

Principles of
**MICRO
ECONOMICS**

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TENTH EDITION

Chapter

1

Ten Principles of Economics

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IN THIS CHAPTER

- What kinds of questions does economics address?
- What are the principles of how people make decisions?
- What are the principles of how people interact?
- What are the principles of how the economy as a whole works?

Ten Principles of Microeconomics

Resources are scarce

- **Scarcity:** the limited nature of society's resources
 - Society has limited resources and, therefore, cannot produce all the goods and services people want
- **Economics**
 - The study of how society manages its scarce resources

Ten Principles of Microeconomics

- **Economists examine:**
 - How people decide how much they work, what they buy, how much they save, how they invest their savings
 - How firms decide how much to produce and how many workers to hire
 - Forces and trends that affect the overall economy: growth in average income, unemployment, rate at which prices are rising

How People Make Decisions

Principle 1: People face trade-offs.

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

Principle 3: Rational people think at the margin.

Principle 4: People respond to incentives.

Principle 1: People Face Trade-Offs

To get one thing you want, you usually must give up another thing you want. Making decisions: trading off one goal for another.

- Going to a party the night before an exam
 - Less time for studying
- Having more money to buy stuff
 - Working longer hours, less time for leisure
- Protecting the environment
 - Resources could be used to produce consumer goods.

EXAMPLE 1A: Society faces trade-offs

- The more it spends on the military (guns) to protect from foreign aggressors
 - The less it can spend on consumer goods (butter) to raise its standard of living
- Pollution regulations: cleaner environment and improved health
 - But at the cost of reducing the well-being of the firms' owners, workers, and customers

EXAMPLE 1B: Society faces trade-offs

- **Efficiency:** Society gets the maximum benefits from its scarce resources
- **Equality:** Economic prosperity is distributed uniformly among society's members.
 - Trade-off:
 - To achieve greater equality, we could redistribute income from wealthy to poor.
 - But this reduces incentive to work and produce, shrinking the size of economic “pie”.

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

- **Making decisions:**
 - Compare costs with benefits of alternative decisions
 - Need to include opportunity costs
- **Opportunity cost of an item**
 - Whatever must be given up to obtain it

EXAMPLE 2: Opportunity cost

- What is the opportunity cost of going to college for a year?
 - Tuition, books, and fees
 - NOT: room and board
 - PLUS foregone earnings
- What is the opportunity cost of going to the movies?
 - The price of the movie ticket
 - PLUS the value of the time you spend in the theater

Principle 3: Rational People Think at the Margin

- **Rational people**
 - Systematically and purposefully do the best they can to achieve their goals, given the available opportunities
 - Make decisions by evaluating costs and benefits of **marginal changes**
 - Small incremental adjustments to a plan of action
 - Marginal benefit vs. marginal cost

Active Learning 1: Thinking at the margin

- A. As the manager at the local Save-a-lot, you are thinking of hiring one more cashier that would increase sales revenues by \$400 per week. The new cashier would earn \$300 per week. Should you hire the new cashier? Why?

- B. You pay \$8/month for access to Disney Plus, regardless of how many movies or TV shows you watch in a month. Should you watch one more movie (or episode)? Why?

Principle 4: People Respond to Incentives

- **Incentive**
 - Something that induces a person to act
 - Can have unintended consequences
- **People respond to incentives**
 - Because rational people make decisions by comparing costs and benefits
- **An increase in the price of doughnuts:**
 - Consumers buy fewer doughnuts.
 - Sellers produce more doughnuts.

EXAMPLE 3: Incentives

The government increases the gasoline tax by \$1 per gallon.

- How do consumers respond?
 - Drive more fuel-efficient cars, shift to electric cars
 - Carpool, ride bikes
 - Use public transportation
 - Move closer to work
- How do businesses respond?

Active Learning 2: Applying the principles

You are selling your black 1967 Chevy Impala. You have already spent \$2,000 on repairs. At the last minute, the transmission dies. You can pay \$1,400 to have it repaired or sell the car “as is.”

In each of the following scenarios, should you have the transmission repaired? Explain.

- A. Blue book value (what you could get for the car) is \$14,500 if transmission works, \$11,200 if it doesn't.
- B. Blue book value is \$12,300 if transmission works, \$11,000 if it doesn't.

How People Interact

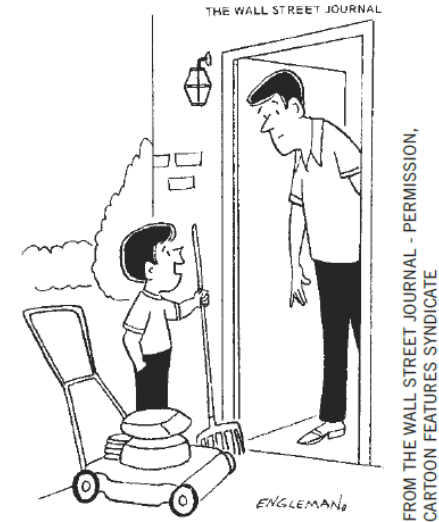
Principle 5: Trade can make everyone better off.

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

Principle 7: Governments can sometimes improve market outcomes.

Principle 5: Trade Can Make Everyone Better Off

- **People benefit from trade:**
 - People can buy a greater variety of goods and services at lower cost.
- **Countries benefit from trade:**
 - Allows countries to specialize in what they do best
 - Enjoy a greater variety of goods and services



*“For \$5 a week
you can watch
baseball without
being nagged to
cut the grass!”*

Principle 6: Markets Are Usually a Good Way to Organize Economic Activity – 1

- **Market**
 - A group of buyers and sellers (need not be in a single location)
- **Organize economic activity**
 - What goods and services to produce
 - How to produce these goods and services
 - How to allocate them to their final user

Principle 6: Markets Are Usually a Good Way to Organize Economic Activity – 2

- **Market economy**
 - Allocates resources through the decentralized decisions of many firms and households
 - As they interact in markets for goods and services
 - Proven remarkably successful in organizing economic activity to promote prosperity

Principle 6: Markets Are Usually a Good Way to Organize Economic Activity – 3

- **Prices:**
 - Determined by the interaction of buyers and sellers
 - Reflect the good's value to buyers
 - Reflect the cost of producing the good
- **Adam Smith's "invisible hand"**
 - Prices adjust to guide market participants to reach outcomes that, often, maximize the well-being of society as a whole

Principle 7: Governments Can Sometimes Improve Market Outcomes – 1

- **Government: enforce property rights**
 - Enforce rules and maintain institutions that are key to a market economy
 - People are less inclined to work, produce, invest, or purchase if there is a large risk of their property being stolen.
 - We rely on government-provided police and courts to enforce our rights over the things we produce.

Principle 7: Governments Can Sometimes Improve Market Outcomes – 2

- **Government: promote efficiency**
 - Avoid **market failures**: Market left on its own fails to allocate resources efficiently.
 - **Externality** – source of market failure
 - How the production or consumption of a good affects bystanders (e.g. pollution).
 - **Market power** – source of market failure
 - A single buyer or seller has substantial influence on market price (e.g., monopoly).

Principle 7: Governments Can Sometimes Improve Market Outcomes – 3

- **Government: promote equality**
 - Avoid disparities in economic well-being
 - Use tax or welfare policies to change how the economic “pie” is divided.
- **To say that the government can improve market outcomes**
 - Does not mean that it always will

Active Learning 3: The government

In each of the following situations, what is the government's role?

Does the government's intervention improve the outcome?

- A. Public schools for K-12
- B. Workplace safety regulations
- C. Public highways
- D. Patent laws, which allow drug companies to charge high prices for life-saving drugs

How the economy as a whole works

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

Principle 9: Prices rise when the government prints too much money.

Principle 10: Society faces a short-run trade-off between inflation and unemployment.

Principle 8: Country's Standard of Living Depends on Its Ability to Produce Goods and Services – 1

- **Huge variation in living standards across countries and over time**
 - 2019 average income:
 - \$65,000 in the U.S.; \$5,000 in Nigeria
 - Average income in the U.S.
 - Growth rate of 2 % per year
 - Doubles every 35 years
 - The U.S. standard of living today
 - Is eight times greater than 100 years ago

Principle 8: Country's Standard of Living Depends on Its Ability to Produce Goods and Services – 2

- **Productivity: most important determinant of living standards**
 - Quantity of goods and services produced from each unit of labor input
 - Depends on the equipment, skills, and technology available to workers
 - Other factors (e.g., labor unions, competition from abroad) have far less impact on living standards.

Principle 9: Prices Rise When the Government Prints Too Much Money – 1

- **Inflation**
 - An increase in the overall level of prices in the economy
- **High inflation**
 - Imposes various costs on society
- **Goal of economic policymakers:**
 - Keep inflation at a reasonable rate



"Well it may have been 68 cents when you got in line, but it's 74 cents now!"

Principle 9: Prices Rise When the Government Prints Too Much Money – 2

- **In the long run**
 - Inflation is almost always caused by excessive growth in the quantity of money, which causes the value of money to fall
 - The faster the government creates money, the greater the inflation rate

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

- **Short-run trade-off between inflation and unemployment**
 - In the short-run, many economic policies push inflation and unemployment in opposite directions.
 - Other factors can make this trade-off more or less favorable, but the trade-off is always present.



THINK-PAIR-SHARE

Your university decides to reduce the price of a parking permit on campus from \$250 per semester to \$10 per semester.

- A. The number of students desiring to park their cars on campus will _____.
- B. The amount of time it would take to find a parking place will _____.
- C. Will the lower price of a parking permit necessarily lower the true cost of parking? (Hint: opportunity cost)
- D. Would the opportunity cost of parking be the same for students with no outside employment and students with jobs earning \$15 per hour?

CHAPTER IN A NUTSHELL

- **Individual decision making:**
 - People face trade-offs among alternative goals.
 - The cost of any action is measured in terms of forgone opportunities.
 - Rational people make decisions by comparing marginal costs and marginal benefits.
 - People change their behavior in response to the incentives they face.

CHAPTER IN A NUTSHELL

- Economic interactions among people:
 - Trade and interdependence can be mutually beneficial.
 - Markets are usually a good way of coordinating economic activity.
 - Governments can potentially improve market outcomes by remedying a market failure or by promoting greater economic equality.

CHAPTER IN A NUTSHELL

- The economy as a whole:
 - Productivity is the ultimate source of living standards.
 - Growth in the quantity of money is the ultimate source of inflation.
 - Society faces a short-run trade-off between inflation and unemployment.