Chapter no 1

The ten principles of economics;

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Summary;

10 Principles of Economics

Contents

Gregory Mankiw in his **Principles of Economics** outlines Ten Principles of Economics that we will replicate here, they are:

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
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
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.

How People Make Decisions

People face trade-offs

- “There is no such thing as a free lunch (TINSTAAFL).” 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 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 equality.
    - Definition of efficiency: the property of society getting the maximum benefits from its scarce resources.
    - Definition of equality: the property of distributing economic prosperity fairly among the members of society.
    - For example, tax paid by wealthy people and then distributed to poor may improve equality but lower the incentive for hard work and therefore reduce the level of output produced by our resources.
    - This implies that the cost of this increased equality 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 borders, 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.

Significance of opportunity cost in decision making

- Because people face tradeoffs, 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 resource
- Definition of **o**pportunity cost: whatever must be given up in order to obtain some item. or last best alternative forgone
- When making any decision, decision makers should consider the opportunity costs of each possible.

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 allow 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.
- 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.
- If the additional satisfaction obtained by an addition in the units of a commodity is equal to the price a consumer is willing to pay for that commodity, he achieves maximum satisfaction, which is the main goal of every rational consumer.
  - Example: Suppose that flying a 200-seat plane across the country costs the airline $1,000,000, which means that the average cost of each seat is $5000. Suppose that the plane is minutes away 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.

People respond to incentives

- Incentive is something that induces a person to act [by offering rewards to people who change their behavior].
- Because rational people make decisions by comparing costs and benefits, they respond to incentives.
- Incentives may possess a negative or a positive intention. It may be in a positive or a negative way.

For example, by offering a raise in the salary of whosoever works harder can induce people to work hard which is a positive incentive. Whereas putting a tax on a good, say fuel, can induce people to consume it less which is a negative incentive.

How People Interact With Each Other

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 benefits countries (or families)
- For example, it was widely believed for centuries that in international trade one country's gain from an exchange must be the other country's loss.

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.

Markets are where the buyers and sellers can meet to get goods and conversation items.

Government can sometimes improve market outcomes

There are two broad reasons for the government to interfere with the economy: the promotion of competence and equality.

- Government policy can be most useful when there is market failure.
    - Definition of market failure: a situation in which a market left on its own fails to allocate resources efficiently.
- Examples of Market Failure
    - Definition of externality: the impact of one person's actions on the well-being of a bystander. (Ex.: Pollution)
    - Definition of market power: the ability of a single economic actor (or small group of actors) to have a substantial influence on market prices.
    - Because a market economy plunders 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.

The Forces and Trends That Affect How The Economy as a Whole Works

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A country's standard of living depends on country production

- Differences in the standard of living 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, politicians must understand the impact of any policy on our ability to produce goods and services.
- To boost living morals the policy makers need to raise output by ensuring that workers are well educated, have the tools needed to produce goods and services, and have access to the best available technology.
- Per capita income of nation

Prices rise when the government prints too much money.

- Definition of inflation: sustained increase in the general 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), the United States in the 1970s and Zimbabwe in the 2000s.

Society faces a short-run tradeoff between inflation and unemployment.

- Most economists believe that the short-run effect of a monetary injection (inserting/adding money into the economy) is lower unemployment and higher prices.
    - An increase in the amount of money in the economy stimulates spending and increases the demand of goods and services in the economy.
    - Higher demand may over time cause firms to raise their prices but in the meantime, it also inspires 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 joblessness plays a key role in analysis of the business cycle.
- Definition of business cycle: variations 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..

Chapter 2;

Thinking like economist;

Summary;

Some time. Yet with a mixture of theory, case studies, and examples of economics in the news, this book will give you ample opportunity to develop and practice this skill. Before investigating into the material and details of economics, it is helpful to have an overview of how economists approach the world.

This chapter, therefore, deliberates the field's practice. What is characteristic about how economists challenge a question? What does it mean to think like an economist? THE ECONOMIST AS SCIENTIST Economists try to address their subject with a scientist's objectivity. They approach the study of the economy in much the same way as a physicist methods the study of substance and a biologist approaches the study of life: They devise theories, collect data, and then analyze these data in an effort to verify or refute their theories.

To beginners, it can seem odd to claim that economics is a science. After all, economists do not work with test tubes or telescopes. The essence of science, "I'm a social scientist, Michael. That means I can't explain electricity or anything like that, but if you ever want to know about people I'm your man." CHAPTER 2 THINKING LIKE AN ECONOMIST 21 however, is the scientific method—the composed development and testing of theories about how the world works. This method of inquiry is as applicable to studying a nation's economy as it is to studying the earth's gravity or a species' evolution.

As Albert Einstein once put it, "The whole of science is nothing more than the modification of everyday thinking." Although Einstein's comment is as true for social sciences such as economics as it is for natural sciences such as physics, most people are not familiar to looking at society through the eyes of a scientist. Let's therefore discuss some of the ways in which economists apply the logic of science to examine how an economy works.