BY THE END OF THIS CHAPTER, STUDENTS SHOULD UNDERSTAND:

- that economics is about the allocation of scarce resources.
- that individuals face trade-offs.
- the meaning of opportunity cost.
- how to use marginal reasoning when making decisions.
- how incentives affect people's behavior.
- why trade among people or nations can be good for everyone.
- why markets are a good, but not perfect, way to allocate resources.
- what determines some trends in the overall economy.

I. INTRODUCTION

- The word "economy" comes from the Greek word *oikonomos* meaning "one who manages a household."
- This makes some sense because in the economy we are faced with many decisions (just as a household is).
- Fundamental economic problem: resources are scarce.
- Definition of **scarcity: the limited nature of society's resources.**
- Definition of **economics: the study of how society manages its scarce resources.**
  - How people decide how much to work, save, and spend, and what to buy
  - How firms decide how much to produce, how many workers to hire
  - How society decides how to divide its resources between national defense, consumer goods, protecting the environment, and other needs
- This chapter discusses Ten Principles of Economics.

TABLE 1

Ten Principles of Economics

How People Make Decisions
1: People Face Trade-offs
2: The Cost of Something Is What You Give Up to Get It
3: Rational People Think at the Margin
4: People Respond to Incentives

How People Interact
5: Trade Can Make Everyone Better Off
6: Markets Are Usually a Good Way to Organize Economic Activity
7: Governments Can Sometimes Improve Market Outcomes

How the Economy as a Whole Works
8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services
9: Prices Rise When the Government Prints Too Much Money
10: Society Faces a Short-Run Trade-off between Inflation and Unemployment

II. HOW PEOPLE MAKE DECISIONS

Principle #1: People Face Trade-offs

- "There is no such thing as a free lunch." To get one thing that we like, we usually have to give up another thing that we like. Making decisions requires trading one goal for another.
- Examples include how students spend their time, how a family decides to spend its income, how the Indian government spends revenue, and how regulations may protect the environment at a cost to firm owners.
- A special example of a trade-off is the trade-off between efficiency and equity.
  - Definition of **efficiency: the property of society getting the maximum benefits from its scarce resources.**
  - Definition of **equity: the property of distributing economic prosperity fairly among the members of society.**
  - For example, tax paid by wealthy Indians and then distributed to poor may improve equity but lower the return to hard work and therefore reduce the level of output produced by our resources.
  - This implies that the cost of this increased equity is a reduction in the efficient use of our resources.
- Another Example is "**guns and butter":** The more we spend on national defense(guns) to protect our boarders, the less we can spend on consumer goods (butter) to raise our standard of living at home.
- Recognizing that trade-offs exist does not indicate what decisions should or will be made.

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

- Because people face trade off, making decisions requires comparing the costs and benefits of alternative courses of action.
- The cost of…
  - …going to college for a year is not just the tuition, books, and fees, but also the foregone wages.
  - …seeing a movie is not just the price of the ticket, but the value of the time you spend in the theater
- This is called opportunity cost of a resource
- Definition of **opportunity cost: whatever must be given up in order to obtain some item.**
- When making any decision, decision makers should consider the opportunity costs of each possible action**.**

Principle #3: Rational People Think at the Margin

- Economists generally assume that people are rational.
  - Definition of **rational: systematically and purposefully doing the best you can to achieve your objectives.**
  - Consumers want to purchase the bundle of goods and services that allows them the greatest level of satisfaction given their incomes and the prices they face.
  - Firms want to produce the level of output that maximizes the profits they earn.
- Many decisions in life involve incremental decisions: Should I remain in school this semester? Should I take another course this semester? Should I study an additional hour for tomorrow's exam?
- Rational people often make decisions by comparing marginal benefits and marginal costs

- Example: Suppose that flying a 200-seat plane across the country costs the airline Rs. 10,00,000, which means that the average cost of each seat is Rs. 5000. Suppose that the plane is minutes from departure and a passenger is willing to pay 3000 for a seat. Should the airline sell the seat for 3000? In this case, the marginal cost of an additional passenger is very small.
- Another example: Why is water so cheap while diamonds are expensive? Because water is plentiful, the marginal benefit of an additional cup is small. Because diamonds are rare, the marginal benefit of an extra diamond is high.

Principle #4: People Respond to Incentives

- Definition of **incentive: something that induces a person to act.**
- Because rational people make decisions by weighing costs and benefits, their decisions may change in response to incentives.
  - When the price of a good rises, consumers will buy less of it because its cost has risen.
  - When the price of a good rises, producers will allocate more resources to the production of the good because the benefit from producing the good has risen.
- Many public policies change the costs and benefits that people face. Sometimes policymakers fail to understand how policies alter incentives and behavior.

III. HOW PEOPLE INTERACT

Principle #5: Trade Can Make Everyone Better Off

- Trade is not like a sports competition, where one side gains and the other side loses.
- Consider trade that takes place inside your home. Your family is likely to be involved in trade with other families on a daily basis. Most families do not build their own homes, make their own clothes, or grow their own food.
- Countries benefit from trading with one another as well.
- Trade allows for specialization in products that countries (or families) can do best.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity

- Many countries that once had centrally planned economies have abandoned this system and are trying to develop market economies.
- Definition of **market economy: an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.**
- Market prices reflect both the value of a product to consumers and the cost of the resources used to produce it.
- Centrally planned economies have failed because they did not allow the market to work.
- *Adam Smith and the Invisible Hand*
  - Adam Smith's 1776 work suggested that although individuals are motivated by self-interest, an invisible hand guides this self-interest into promoting society's economic well-being.
  - Smith's perceptions will be discussed more fully in the chapters to come.

Principle #7: Governments Can Sometimes Improve Market Outcomes

- There are two broad reasons for the government to interfere with the economy: the promotion of efficiency and equity.
- Government policy can be most useful when there is market failure.
  - o Definition of **market failure: a situation in which a market left on its own fails to allocate resources efficiently.**
- Examples of Market Failure
  - o Definition of **externality: the impact of one person's actions on the well-being of a bystander.** (Ex.: Pollution)
  - o Definition of **market power: the ability of a single economic actor (or small group of actors) to have a substantial influence on market prices.**
  - o Because a market economy rewards people for their ability to produce things that other people are willing to pay for, there will be an unequal distribution of economic prosperity.
- Note that the principle states that the government *can* improve market outcomes. This is not saying that the government always *does* improve market outcomes.

IV. HOW THE ECONOMY AS A WHOLE WORKS

Principle #8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services

- Differences in living standards from one country to another are quite large.
- Changes in living standards over time are also quite large.
- The explanation for differences in living standards lies in differences in productivity.
- Definition of **productivity: the quantity of goods and services produced from each hour of a worker's time.**
- High productivity implies a high standard of living.
- Thus, policymakers must understand the impact of any policy on our ability to produce goods and services.
- To boost living standards the policy makers 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

- Definition of **inflation: an increase in the overall level of prices in the economy.**
- When the government creates a large amount of money, the value of money falls.
- Examples: Germany after World War I (in the early 1920s) and the United States in the 1970s.

Principle #10: Society Faces a Short-Run Trade-off between Inflation and Unemployment

- Most economists believe that the short-run effect of a monetary injection-*(injecting/ adding money in the economy)* is lower unemployment and higher prices.
  - o An increase in the amount of money in the economy stimulates spending and increases the demand of goods and services in the economy.
  - o Higher demand may overtime cause firms to raise their prices but in the meantime, it also encourages them to increase the quantity of goods and services they produce and to hire more workers to produce those goods and services. More hiring means lower unemployment.

- Some economists question whether this relationship still exists.
- The short-run trade-off between inflation and unemployment plays a key role in the analysis of the business cycle.
- Definition of **<u>business cycle</u>: fluctuations in economic activity, such as employment and production.**
- Policymakers can exploit this trade-off by using various policy instruments, but the extent and desirability of these interventions is a subject of continuing debate.