Chapter 1: Ten Principles of Economics
Principles of Economics, 8th Edition
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I. Introduction

- *A.* *Use the margins in your book for note keeping.*
- *B.* *My comments in these chapter summaries are in italics.*
- *C.* *For testing purposes, you are responsible for material covered in the text, but not for my comments.*
- *D.* *The margins in your book are wide, so use them for note taking rather than having a notebook.*
- *E.* *The summaries at the end of the chapters are excellent reviews.*
- *F.* *Much of the power of economics is rooted in the fact that a single set of assumptions (that rational people attempt to maximize their welfare) and a single set of analytical concepts (demand, supply, price, quantity) have proven useful in explaining behavior in such diverse settings as commodity markets, labor markets and foreign exchange as well as non-market phenomena such marriage, education and crime.*
- *G.* *The central features of this framework are as follows.*
    - *1.* *People are constantly confronted with the necessity of making choices - as consumers, workers, investors, parents, and in many other roles.*
    - *2.* *In making these choices, they try to do the best they can, given the constraints they face - constraints of money, time, energy, and information.*
        - *a.* *Economists assume that people are "rational," which does not mean that they are brilliant, but just that they act in a purposeful manner---being better off is preferred to being worse off.*
    - *3.* *Their choices are influenced by relative "prices" -using this term in its broadest sense to include not only money costs but time costs, psychic costs, alternative costs, and others.*
    - *4.* *Their choices may also be influenced by a host of other factors, such as religion, social class, physical and psychological needs, and external pressures.*
        - *a.* *When we observe large-scale, systematic changes in behavior, however, a sensible research strategy is to look first to see if there have been changes in the constraints or in relative prices.*
- *H.* *Fundamentally, economics is the study of choice because*
    - *1.* *resources are scarce relative to*
    - *2.* *our wants.*
- *I.* *Economics is broken down into two areas:*
    - *1.* *Microeconomics consisting on individual decision making and*
    - *2.* *Macroeconomics consisting of national and international analysis.*
- J. The word economy comes from the Greek word oikonomos, which means,

"one who manages a household."

K. Households and economies have much in common.

L. The management of society's resources is important because resources are scarce.
   1. Scarcity is the limited nature of society's resources. P. 4

M. Economics is the study of how society manages its scarce resources. P.4
   1. People make decisions.
   2. People interact with each other.
   3. Their actions affect the economy as a whole.

N. *When thinking about the economy it is often helpful to consider decision making within a family.*

II. How People Make Decisions

A. *These principles are a great way to introduce you to economics.*
   1. *Please note that there is nothing here about memorizing numbers such as gross domestic product figures, etc.*
   2. *Economics is a way of viewing the world.*

B. Principle #1: People face trade offs
   1. *This is one of the reasons why economics is the "dismal science":* if you want more of one thing, then you have to have less of something else.
      a. *Sure free health care would be great as would be a pollution free environment, but what do we have to give up to get them?*
   2. There is no such thing as a free lunch.
   3. There are tradeoffs between
      a. the environment and material standard of living and
         (1) *however, the preferred environmental policies recognize the benefits and costs.*
      b. *between income and work effort.*
   4. One tradeoff can be between efficiency and equality.
      a. Efficiency is the property of society getting the most it can from its scarce resources. P. 5
      b. Equality is the property of distributing economic prosperity uniformly among the members of society. P. 5
      c. An attempt to cut the pie into equal shares can cause the pie to get smaller.

C. Principle #2: The cost of something is what you give up to get it.
   1. Because people face tradeoffs, making decisions requires comparing the costs and benefits of alternative courses of action.
   2. Some expenditures are not really costs because they would have occurred any way.
      a. Meals while at college.

3. Many costs do not involve financial expenditures.
    a. Your time and what else you could be doing with it.
    b. A major cost of the Executive MBA program is the value of your time.
4. Opportunity cost is whatever must be given up to obtain some item. P. 6

D. Principle #3: Rational people think at the margin.

1. Rational people are people who systematically and purposely do the best they can to achieve their objectives. P. 6.
    a. Therefore, rationality does not require people to be particularly intelligent.
2. Why would people make poor decisions?
    a. Mental Illness
    b. Behavior Economics
        (1) Intuition versus Reason: 401k plans
        (2) Thinking is costly.
    c. Poor Information: Social situation
    d. Assumed conditions change.
    e. Incorrect discount rate.
3. People make decisions incrementally at the margin.
4. Example: airplane ticket prices and cell phone use.
5. Every time that you see the word marginal--and you will see it a lot in this course--insert "incremental" if you find that an easier concept to grasp.
6. Decisions in life are rarely black and white but usually involve shades of gray.
7. Marginal analysis helps to explain the diamond water paradox.
8. This leads to the important conclusion that choices are desirable if the marginal (*incremental*) benefits exceed the marginal (*incremental*) costs.
9. Marginal changes are small incremental adjustments to a plan of action. P. 6

E. Principle #4: People respond to incentives.

1. Incentive is something that induces a person to act. P. 7.
    a. *The famous carrot (a reward) or a stick (a punishment).*
2. Incentives are crucial to analyzing how markets work as the price effects the behavior of buyers and sellers, for example.
3. Because people make decisions by comparing costs and benefits, their behavior may change when the costs or benefits change.
4. Implied in this is that people make decisions based on their self-interest.
    a. Essentially, economics has only a limited role for altruism.

b. *Still, there is a big difference between egocentric behavior and self-interest.*
c. *The most important thing I do every day in my self-interest is keep my wife happy being married to me.*

5. In a business setting, these incentives are not exclusively monetary.
6. Governments have to be aware of unintended consequences.
   a. Seat belts can lead to more reckless driving.
      (1) Fewer deaths per accidents, but more accidents.
      (2) Same driver deaths, but more pedestrian deaths.
   b. *Sam Peltzman was my dissertation adviser.*

III. How People Interact

A. Principle #5: Trade can make everyone better off.

1. Trade between two countries can make each country better off.
   a. *Of course, trade never occurs between countries, it occurs between entities that are in countries.*

b. *This tends to be a controversial topic because producers are more aware of the adverse effects of increased trade than are the consumers who often benefit.*

2. Trade permits countries to specialize.
3. This is true at many different levels: families, businesses and countries.

B. Principle #6: Markets are usually a good way to organize economic activity.

1. Decentralized markets coupled with the self-interest of participants tend to create and use information more efficiently.

2. *People who feel that they are smarter than average often question that decisions of people less intelligent than themselves could possibly be efficient or optimal.*
3. This is constrained by the next Principle.
4. 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 service. P. 9
5. Problems occur when the government interferers with the price mechanism.
   a. Taxes distort prices
   b. Rent Controls limit price adjustments
6. **FYI: Adam Smith and the Invisible Hand, P. 10.**

a. *Our first reference to Adam Smith's **The Wealth of Nations**--the economic bible.*

7. **Adam Smith Would Have Loved Uber**

a. Taxis are regulated
b. Economists like Uber because
(1) Its increases well fare and
(2) Its responds to changes in demand.

C. Principle #7: Governments can sometimes improve market outcomes.
1. Markets operate more smoothly if governments enforce rules and maintain order.
a. It is important that property rights are protected.
b. Property rights are the ability of an individual to own land exercise control over scarce resources. P. 11
2. There are two broad reasons for a government to intervene in the economy and change the allocation of resources that people would choose on their own:
a. to promote efficiency and
(1) Market failure is a situation in which a market left on its own fails to allocate resources efficiently. P. 12
(2) Externality is the impact of one person's actions on the well-being of a bystander. P. 12
(3) Market power is the ability of a single economic actor to have a substantial influence on market prices. P. 13
(4) Correcting a market failure can result in government failure as elected officials and government employee respond to incentives.
(5) Because domestic producers have a narrower focus than domestic consumers of foreign produced goods, there often are attempts to use the political process to protect the producers to the detriment of the consumers.
b. to promote equality.
3. Regrettably, sometimes policies are designed simply to reward the politically powerful.

IV. How Economy as a Whole Works
A. Principle #8: A country's standard of living depends on its ability to produce goods and services.
1. The differences in living standards around the world are staggering.
a. In the US, output per worker increases at 2% per year.
2. Almost all variation in living standards is attributable to differences in countries' productivity.

a. Productivity is the quantity of goods and services produced from each hour of a worker's time. P. 13

3. *We recognize that productivity (and the institutions that encourage it) is far more important than natural resources, for example.*
4. Labor unions and minimum wage laws can redistribute output, but they do not increase it.
5. Policymakers need to take steps to increase productivity.
   a. Education
   b. Capital Equipment
   c. Technology

B. Principle #9: Prices rise when the government prints too much money.

1. In almost all cases of large or persistent inflation, the culprit is growth in the quantity of money.
2. *This is one of the most poorly reported relationships in the media.*
3. *From the end of World War II up until very recently, macroeconomics was dominated by activists who viewed the government as the solver of problems rather than the cause.*
   a. *Therefore, the government could not cause inflation.*
   b. *The explanation had to be with big business or natural disasters.*
4. *Now we recognize that there is one--and only one--reason why inflation exists and that is because the money supply (controlled by the government) has risen more rapidly than the availability of goods and services.*
5. Productivity is the quantity of goods and services produced from each unit of labor input. P. 13.
6. Inflation is an increase in the overall level of prices in the economy. P. 13.

C. Principle #10: Society faces short-run tradeoff between inflation and unemployment.

1. This tradeoff between inflation and unemployment is called the **Phillips Curve**.
2. *When prices are sticky (as they tend to be in the short run), an increase in the money supply causes sellers to produce more, thereby, hiring more workers that reduces unemployment.*
3. However, ultimately the result is higher prices and unemployment goes back to its prior level.
4. *Implicit in Mankiw's comments is the assumption that any change in inflation is unexpected, because the short term tradeoff is actually between expected inflation and unemployment.*
   a. *So if an increase in inflation is unexpected, unemployment*

goes down.

b. *However, if it is anticipated, there is no change in unemployment.*

5. *In the long run when expectations adjust to reflect the actual situation, there is no tradeoff.*

    a. *In some cases, higher inflation may lead to higher unemployment because it is a disruptive influence on the economy.*

6. Business cycle is fluctuations in economic activity, such as employment and production. P. 14

a. *See Figure 2 on page 495.*

V. Conclusion

A. **Table 1: Ten Principles of Economics, P. 15.**

VI. Summary

A. *Get in the habit of really thinking about the Summaries to the Chapters.*