

Introduction

Chapter 1: Ten Principles of Economics

. . . 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.

- How people make decisions.
- People face tradeoffs.
- The cost of something is what you give up to get it.
- Rational people think at the margin.
- People respond to incentives
- How people interact with each other.
- Trade can make everyone better off.
- Markets are usually a good way to organize economic activity.
- Governments can sometimes improve economic outcomes.
- The forces and trends that affect how the economy as a whole works.
- The standard of living depends on a country’s production.
- Prices rise when the government prints too much money.
- Society faces a short-run tradeoff between inflation and unemployment.

Principle #1: People Face Tradeoffs

There is no such thing as a free lunch

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

Making decisions requires trading off one goal against another

- *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.

Principle #2: The Cost of Something Is What You Give Up to Get It.

- 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

Principle #4: People Respond to Incentives

- Marginal changes in costs or benefits motivate people to respond.
- The decision to choose one alternative over another occurs when that alternative's marginal benefits exceed its marginal costs

Principle #5: Trade Can Make Everyone Better Off.

- 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.
- Adam Smith made the observation that households and firms interacting in markets act as if guided by an “invisible hand.”
- Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social costs of their actions.
- As a result, prices guide decision makers to reach outcomes that tend to maximize the welfare of society as a whole.

Principle #7: Governments Can Sometimes Improve Market Outcomes.

- Market failure* occurs when the market fails to allocate resources efficiently.
- When the market fails (breaks down) government can intervene to promote efficiency and equity.
- 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.

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.

- Standard of living may be measured in different ways:
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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.

- The Phillips Curve illustrates the tradeoff between inflation and unemployment: It's a short-run tradeoff!

Summary

- When individuals make decisions, they face tradeoffs among alternative goals.
- The cost of any action is measured in terms of foregone opportunities.
- Rational people make decisions by comparing marginal costs and marginal benefits.
- People change their behavior in response to the incentives they face.
- Trade can be mutually beneficial.
- Markets are usually a good way of coordinating trade among people.
- Government can potentially improve market outcomes if there is some market failure or if the market outcome is inequitable.
- Productivity is the ultimate source of living standards.
- Money growth is the ultimate source of inflation.
- Society faces a short-run tradeoff between inflation and unemployment.

Chapter 2: Thinking Like an Economist

- Every field of study has its own terminology
- Mathematics
 - integrals v axioms v vector spaces
- Psychology
 - ego v id v cognitive dissonance
- Law
 - promissory v estoppel v torts v venues
- Economics
 - supply v opportunity cost v elasticity v consumer surplus v demand v comparative advantage v deadweight loss
 - Economics trains you to. . . .
 - Think in terms of alternatives.
 - Evaluate the cost of individual and social choices.
 - Examine and understand how certain events and issues are related.

The Economist As A Scientist

- The economic way of thinking . . .
- Involves thinking analytically and objectively.
- Makes use of the scientific method
- Uses abstract models to help explain how a complex, real world operates. •Develops theories, collects, and analyzes data to evaluate the theories.
- Economists make assumptions in order to make the world easier to understand.
- The art in scientific thinking is deciding which assumptions to make.
- Economists use different assumptions to answer different questions.
- Economists use models to simplify reality in order to improve our understanding of the world
- Two of the most basic economic models include:

1. The Circular Flow Diagram

2. The Production Possibilities Frontier

•First Model: The Circular-Flow Diagram

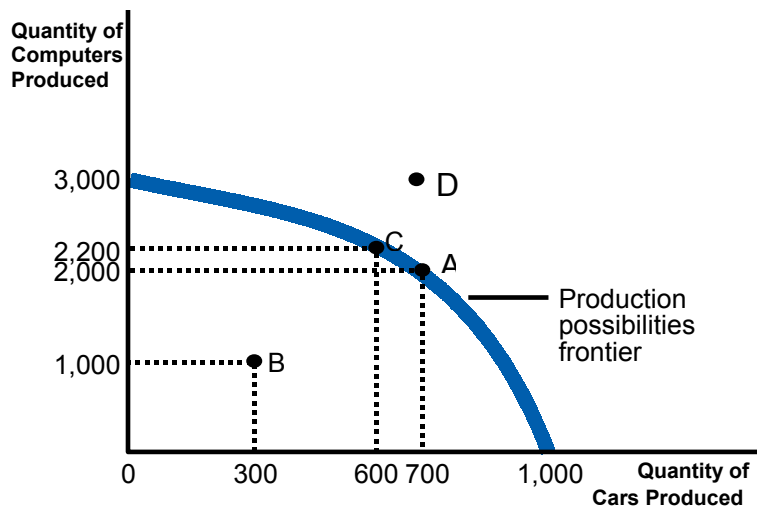
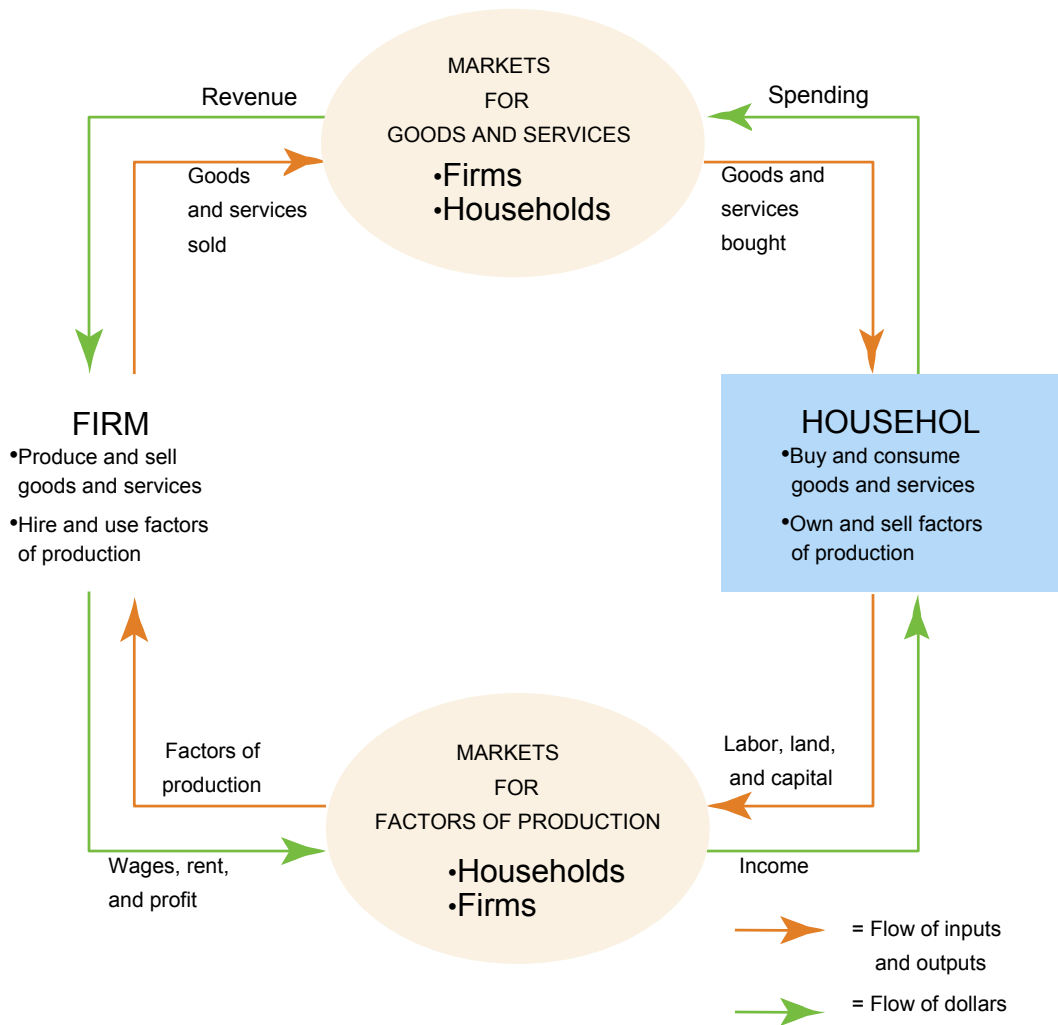
- The *circular-flow diagram* is a visual model of the economy that shows how dollars flow through markets among households and firms.
- Firms
 - Produce and sell goods and services
 - Hire and use factors of production
- Households
 - Buy and consume goods and services
 - Own and sell factors of production
- Markets for Goods and Services
 - Firms sell
 - Households buy
- Markets for Factors of Production
 - Households sell
 - Firms buy
- Factors of Production
 - Inputs used to produce goods and services
 - Land, labor, and capital

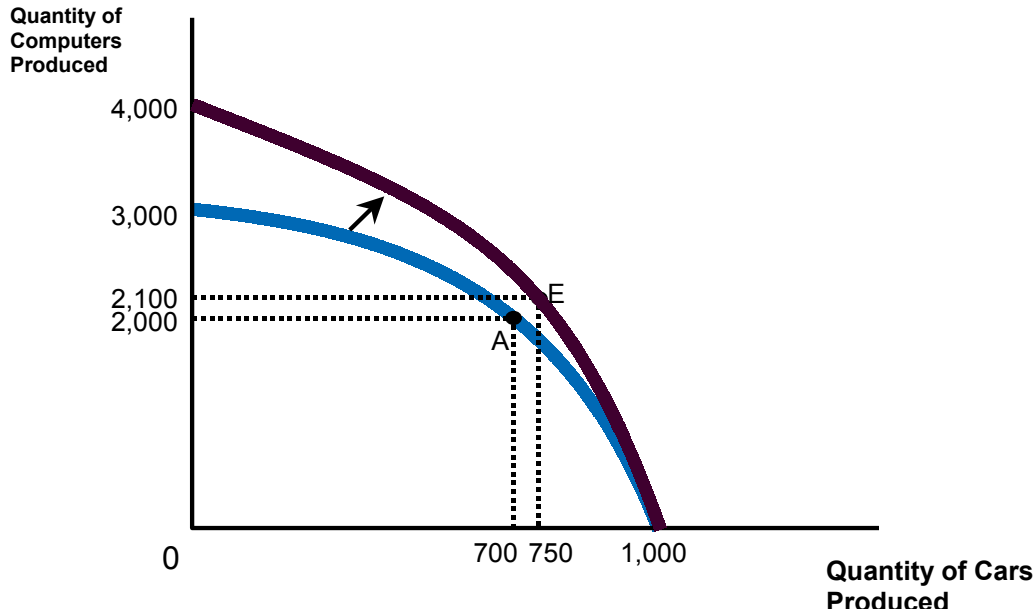
Second Model: The Production Possibilities Frontier

- The *production possibilities frontier* is a graph that shows the combinations of output that the economy can possibly produce given the available factors of production and the available production technology.

Concepts Illustrated by the Production Possibilities Frontier

- Efficiency
- Tradeoffs
- Opportunity Cost
- Economic Growth





- *Microeconomics* focuses on the individual parts of the economy.
- How households and firms make decisions and how they interact in specific markets
- *Macroeconomics* looks at the economy as a whole.
- Economy-wide phenomena, including inflation, unemployment, and economic growth
- When economists are trying to explain the world, they are scientists.
- When economists are trying to change the world, they are policy advisor.
- *Positive statements* are statements that attempt to describe the world as it is.
- Called descriptive analysis
- e.g Higher federal budget deficits will cause interest rates to increase
- e.g An increase in the minimum wage will cause a decrease in employment among the least-skilled
- *Normative statements* are statements about how the world should be.
- Called prescriptive analysis
- e.g The income gains from a higher minimum wage are worth more than any slight reductions in employment.
- State governments should be allowed to collect from tobacco companies the costs of treating smoking-related illnesses among the poor.

Summary

- Economists try to address their subjects with a scientist's objectivity.
- They make appropriate assumptions and build simplified models in order to understand the world around them.
- Two simple economic models are the circular-flow diagram and the production possibilities frontier.
- Economics is divided into two subfields:
- Microeconomists study decisionmaking by households and firms in the marketplace.
- Macroeconomists study the forces and trends that affect the economy as a whole
- A positive statement is an assertion about how the world is.

- A normative statement is an assertion about how the world ought to be.
- When economists make normative statements, they are acting more as policy advisors than scientists.
- Economists who advise policymakers offer conflicting advice either because of differences in scientific judgments or because of differences in values.
- At other times, economists are united in the advice they offer, but policymakers may choose to ignore it.

Reference

N. Gregory Mankiw. 2004. *Principle of Economics*, 4th Edition, Thomson South-Western