Ten Principles of Economics

Chapter 1

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Economy...

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

... **oikos nomos**

Oikos: house, household.
Nomos: knowledge

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**

Economics is the study of how society manages its scarce resources.

**Economists study . . .**

- *How people make decisions.*
- *How people interact with each other.*

**Ten Principles of Economics**

**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.
Ten Principles of Economics

How People Interact

- Trade can make everyone better off.
- Markets are usually a good way to organize economic activity.
- Governments can sometimes improve economic outcomes.

1. People face tradeoffs.

“There is no such thing as a free lunch!”

1. People face tradeoffs.

To get one thing, we usually have to give up another thing.
- Guns v. butter
- Food v. clothing
- Environment v. income
- Security v. individual freedom

Making decisions requires trading off one goal against another.
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?
2. The cost of something is what you give up to get it.

The **opportunity cost** of an item is what you give up to obtain that item.

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**.

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**Maximum happiness**

- Maximum happiness occurs at point **e**.

**The optimal decision**

- The optimal decision is made when **Marginal cost < marginal benefit**.
- The optimal decision is made when **Marginal cost > Marginal benefit**.
Be careful!

This is not a maximum

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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!

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LA Laker basketball star Kobe Bryant chose to skip college and go straight to the NBA from high school when offered a $10 million contract.
Benefit

Cost

Benefit before

Benefit after
4. People respond to incentives.

- What’s the effect of seat-belts on car accidents?
- What’s the effect on number fatal accidents?
- How are deaths distributed among drivers and pedestrians?
As a result...

- The speed is increased.
- The number of accidents go up.
- The effect on the number of fatal accidents is ambiguous:
  - more accidents
  - Less deaths per accident
- Pedestrians suffer more.

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.

6. Markets are usually a good way to organize economic activity.

- In a market economy, 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.”
6. Markets are usually a good way to organize economic activity.

- 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.

7. Governments can sometimes improve market outcomes.

When the market fails (breaks down) government can intervene to promote efficiency.

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.
Example of externality

- When the driver increases the speed, he increases not only his cost, but also that of the pedestrians.
- The driver does not take into account the cost imposed on the pedestrian.
- Governments can intervene in order to make the driver internalize the cost imposed on the pedestrian.

7. Governments can sometimes improve market outcomes.

Market failure may also be caused by market power, which is the ability of a single person or firm to unduly influence market prices.