Economics 1
Principles of Economics

Ten Principles of Economics
(Chapter 1)

Dr. Randall R. Rojas

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?

I. What Economics Is All About

- Def: Scarcity = The limited nature of society's resources.

- Def: 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.

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Idea #1: Incentives Matter

- Def: Incentives = Something that induces a person to act, i.e. the prospect of a reward or punishment.
  - Rational people respond to incentives.
  - People respond to incentives in predictable ways.
  - Self-interest is an important incentive in economics.

Examples:

- When gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUVs.
- When cigarette taxes increase,
  teen smoking falls.
- Ralph Nader's Book (1960): Unsafe at Any Speed.

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Idea #2: Markets Are Usually A Good Way to Organize Economic Activity 1 of 3

- Def: Market = A group of buyers and sellers (need not be in a single location).

- "Organize economic activity" means determining
  – what goods to produce.
  – how to produce them.
  – how much of each to produce.
  – who gets them.

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Idea #2: Markets Are Usually A Good Way to Organize Economic Activity 2 of 3

- 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.

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Idea #2: Markets Are Usually A Good Way to Organize Economic Activity 3 of 3

- The invisible hand works through the price system:
  - The interaction of buyers and sellers determines prices.
  - Each price reflects the good's value to buyers and the cost of producing the good.
  - Prices guide self-interested households and firms to make decisions that, in many cases, maximize society's economic well-being.

*Watch Milton Friedman's "Lesson of the Pencil"

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Idea #3: People Face Tradeoffs 1 of 3

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.

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Idea #3: People Face Tradeoffs 2 of 3

- Central Idea: Society faces an important tradeoff:
  efficiency vs. equality
- Def: Efficiency = When society gets the most from its scarce resources.
- Def: Equality = when prosperity is distributed uniformly among society's members.
- Tradeoff: To achieve greater equality, we could redistribute income from wealthy to poor.
  But this reduces the incentive to work and produce, shrinks the size of the economic "pie."

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Idea #3: People Face Tradeoffs 3 of 3

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

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Idea #4: Rational People Think at the Margin 1 of 2

Def: 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.

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Idea #4: Rational People Think at the Margin 2 of 2

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.
- The diamond-water paradox: water is essential for life but virtually free; diamonds are inessential but expensive.
- The near-zero marginal cost of an airline taking an extra passenger when the flight isn’t full.

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Idea #5: The Power of Trade

- 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.
- Central Idea: Trade can make everyone better off.

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Idea #6: The Importance of Wealth and Economic Growth 1 of 2

- Central Idea: A country's standard of living depends on its ability to produce goods and services.
- Huge variation in living standards across countries and over time:
  - Average income in rich countries is more than ten times average income in poor countries.
  - The U.S. standard of living today is about eight times larger than 100 years ago.

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Idea #6: The Importance of Wealth and Economic Growth 2 of 2

- Central Idea: The most important determinant of living standards is productivity, i.e., 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.

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Idea #7: Institutions Matter 1 of 3

- Central Idea: The important role for government is to enforce property rights (with e.g., police, courts, etc.).
- People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.
- Two examples of the idea in the second bullet point:
  - A restaurant won't serve meals if customers do not pay before they leave.
  - A music company won't produce CDs if too many people avoid paying by making illegal copies.

See e.g., Mankiw, June 12, 2000, issue of *Fortune* magazine entitled "Ukraine: How Not To Run An Economy."

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Idea #7: Institutions Matter 2 of 3

- Def: Market failure =When the market fails to allocate society's resources efficiently.
- Causes of market failure:
  - Externalities, when the production or consumption of a good affects bystanders (e.g. pollution).
  - Market power, a single buyer or seller has substantial influence on market price
    (e.g. monopoly).

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Idea #7: Institutions Matter 3 of 3

- Central Idea: Public policy may promote efficiency.
- Central Idea: Government may alter market outcome to promote equity.
- If the market's distribution of economic well-being is not desirable, tax or welfare policies can change how the economic "pie" is divided.

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Idea #8: Economic Booms and Bursts Cannot be Avoided but can be Moderated 1 of 2

- Central Idea: Policymakers use Fiscal Policy and Monetary Policy to attempt to smooth out this economic volatility.

- Q: Can we make the economy smoother?

* Fiscal policy is the use of government revenue collection (taxation) and expenditure (spending) to influence the economy.
* Monetary policy is the process by which the government controls the supply of money, often targeting a rate of interest for the purpose of promoting economic growth and stability.

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Idea #8: Economic Booms and Bursts Cannot be Avoided but can be Moderated 2 of 2

- Def: Market failure is when the market fails to allocate society's resources efficiently
- Causes of market failure:
  - Externalities, when the production or consumption of a good affects bystanders (e.g. pollution)
  - Market power, a single buyer or seller has substantial influence on market price (e.g. monopoly)
- Public policy may promote efficiency.
- Government may alter market outcome to promote equity.

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

- Def: Inflation = Increase 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 government creates money, the greater the inflation rate.

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Idea #10: Central Banking Is a Hard Job 1 of 2

- Central Idea: 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.

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Idea #10: Central Banking Is a Hard Job 2 of 2

- The Federal Reserve is the U.S.'s central bank.
- "The Fed" is in charge of money supply
  - Helping the economy be stable.
  - Balancing inflation and unemployment.
  - Preventing banking crises?

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.
- Government 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.