

Seventh Edition

Principles of Economics

N. Gregory Mankiw



Wojciech Gerson (1831-1901)

CHAPTER 1

Ten Principles of Economics

In this chapter, 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

- **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**



©lithian/Shutterstock.com

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.

ACTIVE LEARNING 1

Applying the principles

You are selling your 1996 Mustang. You have already spent \$1000 on repairs.

At the last minute, the transmission dies. You can pay \$600 to have it repaired, or sell the car “as is.”

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

- A.** Blue book value (what you could get for the car) is \$6500 if transmission works, \$5700 if it doesn't
- B.** Blue book value is \$6000 if transmission works, \$5500 if it doesn't

ACTIVE LEARNING 1

Answers

Cost of fixing transmission = \$600

- A.** Blue book value is \$6500 if transmission works,
\$5700 if it doesn't

Benefit of fixing transmission = \$800
(\$6500 – 5700).

Get the transmission fixed.

- B.** Blue book value is \$6000 if transmission works,
\$5500 if it doesn't

Benefit of fixing the transmission is only \$500.
Do not pay \$600 to fix it.

ACTIVE LEARNING 1

Observations

- The \$1000 you previously spent on repairs is irrelevant. What matters is the cost and benefit of the *marginal* repair (the transmission).
- The change in incentives from scenario A to scenario B caused your decision to change.

The principles of **HOW PEOPLE INTERACT**



©Pressmaster/Shutterstock.com

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
 - what goods to produce
 - how to produce them
 - how much of each to produce
 - who 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.

PRINCIPLE 6

Markets Are Usually A Good Way to Organize Economic Activity

- 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.

PRINCIPLE 7

Governments Can Sometimes Improve Market Outcomes

- Important role for govt: **enforce property rights** (with police, courts)
- People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.

PRINCIPLE 7

Governments Can Sometimes Improve Market Outcomes

- **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)
- Public policy may **promote efficiency**.

PRINCIPLE 7

Governments Can Sometimes Improve Market Outcomes

- Govt 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.

ACTIVE LEARNING 2

Discussion Question

In each of the following situations, what is the government's role? Does the government's intervention improve the outcome?

- a.** Public schools for K-12
- b.** Workplace safety regulations
- c.** Public highways
- d.** Patent laws, which allow drug companies to charge high prices for life-saving drugs

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.