**Economics**

**Lecture No. 1**

**Principles of Economics**

In this topic, 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

**TEN PRINCIPLES OF ECONOMICS**

**A. HOW PEOPLE MAKE DECISIONS**

1. **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.

♣ 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.”

1. **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.

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.

1. **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.

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.

1. **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 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**. Book value is $6500 if transmission works, $5700 if it doesn’t

**b**. Book value is $6000 if transmission works, $5500 if it doesn’t

**ACTIVE LEARNING 1 Answers**

Cost of fixing transmission = $600

**a.** Book value is $6500 if transmission works, $5700 if it doesn’t

Benefit of fixing the transmission = $800 ($6500 – 5700). It’s worthwhile to have the transmission fixed.

**b.** Book value is $6000 if transmission works, $5500 if it doesn’t

Benefit of fixing the transmission is only $500. Paying $600 to fix transmission is not worthwhile.

**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.

**B. HOW PEOPLE INTERACT**

1. **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:

- Get a better price abroad for goods they produce

- Buy other goods more cheaply from abroad than could be produced at home

1. **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)

- Market is set of all actual & potential buyers & sellers of any particular product irrespective of place

♣ “Organize economic activity” means determining

- what goods to produce

- how to produce them

- how much of each to produce

- who gets them

♣ 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.

- 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.

1. **Principle #7**: Governments Can Sometimes Improve Market Outcomes

♣ Important role for govt: enforce laws and property rights (with polices, courts)

♣ People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.

♣ Market failure: when the market fails to allocate society’s resources efficiently

♣ Causes:

- 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)

♣ In such cases, public policy may promote efficiency.

♣ 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 Questions

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

**a**. Public schools

**b**. Workplace safety regulations

**c**. Public highways

d. Patent laws, which allow drug companies to charge high prices for life-saving drugs

1. **HOW THE ECONOMY AS A WHOLE WORKS**
2. **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.

♣ 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.

1. **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.

1. **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.

**CHAPTER 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.

**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.

**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.

***Book: Principles of Economics by Gragory Mankiv***