Chapter 1. Ten Principles of Economics

I. Introduction

A. The word **"economy"** comes from the Greek word meaning "one who manages a household."

B. This makes some sense since in the economy we are faced with many decisions (just as a household is).

C. Fundamental economic problem: resources are scarce.

D. **scarcity: the limited nature of society's resources.**

E. **economics: the study of how society manages its scarce resources.**

II. How People make Decisions

A. Principle #1: <u>People Face Tradeoffs</u>

1. "There is no such thing as a free lunch." Making decisions requires trading off one goal for another.

2. <u>Examples:</u>

   - Student deciding between studying and partying

   - Families deciding between college and vacations

   - Governments deciding between education and warheads

3. <u>Another example of a tradeoff</u>: efficiency vs. equity.

   a. **<u>efficiency</u>: the property of society getting the most it can from its scarce resources.**

   b. **<u>equity</u>: the property of distributing economic prosperity fairly among the members of society.**

B. Principle #2: <u>The Cost of Something Is What You Give Up to Get It</u>

1. Making decisions requires individuals to consider the benefits and costs of some action.

2. What are the costs of going to college?

3. **<u>opportunity cost</u>: whatever must be given up to obtain some item.**

C. Principle #3: <u>Rational People Think at the Margin</u>

1. Many decisions in life involve incremental decisions:
   - Should I remain in school this semester?
   - Should I take another course this semester?
   - Should I study an additional hour for tomorrow's exam?

2. **<u>marginal changes</u>: small incremental adjustments to a plan of action.**

3. <u>Example</u>: deciding whether or not to stay in school

D. Principle #4: <u>People Respond to Incentives</u>

1. People's decisions may change in response to changes in costs and benefits.

   a. The price of a good rises ➔ consumers will buy less of it

   b. The price of a good rises ➔ producers will produce more of it

2. <u>Examples</u>: Unemployment Insurance, Seat Belts

III. How People Interact

A. Principle #5: <u>Trade Can Make Everyone Better Off</u>

1. Trade is not like a sports competition where one side gains and the other side loses.

2. Your family is involved in trade with other families on a daily basis. Most families do not build their own homes, make their own clothes, or grow their own food.

3. Just like families benefit from trading with one another so do countries.

4. This occurs because it allows for specialization in are as that countries (or families) can do best.

B. Principle #6: <u>Markets Are Usually a Good Way to Organize Economic Activity</u>

1. **<u>market economy</u>: an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.**

2. Market prices reflect both the value of a product to consumers and the cost of the resources used to produce it.

3. Centrally planned economies have failed because they did not allow the market to work.

4. Adam Smith's 1776 work suggested that although individuals are motivated by self-interest, **an invisible hand** guides this self-interest into promoting society's economic well-being.

C. Principle #7: <u>Governments Can Sometimes Improve Market Outcomes</u>

1. Two broad reasons for the government to interfere with the economy: the promotion of efficiency and equity.

2. Government policy can be most useful when there is market failure.

   a. **<u>market failure</u>: a situation in which a market left on its own fails to allocate resources efficiently.**

3. <u>Examples of Market Failure</u>:

   a. **<u>externality</u>: the impact of one person's actions on the well-being of a bystander.**

   b. **<u>market power</u>: the ability of a single economic actor (or small group of actors) to have a substantial influence on market prices.**

4. The government *can* improve market outcomes but does not always do so.

IV. How the Economy as a Whole Works

A. Principle #8: <u>A Country's Standard of Living Depends on Its Ability to Produce Goods and Services</u>

1. Differences in living standards from one country to another are quite large.

2. Changes in living standards over time are also great.

3. The explanation for differences in living standards lies in differences in productivity.

4. **<u>productivity</u>: the quantity of goods and services produced from each hour of a worker's time.**

5. High productivity implies a high standard of living.

6. Thus, policymakers must understand the impact of any policy on our ability to produce goods and services.

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

1. **inflation: an increase in the overall level of prices in the economy.**

2. When the government creates a large amount of money, the value of money falls.

3. Examples: Germany after World War I (in the early 1920s), the United States in the 1970s.

C. Principle #10: Society Faces a Short-Run Tradeoff between Inflation and Unemployment

1. **Phillips curve: a curve that shows the short-run tradeoff between inflation and unemployment.**

2. This is a controversial topic among economists.

3. This tradeoff is only temporary but it can last for several years.

4. The Phillips curve is important for understanding the business cycle.

5. business cycle: fluctuations in economic activity, such as employment and production.