1

## **Ten Principles of Economics**



#### N. GREGORY MANKIW

Premium PowerPoint® Slides by Ron Cronovich 2008 update

© 2008 South-Western, a part of Cengage Learning, all rights reserved

# 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?

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

1

# What Economics Is All About

### § Scarcity:

### § Economics:

- 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

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

# The principles of HOW PEOPLE MAKE DECISIONS



#### 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.

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

\_\_\_

### HOW PEOPLE MAKE DECISIONS

# Principle #1: People Face Tradeoffs

- § Society faces an important tradeoff: efficiency vs. equity
- § efficiency:
- § equity:
- § Tradeoff:

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

# **HOW PEOPLE MAKE DECISIONS** 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 It is the relevant cost for decision making. CHAPTER 1 TEN PRINCIPLES OF ECONOMICS HOW PEOPLE MAKE DECISIONS 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 ...seeing a movie CHAPTER 1 TEN PRINCIPLES OF ECONOMICS **HOW PEOPLE MAKE DECISIONS** Principle #3: Rational People Think at the Margin § A person is rational if § When making decisions, rational consumers and businesspeople evaluate the costs and benefits of marginal changes -

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

#### **HOW PEOPLE MAKE DECISIONS**

# Principle #3: Rational People Think at the Margin

#### Examples:

- § A student considers whether to go to college for an additional year, comparing
- § A firm considers whether to increase output, comparing

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

9

#### HOW PEOPLE MAKE DECISIONS

### Principle #4: People Respond to Incentives

§ incentive:

- § Rational people respond to incentives. Examples:
  - When gas prices rise, consumers buy more hybrid cars (e.g., Toyota Prius).
  - When cigarette taxes increase, teen smoking falls.

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

10

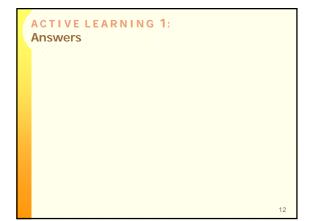
# ACTIVE LEARNING 1: Exercise

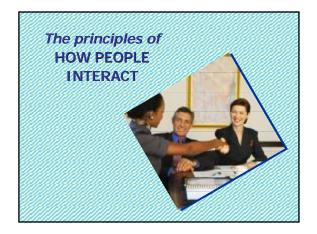
You are selling your 1996 Mustang. You have already spent \$1000 on repairs.

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?

- A. Blue book value is \$6500 if transmission works, \$5700 if it doesn't
- B. Blue book value is \$6000 if transmission works, \$5500 if it doesn't





### 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 & specialization:

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

# **HOW PEOPLE INTERACT** Principle #6: Markets Are Usually A Good Way to Organize Economic Activity § Market: § "Organize economic activity" means CHAPTER 1 TEN PRINCIPLES OF ECONOMICS HOW PEOPLE INTERACT Principle #6: Markets Are Usually A Good Way to Organize Economic Activity § In a market economy, these decisions result from the interactions of many households and firms. § Famous insight by Adam Smith in The Wealth of Nations (1776): Each of these households and firms CHAPTER 1 TEN PRINCIPLES OF ECONOMICS **HOW PEOPLE INTERACT** Principle #6: Markets Are Usually A Good Way to Organize Economic Activity § The invisible hand • The interaction of buyers and sellers

determines prices.

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

 Prices guide self-interested households and firms to make decisions that, in many cases, maximize society's economic well-being.

Each price

HOW PEOPLE INTERACT	
Principle #7: Governments Can Sometimes Improve Market Outcomes	
§ Important role for govt:	
§ People are less inclined to work, produce, invest,	
or purchase if large risk of their property being stolen.	
CHAPTER 1 TEN PRINCIPLES OF ECONOMICS 19	
HOW PEOPLE INTERACT	1
Principle #7: Governments Can Sometimes	
Improve Market Outcomes	
§ market failure:	
§ Causes:	
• externalities	
• market power	
§ In such cases, public policy	
CHAPTER 1 TEN PRINCIPLES OF ECONOMICS 20	
	_
HOW PEOPLE INTERACT	
Principle #7: Governments Can Sometimes Improve Market Outcomes	
§ Govt may alter market outcome to	
§ If the market's distribution of economic well-being is not desirable,	
io noi doditabio,	
CHAPTER 1 TEN PRINCIPLES OF ECONOMICS 21	

# ACTIVE LEARNING 2: Discussion Questions

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

22

The principles of HOW THE ECONOMY AS A WHOLE WORKS



#### HOW THE ECONOMY AS A WHOLE WORKS

Principle #8: A country's standard of living depends on its ability to produce goods & services.

§

- 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.

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

HOW THE ECONOMY AS A WHOLE WORKS	
Principle #8: A country's standard of living depends on its ability to produce goods & services.	
§ The most important determinant of living standards:	
§ Productivity depends on	
§ Other factors (e.g., labor unions, competition from abroad) have far less impact on living standards.  CHAPTER 1 TEN PRINCIPLES OF ECONOMICS 25	
HOW THE ECONOMY AS A WHOLE WORKS	]
Principle #9: Prices rise when the government prints too much money.	-
§ Inflation:	
§ In the long run, inflation is	-
CHAPTER 1 TEN PRINCIPLES OF ECONOMICS 26	
	<b></b>
	_
HOW THE ECONOMY AS A WHOLE WORKS	
Principle #10: Society faces a short-run tradeoff between inflation and unemployment	
§ In the short-run (1 – 2 years),	
§ Other factors can make this tradeoff more or less	
favorable, but the tradeoff is always present.	
CHAPTER 1 TEN PRINCIPLES OF ECONOMICS 27	

FYI: How to Read Your Textbook	
Summarize, don't highlight.     Highlighting is a passive activity that won't improve your comprehension or retention. Instead, summarize	
each section in a few sentences of your own words.  When you finish, compare your summary to the one at the end of the chapter.	
Test yourself.  Try the "QuickQuiz" that follows each section before	
moving on to the next section. Write your answers down, and compare them to the answers in the back of the book. If your answers are incorrect, review the section before moving on.	
CHAPTER 1 TEN PRINCIPLES OF ECONOMICS 28	
	1
FYI: How to Read Your Textbook	
Practice, practice, practice.  Work through the end-of-chapter review questions and problems. They are often good practice for the	
exams. And the more you use your new knowledge, the more solid it will become.	
Go online. The book comes with excellent web resources, including practice quizzes, tools to strengthen your graphing skills, helpful video clips, and other	
resources to help you learn the textbook material more easily and effectively.	
CHAPTER 1 TEN PRINCIPLES OF ECONOMICS 29	
FYI: How to Read Your Textbook	
5. Study in groups. Get together with a few of your classmates to review	
each chapter, quiz each other, and help each other understand the material in the chapter.	
6. <u>Don't forget the real world.</u> Read the Case Studies and In The News boxes in	
each chapter. They will help you see how the new terms, concepts, models, and graphs apply to the real	
world. As you read the newspaper or watch the evening news, see if you can find the connections	

CHAPTER 1 TEN PRINCIPLES OF ECONOMICS

# CONCLUSION

- § Economics offers many insights about the behavior of people, markets, and economies.
- § It is based on a few ideas that can be applied in many situations.
- § Whenever we refer back to one of the *Ten Principles* from this chapter, you will see an icon like this one:



CHAPTER 1 TEN PRINCIPLES OF ECONOMICS