Ten Principles of Economics
Economy...

... The word *economy* comes from a Greek word for “one who manages a household.”

- A household and an economy face many decisions:
  - Who will work?
  - What goods and how many of them should be produced?
  - What resources should be used in production?
  - At what price should the goods be sold?
Society and Scarce Resources:

✓ The management of society’s resources is important because resources are scarce.

✓ *Scarcity*. . . means that society has limited resources and therefore cannot produce all the goods and services people wish to have.

✓ *Economics* is the study of how society manages its scarce resources.
Principle #1: People Face Tradeoffs.

To get one thing, we usually have to give up another thing.

- Guns v. butter
- Food v. clothing
- Leisure time v. work
- Efficiency v. equity

- Efficiency v. Equity
  - *Efficiency* means society gets the most that it can from its scarce resources.
  - *Equity* means the benefits of those resources are distributed fairly among the members of society.

- Decisions require comparing costs and benefits of alternatives.
  - Whether to go to college or to work?
  - Whether to study or go out on a date?
  - Whether to go to class or sleep in?

- The opportunity cost of an item is what you give up to obtain that item.
Principle #3: Rational People Think at the Margin.

- Marginal changes are small, incremental adjustments to an existing plan of action.
- People make decisions by comparing costs and benefits at the margin.
- Thinking rationally doesn’t mean that it’s the right or best decision. (ex. Drunk driving)
Principle #4: People Respond to Incentives.

- An incentive is something (such as the prospect of a punishment or a reward) that induces a person to act.
- Because rational people make decisions by comparing costs and benefits, they respond to incentives.
- Incentives are crucial to analyzing how markets work.

- People gain from their ability to trade with one another.
- Competition results in gains from trading.
- Trade allows people to specialize in what they do best.
Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

✓ A *market economy* is an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.

✓ Households decide what to buy and who to work for.

✓ Firms decide who to hire and what to produce.
Principle #7: Governments Can Sometimes Improve Market Outcomes.

- **Market failure** occurs when the market fails to allocate resources efficiently.
- Market failure may be caused by:
  - an *externality*, which is the impact of one person or firm’s actions on the well-being of a bystander.
  - *market power*, which is the ability of a single person or firm to unduly influence market prices.
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Principle #8: The Standard of Living Depends on a Country’s Production.

- Standard of living may be measured in different ways:
  - By comparing personal incomes.
  - By comparing the total market value of a nation’s production.

- Almost all variations in living standards are explained by differences in countries’ productivities.

- *Productivity* is the amount of goods and services produced from each hour of a worker’s time.
Principle #9: Prices Rise When the Government Prints Too Much Money.

- Inflation is an increase in the overall level of prices in the economy.
- One cause of inflation is the growth in the quantity of money.
- When the government creates large quantities of money, the value of the money falls.
Principle #10: Society Faces a Short-run Tradeoff Between Inflation and Unemployment.

- If inflation goes down then unemployment goes up and the opposite is true.