Ten Principles of Economics
Ten Principles of Economics

• Economy, “oikonomos” (Greek)
  – “One who manages a household”
  – Households and economies have much in common

• Households face many decisions
  – Allocate scarce resources
    • Ability, effort, and desire

• Society faces many decisions
  – Allocate resources and output
Ten Principles of Economics

• Resources are scarce

• Scarcity
  – The limited nature of society’s resources
  – Society has limited resources and therefore cannot produce all the goods and services people wish to have

• Economics
  – How society manages its scarce resources
  – How people make decisions
Ten Principles of Economics

• Economists study:
  – How people make decisions
    • Work, buy, save, invest
  – How people interact with one another
  – Analyze forces and trends that affect the economy as a whole
    • Growth in average income
    • Fraction of the population that cannot find work
    • Rate at which prices are rising
Ten Principles of Economics

• 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
Ten Principles of Economics

• 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
Ten Principles of Economics

• 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
Principle 1: People face trade-offs

• “There ain’t no such thing as a free lunch”
  – To get something that we like, we usually have to give up something else that we also like

• Making decisions
  – Trade off one goal against another
How People Make Decisions, #1

• Trade offs
  – Students: time
  – Parents: income
  – Society
    • National defense vs. consumer goods (guns vs. butter)
    • Clean environment vs. high level of income
    • Efficiency vs. equality
How People Make Decisions, #1

• Efficiency
  – Society getting the maximum benefits from its scarce resources
  – Size of the economic pie

• Equality
  – Distributing economic prosperity uniformly among the members of society
  – How the pie is divided into individual slices
Principle 2: The cost of something is what you give up to get it

- People face trade-offs
  - Make decisions
  - Compare cost with benefits of alternatives

- Opportunity cost
  - Whatever must be given up to obtain some item
Principle 3: Rational people think at the margin

- Rational people
  - Systematically and purposefully do the best they can to achieve their objectives

- Marginal changes
  - Small incremental adjustments to a plan of action
How People Make Decisions, #3

- Rational decision maker
  - Make decisions by comparing marginal benefits and marginal costs
  - Take action only if:
    - Marginal benefits > Marginal costs

"Is the marginal benefit of this call greater than the marginal cost?"
Principle 4: People respond to incentives

- **Incentive**
  - Something that induces a person to act
  - Higher price
    - Buyers - consume less
    - Sellers - produce more
- Public policy
  - Change costs or benefits
  - Change people’s behavior
The Incentive Effects of Gasoline Prices

• 2005 to 2008, price of oil in world oil markets skyrocketed
  – Limited supplies
  – Surging demand from robust world growth
  – Price of gasoline in the United States rose from about $2 to about $4 a gallon
The Incentive Effects of Gasoline Prices

- **Increased incentive to conserve gas**
  - Smaller cars, scooters, bicycles, mass transit
  - Camels (India)
  - New, more fuel-efficient aircraft
    - Airbus A320 and Boeing 737
  - Moving near an Amtrak station
  - Online courses
  - Sean “Diddy” Combs - flying on commercial airlines
Principle 5: Trade can make everyone better off

- Trade
  - Allows each person to specialize in the activities he or she does best
  - Enjoy a greater variety of goods and services at lower cost

“For $5 a week you can watch baseball without being nagged to cut the grass!”
How People Interact, #6

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 and services were produced
      – How much was produced
      – Who produced and consumed these goods and services
How People Interact, #6

- Market economy, allocation of resources
  - Through decentralized decisions of many firms and households
  - As they interact in markets for goods and services
  - Guided by prices and self-interest
How People Interact, #6

• 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
How People Interact, #7

Principle 7: Governments can sometimes improve market outcomes

• We need government
  – Enforce rules and maintain institutions that are key to a market economy
  – Enforce property rights
  – Promote efficiency, avoid market failure
  – Promote equality, avoid disparities in economic wellbeing
How People Interact, #7

- **Property rights**
  - Ability of an individual to own and exercise control over scarce resources

- **Market failure**
  - Situation in which the market left on its own fails to allocate resources efficiently
    - Externalities
    - Market power
How People Interact, #7

• Externality
  – Impact of one person’s actions on the well-being of a bystander
  – Pollution

• Market power
  – Ability of a single economic actor (or small group of actors) to have a substantial influence on market prices
How People Interact, #7

• 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
    • Aim to achieve a more equal distribution of economic well-being
    • May diminish inequality
    • Process far from perfect
Principle 8: A country’s standard of living depends on its ability to produce goods and services

- Large differences in living standards
  - Among countries
  - Over time
- Average annual income, 2011
  - $48,000 (U.S.); $9,000 (Mexico)
  - $5,000 (China); $1,200 (Nigeria)
How the Economy as a Whole Works, #8

• Explanation: differences in productivity

• Productivity
  – Quantity of goods and services produced from each unit of labor input
  – Higher productivity
    • Higher standard of living
  – Growth rate of nation’s productivity
    • Determines growth rate of its average income
Principle 9: Prices rise when the government prints too much money

- Inflation
  - An increase in the overall level of prices in the economy

- Causes for large or persistent inflation
  - Growth in quantity of money
  - Value of money falls

“Well it may have been 68 cents when you got in line, but it’s 74 cents now!”
Principle 10: Society faces a short-run trade-off between inflation and unemployment

- Short-run effects of monetary injections:
  - Stimulates the overall level of spending
    - Higher demand for goods and services
  - Firms – raise prices; hire more workers; produce more goods and services
  - Lower unemployment
How the Economy as a Whole Works, #10

• **Short-run trade-off between unemployment and inflation**
  – Key role – analysis of business cycle

• **Business cycle**
  – Fluctuations in economic activity
    • Employment
    • Production
Table 1

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