“Ten Principles” of Economics: Intro

One Approach to Some of the Core Concepts in Economic Analysis

Ten Principles of Economics

Summary

How People Make Decisions	#1: People Face Tradeoffs
	#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 Tradeoff between Inflation and Unemployment

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Principle 1: People Face Trade-Offs

- Fundamental Problem of Economics
- Scarcity Exists
  - Limits
  - Constraints
- Decisions Must be Made
  - Choices
  - Trade Offs
- Goods & Services
  - Provide Satisfaction
  - "Utility"
- Do It Right
  - It Can Work Out OK

- London School of Economics Student, and geriatric rocker, Mick Jagger

- "I can't get no… …satisfaction…"
- "You can't always get what you want…."
- "But if you try sometimes …you just might find… you get what you need"

Principle 1: People Face Trade-Offs

- Economics is Study of:
  - Procedures & Institutions
  - Answering Basic Questions
    - WHAT ?
    - HOW ?
    - FOR WHOM ?
- That is:
  - Dealing with Scarcity
  - Making Choices

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

- The Difficult Part of Trade-Offs
- Opportunity Cost
  - A Reflection of Trade Offs
  - A Measure of Costs
  - Cost of What is Given Up…Next Best Alternative
- Cost of EMBA?
  - Family
  - Work
  - Leisure
  - Sanity

Principle 3: Rational People Think at the Margin

- Rational People:
  - Systematic & Purposeful Behavior
  - Do the Best They Can to Achieve Objectives
- "Decision Making at the Margin"
  - Small Adjustments to a Plan of Action
  - Marginal = Extra; Additional; Incremental
  - Evaluate Marginal Benefits vs. Marginal Costs
- Rational Decision Maker = Take Action Only If:
  - Marginal Benefits > Marginal Costs

Principle 3: Rational People Think at the Margin

- General Approach in Econ:
  - Who is Decision Maker?
  - What Does He/She Give Up & Get?
    - Cash vs. NonCash
    - Psychic Benefits/Costs
- Observing "Irrational" Behavior?
  - Check Individual Level Incentive (MB vs. MC)
  - Consider Informational or Other Limitations
  - Acknowledge Quirks of Individual Human Behavior

Principle 4: People Respond to Incentives

- Market Signals ➔ Price Signals
  - Price Matters; Price Increase Means:
  - Buyers - Consume Less
  - Sellers - Produce More
- Public Policy ➔ Affect Marg. Benefits/Costs
  - Gasoline/Carbon Tax; Cigarette Tax
  - Fuel Efficiency Standards
  - Mortgage & Business Interest Deductibility
  - Tax Credits & Subsidies
- Aside: Unintended Consequences
  - Failure to Consider How Policies Affect Incentives
  - Second Round of Responses

Principle 5: Trade Can Make Everyone Better Off

- "Mutual Gains from Exchange"
- Trade: Voluntary Exchange ➔ Mutual Benefits
  - Marginal Benefits > Marginal Costs: Agree
  - Marginal Benefits < Marginal Costs: Refuse
- Exchange Among Individuals, Groups, Countries
  - Specialization: Focus on What Each Does "Best"
  - Total Productivity Increases: More Available
  - Net Gains (Increases) Split Among Participants

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

- Market Economy Organization:
  - Decentralized: Diffuse Bits of Information
  - Individual Decision Makers: Firms/ Households
- General Procedures:
  - Interaction in Markets Produces Market Signals
  - Self Interested Behavior in Response to Prices
  - Competition Constrains Self Interested Behavior
- Outcome:
  - Resources Allocated Efficiently
  - Marginal Benefits Matched Against Marginal Costs
  - Adam Smith's "Invisible Hand"

Principle 7: Governments Can Sometimes Improve Market Outcomes

- What is The Proper Role of Government?
- Set & Maintain Ground Rules
  - Establish Laws/Courts; Specify Property Rights
- Be A Buyer or Provider of Goods
  - Private Goods
  - Public Goods
- Fix "Market Failures"
  - Lack of Competition
  - "Externalities" or "3rd Party Effects"
  - Alter Resource Allocation; Improve Efficiency

Principle 7: Governments Can Sometimes Improve Market Outcomes

- Some Roles More Controversial
- Redistribution of Income?
  - Improve "Equity" or "Fairness"
- Promote Economic Stability?
  - Dampen Business Cycle
  - Promote Price Stability & "Full" Employment

Principle 8: Standard of Living Depends on Ability to Produce Goods & Services

- Large differences in living standards
  - Among countries
  - Over time
- Explanation: Differences in Productivity
- Higher Productivity = Higher Standard of Living
- Growth Rate of Nation's Productivity
  - Determines Growth Rate of Its Average Income
- Productivity
  - Quantity of Goods & Services Produced from Each Unit of Labor Input

Principle 9: Prices Rise When the Government Prints Too Much Money

- Link Between Money Supply & Inflation
- Inflation: Broad Based Price Increases
  - Rise in: "General Price Level" - "Overall Price Level"
- Inflation: Decline in Value of Money
  - Purchasing Power of Money Falls
  - "Money Doesn't Buy What it Used to"
- Must be Connection Between:
  - Inflation (Decline in Value of Money)
  - Money Supply (Amount Available)
  - Money Demand

Principle 9: Prices Rise When the Government Prints Too Much Money

- Milton Friedman--Famous “Monetarist”
  - “Inflation is always & everywhere a monetary phenomenon.”
  - Inflation is “Too Much Money… Chasing Too Few Goods.”
- Logic:
  - Money Exchanged for Goods
  - How Much Money Does It Take:
    - Given An Amount of Goods
    - People Offer Money for Goods
    - More Money Available ➔ More Offered
    - Prices Bid Up

Principle 10: The Short-Run Trade-Off Between Inflation & Unemployment

- The “Phillips Curve”
- Short-Run Effects of Monetary Injections:
  - More in Peoples’ Hands ➔ More Spending
  - Higher Demand for Goods & Services
  - Firms Hire More; Produce More; Raise Prices
- Short-Run Trade-Off:
  - Hiring Increases ➔ Unemployment Falls
  - Prices Rise ➔ Inflation Increases
- A Concern: Only a Temporary Effect?
  - Depends on Expectations
  - Eventually Everyone Comes to Anticipate
  - Tends to Neutralize Effect

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Mostly Micro

How People Make Decisions	#1: People Face Tradeoffs	Scarcity Exists
	#2: The Cost of Something Is What You Give Up to Get It	Opportunity Cost
	#3: Rational People Think at the Margin	MB = MC
	#4: People Respond to Incentives	Laws of Supply/Demand
How People Interact	#5: Trade Can Make Everyone Better Off	Mutual Gains from Exchange
“Nice Outcome” Constrained Self Interest	#6: Markets Are Usually a Good Way to Organize Economic Activity	
“Market Failures”	#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	Production ➔ Goods ➔ Satisfaction/Utility
Truly “Macro” — “Too Much Money…”	#9: Prices Rise When the Government Prints Too Much Money	
Truly “Macro” — “Phillips Curve”	#10: Society Faces a Short-Run Tradeoff between Inflation and Unemployment	