Principle #1: People Face Tradeoffs

To get something you want, you have to give up something else you want. Scarce resources.

Think of allocating your *time* or *money*.

Societies face a tradeoff between more consumer goods (low taxes) and more public goods (defense, social programs).

Since governments can borrow, there is a tradeoff between consumption for current and future generations.

There is sometimes a tradeoff between the environment and jobs.

equity: fair treatment
efficiency: producing the biggest possible "pie".
tradeoff between the two: will you sacrifice to become a doctor if your wealth is taxed?

Principle #2: The cost of something is what you give up to get it.

example: College education.
The benefits are the job opportunities and personal satisfaction, but there are costs besides "out of pocket" costs like tuition and books.

Make sure you count the 4 years' lost earnings. (Lebron James made a good choice.)

Just count the room and board costs over and above what you would have paid if you didn't go to college.

opportunity cost--what you give up in order to obtain the item in question.

Principle #3: Rational people think at the margin.

A *marginal change* is a small adjustment to an existing plan of action. [a deriv*****]

example: Suppose you are an airline executive deciding whether to sell a standby ticket for $300. The 200 seat plane is nearly, but not quite, sold out, and the total costs for the flight are $100,000, or an average cost of $500.

Should you sell a standby seat "below cost"?
Yes, since the marginal benefit, $300, exceeds the marginal cost (cost of peanuts, soda, *extra* fuel costs, discomfort due to congestion--at most $20).

A rational decision maker (who can finely adjust his/her action) chooses the level of action where the marginal benefit equals the marginal cost.

Principle #4: People respond to incentives.

One obvious source of incentives is the price of goods and services. If gas becomes more expensive, people adjust their behavior.

Public policies can affect private incentives, often in unintended ways.

example: seat belt laws.

The direct effect is that the driver is more likely to survive an accident, so seat belts save lives.

The indirect effect on incentives is that accidents are now less costly, so the new cost-benefit calculation causes drivers to drive faster.

One 1975 study found that the laws led to more accidents, but fewer driver deaths *per accident*. Overall driver deaths remained about the same but pedestrian deaths increased.

Principle #5: Trade can make everyone better off.

Don't think of trade as having one side win and the other side lose. No one is forcing people to trade, so both sides think they benefit.

Trade involves competition. Your family competes with other families in the job market and in the grocery store. Yet, not allowing trade would make everyone worse off.

Trade allows you to specialize in what you do best, allowing more consumption for everyone.

The same point applies to trade between countries. If we are relatively more efficient at producing services than certain manufactured goods, we benefit from having trading partners who supply those goods.

Principle #6: *Markets* are usually a good way to organize economic activity.

A *market economy* is an economic system where prices are determined and resources are allocated through the decentralized decisions of many firms and households.

firm--any producer of a good or service

Adam Smith and the "invisible hand":
Everyone, by acting selfishly, does their part in maximizing the welfare of society as a whole. (Because prices measure the marginal benefit to consumers, and the marginal cost to firms. The net benefit is maximized.)

Then governments can disrupt the invisible hand with excessive taxation or regulation.

In centrally planned economies (old Soviet Union), firms have to be told what inputs they will receive and the output they are required to produce. Households are sometimes told what they will be able to consume.

1. Central planners would have a tough time figuring out the right prices even if they wanted to maximize society's welfare. The market forces of supply and demand give people and firms exactly the information they need.

2. Besides informational problems, central planners face incentive problems as well. Corruption at the top, lack of incentives to work hard, etc.

Principle #7: Governments can sometimes improve market outcomes.

A *market failure* is a situation where the market, on its own, fails to allocate resources efficiently.

externalities (pollution, R&D activities)
public goods (national defense, parks and roads)
market power (monopoly, oligopoly)

Governments can intervene to promote efficiency when there are market failures.

Governments can sometimes intervene to promote equity.

Principle #8: A country's standard of living depends on its ability to produce goods and services.

Things like raising the minimum wage or restricting foreign competition will not affect our standard of living in the long run, because they do not serve to improve productivity.

Principle #9 (money causes inflation) and Principle #10 (short run tradeoff between unemployment and inflation) are Macro topics, which we will skip.

Thinking Like an Economist

Economics is a science.

Scientific Method--construct theories, derive hypotheses, test by observing data.

Unfortunately, experimentation is difficult:

(1) You can't control the US monetary policy for 20 years to see what would happen.

(2) Some of the questions we want to answer (e.g., what will interest rates be this time next year?) involve many, many variables. Behavior on one market is connected to behavior on every other market. The system is complicated, similar to meteorology.

But, things are not so bad.

(1) Sometimes we can find "natural experiments" like the Great Depression.
(2) We can use sophisticated statistical techniques to get the most we can out of imperfect data.
(3) We will be able to answer some questions definitively (e.g., what effect will a gasoline tax have on gasoline consumption?).

Assumptions and Models

To understand the world, we make simplifying assumptions.

example (Physics): Dropping a ball from a tower. Assume: no air resistance, no gravitational pull of the sun and the moon.

example (Economics): The local gasoline market. Assume: all gas stations sell the same homogeneous product, consumers know the prices charged at each station, so all stations must charge the same price.

These assumptions may be reasonable if you want to study the effect of gasoline taxes on gasoline consumption, ***but not*** if you want to study price variation across stations.

A *model* is a simplified replica of the world. The most useful models are not always the most realistic.