

CH 1: TEN PRINCIPLES OF ECONOMICS

The word *economy* comes from the Greek word for “one who manages a household.” **Economics** is the study of how society manages its scarce resources.

Economists therefore study how people make decisions: how much they work, what they buy, how much they save, and how they invest their savings. Economists also study how people interact with one another. Economists analyze forces and trends that affect the economy as a whole.

A) HOW PEOPLE MAKE DECISIONS

Behavior of an economy reflects the behavior of the individuals who make up the economy. Four principles of individual decision making:

PRINCIPLE #1: PEOPLE FACE TRADEOFFS

To get one thing that we like, we usually have to give up another thing that we like. Making decisions requires trading off one goal against another.

PRINCIPLE #2: THE COST OF SOMETHING IS WHAT YOU GIVE UP TO GET IT

Because people face tradeoffs, making decisions requires comparing the costs and benefits of alternative courses of action.

The **opportunity cost** of an item is what you give up to get that item. When making any decision, such as whether to attend college, decision makers should be aware of the opportunity costs that accompany each possible action.

PRINCIPLE #3: RATIONAL PEOPLE THINK AT THE MARGIN

Economists use the term **marginal changes** to describe small incremental adjustments to an existing plan of action. Keep in mind that “margin” means “edge,” so marginal changes are adjustments around the edges of what you are doing.

Individuals and firms can make better decisions by thinking at the margin. A rational decision maker takes an action if and only if the marginal benefit of the action exceeds the marginal cost.

PRINCIPLE #4: PEOPLE RESPOND TO INCENTIVES

Because people make decisions by comparing costs and benefits, their behavior may change when the costs or benefits change. That is, people respond to incentives.

e.g. A tax on gasoline, for instance, encourages people to drive smaller, more fuel-efficient cars. It also encourages people to take public transportation rather than drive and to live closer to where they work.

B) HOW PEOPLE INTERACT

PRINCIPLE #5: TRADE CAN MAKE EVERYONE BETTER OFF

Trade between two countries can make each country better off. Countries as well as families benefit from the ability to trade with one another. Trade allows countries to specialize in what they do best and to enjoy a greater variety of goods and services.

PRINCIPLE #6: MARKETS ARE USUALLY A GOOD WAY TO ORGANIZE ECONOMIC ACTIVITY

Communist countries worked on the premise that central planners in the government were in the best position to guide economic activity. These planners decided what goods and services were produced, how much was produced, and who produced and consumed these goods and services. The theory behind central planning was that only the government could organize economic activity in a way that promoted economic well-being for the country as a whole.

Today, most countries that once had centrally planned economies have abandoned this system and are trying to develop market economies. In a **market economy**, the decisions of a central planner are replaced by the decisions of millions of firms and households. Firms decide whom to hire and what to make. Households decide which firms to work for and what to buy with their incomes. These firms and households interact in the marketplace, where prices and self-interest guide their decisions.

Adam Smith said that households and firms interacting in markets act as if they are guided by an “invisible hand” that leads them to desirable market outcomes.

Prices are the instrument with which the invisible hand directs economic activity. Prices reflect both the value of a good to society and the cost to society of making the good. Because households and firms look at prices when deciding what to buy and sell, they unknowingly take

into account the social benefits and costs of their actions. As a result, prices guide these individual decision makers to reach outcomes that, in many cases, maximize the welfare of society as a whole.

PRINCIPLE #7: GOVERNMENTS CAN SOMETIMES IMPROVE MARKET OUTCOMES

When the government prevents prices from adjusting naturally to supply and demand, it impedes the invisible hand's ability to coordinate the millions of households and firms that make up the economy. This explains why taxes adversely affect the allocation of resources: Taxes distort prices and thus the decisions of households and firms. It also explains the even greater harm caused by policies that directly control prices, such as rent control. And it explains the failure of communism.

Although markets are usually a good way to organize economic activity, this rule has some important exceptions. There are two broad reasons for a government to intervene in the economy: to promote efficiency and to promote equity.

The invisible hand usually leads markets to allocate resources efficiently. Nonetheless, for various reasons, the invisible hand sometimes does not work. Economists use the term **market failure** to refer to a situation in which the market on its own fails to allocate resources efficiently. One possible cause of market failure is an externality. An **externality** is the impact of one person's actions on the well-being of a bystander. The classic example of an external cost is pollution.

Another possible cause of market failure is market power. **Market power** refers to the ability of a single person (or small group of people) to unduly influence market prices. Regulating the price that the monopolist charges can potentially enhance economic efficiency.

C) HOW THE ECONOMY AS A WHOLE WORKS

PRINCIPLE #8: A COUNTRY'S STANDARD OF LIVING DEPENDS ON ITS ABILITY TO PRODUCE GOODS AND SERVICES

The differences in living standards around the world are staggering. Changes in living standards over time are also large.

Almost all variation in living standards is attributable to differences in countries' **productivity**—that is, the amount of goods and services produced from each hour of a worker's time. In nations where workers can produce a large quantity of goods and services per unit of time, most people enjoy a high standard of living; in nations where workers are less productive, most people must endure a more meager existence. Similarly, the growth rate of a nation's productivity determines the growth rate of its average income.

To boost living standards, policymakers need to raise productivity by ensuring that workers are well educated, have the tools needed to produce goods and services, and have access to the best available technology.

PRINCIPLE #9: PRICES RISE WHEN THE GOVERNMENT PRINTS TOO MUCH MONEY

Inflation is the increase in the overall level of prices in the economy. Because high inflation imposes various costs on society, keeping inflation at a low level is a goal of economic policymakers around the world.

What causes inflation? Growth in the quantity of money. When a government creates large quantities of the nation's money, the value of the money falls.

PRINCIPLE #10: SOCIETY FACES A SHORT-RUN TRADEOFF BETWEEN INFLATION AND UNEMPLOYMENT

Reducing inflation is often thought to cause a temporary rise in unemployment. The curve that illustrates this tradeoff between inflation and unemployment is called the **Phillips curve**, after the economist who first examined this relationship.

There is a short-run tradeoff between inflation and unemployment. This simply means that, over a period of a year or two, many economic policies push inflation and unemployment in opposite directions. This short-run tradeoff arises because some prices are slow to adjust.

Hence, policymakers can exploit this tradeoff using various policy instruments. By changing the amount that the government spends, the amount it taxes, and the amount of money it prints, policymakers can, in the short run, influence the combination of inflation and unemployment that the economy experiences.

Suppose, for example, that the government reduces the quantity of money in the economy. In the long run, the only result of this policy change will be a fall in the overall level of prices. Yet not all prices will adjust immediately. It may take several years before all firms issue new catalogs, all unions make wage concessions, and all restaurants print new menus. That is, prices are said to be *sticky* in the short run. Because prices are sticky, various types of government policy have short-run effects that differ from their long-run effects. When the government reduces the quantity of money, for instance, it reduces the amount that people spend. Lower spending, together with prices that are stuck too high, reduces the quantity of goods and services that firms sell. Lower sales, in turn, cause firms to lay off workers. Thus, the reduction in the quantity of money raises unemployment temporarily until prices have fully adjusted to the change.