### 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 usually achieve 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.
### 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

> “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”

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### 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

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### 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

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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

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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 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

Ten Principles of Economics: Summary

<table>
<thead>
<tr>
<th>How People Make Decisions</th>
<th>P1: People Face Traditionally Scarcity Exists</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>P3: Rational People Think at the Margin MB = MC</td>
</tr>
<tr>
<td></td>
<td>P4: People Beyond Inversion Laws of Supply/Demand</td>
</tr>
<tr>
<td>How People Interact</td>
<td>P5: Trade Can Make Everyone Better Off Mutual Gains from Exchange</td>
</tr>
<tr>
<td>“Nice Outcome”</td>
<td>P6: Markets Are Usually a Good Way to Organize Economic Activity</td>
</tr>
<tr>
<td>Constrained Self Interest</td>
<td>P7: Governments Can Sometimes Improve Market Outcomes</td>
</tr>
<tr>
<td>“Market Failures”</td>
<td>P8: A Country’s Standard of Living Depends on its Ability to Produce Goods and Services Production ➔ Goods ➔ Satisfaction/Utility</td>
</tr>
<tr>
<td>How the Economy Works</td>
<td>P9: Prices Rise When the Government Prints Too Much Money</td>
</tr>
<tr>
<td>Truly “Macro”</td>
<td>P10: Society Faces a Short-Run Trade-Off Between Inflation and Unemployment</td>
</tr>
<tr>
<td>“Phillips Curve”</td>
<td></td>
</tr>
</tbody>
</table>