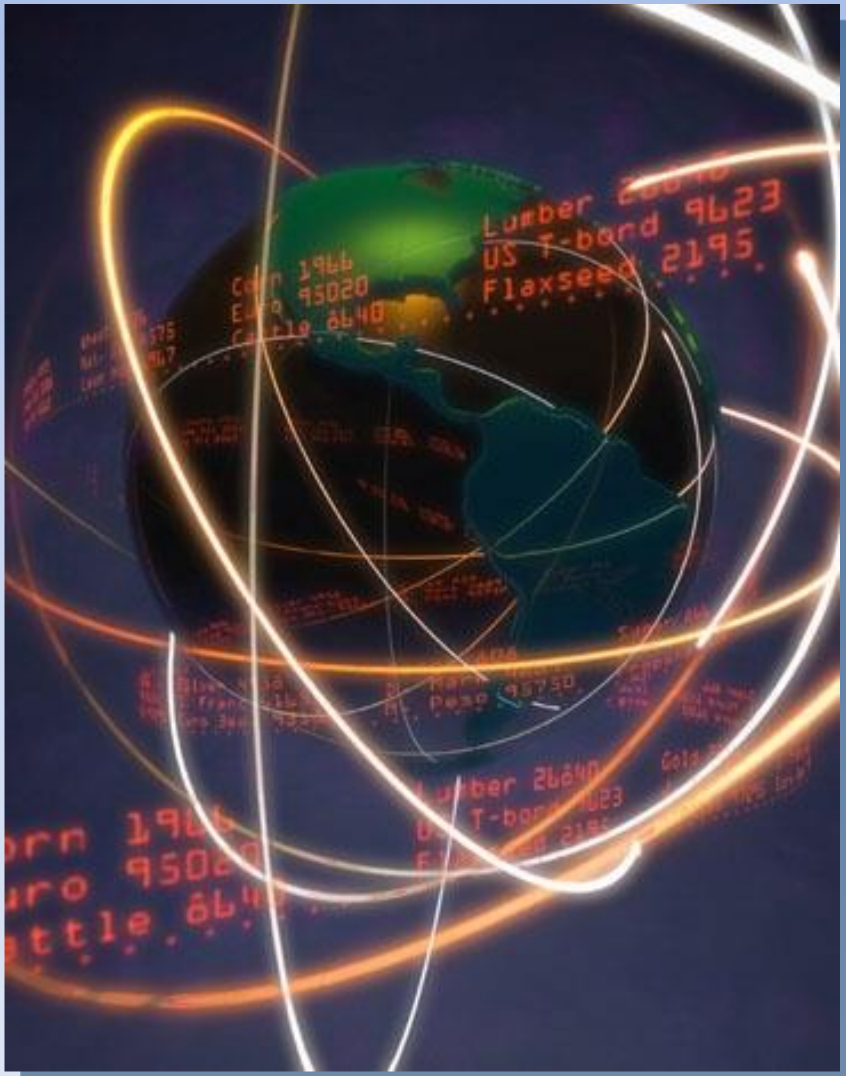
How People Interact

- Causes for market failure
- Externality
  - Impact of one person's actions on the well-being of a bystander
- Market power
  - Ability of a single economic actor (or small group of actors) to have a substantial influence on market prices

How People Interact

- Disparities in economic wellbeing
  - Market economy rewards people
    - According to their ability to produce things that other people are willing to pay for
  - Government intervention: Public policies
    - May diminish inequality
    - Process far from perfect

The principles of
HOW THE ECONOMY AS A WHOLE WORKS



PRINCIPLE #8:

A Country's Standard of Living Depends on Its Ability to Produce Goods & Services

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

PRINCIPLE #8:

A Country's Standard of Living Depends on Its Ability to Produce Goods & Services

- The most important determinant of living standards: **productivity**, the amount of goods and services produced per unit of labor.
- Productivity depends on the equipment, skills, and technology available to workers.
- Other factors (e.g., labor unions, competition from abroad) have far less impact on living standards.

PRINCIPLE #9:

Prices Rise When the Government Prints Too Much Money

- **Inflation**: increases in the general level of prices.
- In the long run, inflation is almost always caused by excessive growth in the quantity of money, which causes the value of money to fall.
- The faster the govt creates money, the greater the inflation rate.

PRINCIPLE #10:

Society Faces a Short-run Tradeoff Between Inflation and Unemployment

- In the short-run (1–2 years), many economic policies push inflation and unemployment in opposite directions.
- Other factors can make this tradeoff more or less favorable, but the tradeoff is always present.

SUMMARY

The principles of decision making are:

- People face tradeoffs.
- The cost of any action is measured in terms of foregone opportunities.
- Rational people make decisions by comparing marginal costs and marginal benefits.
- People respond to incentives.

SUMMARY

The principles of interactions among people are:

- Trade can be mutually beneficial.
- Markets are usually a good way of coordinating trade.
- Govt can potentially improve market outcomes if there is a market failure or if the market outcome is inequitable.

SUMMARY

The principles of the economy as a whole are:

- Productivity is the ultimate source of living standards.
- Money growth is the ultimate source of inflation.
- Society faces a short-run tradeoff between inflation and unemployment.

SUMMARY in ONE SLIDE

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