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Principles of Economics

Arab League Edition

Chapter 1
Ten Principles of Economics

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In this chapter, look for the answers to these questions:

- 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?

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KEY TERMS

- A product is anything offered to a market to satisfy a want or need.
- It includes both tangible goods (e.g., cars, clothes, mobile phones) and services (activities or benefits offered for sale without ownership, such as banking, airline travel, and home repair). (Kotler, 2018)
- Goods are physical objects, while services involve performing tasks for others, like financial services, medical care, or teaching. (Parkin, 2023)
- Human needs are states of felt deprivation. They include basic physical needs for food, clothing, warmth, and safety; social needs for belonging and affection; and individual needs for knowledge and self-expression. (Kotler, 2018)

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KEY TERMS

- Wants are the form human needs take as they are shaped by culture and individual personality. An American needs food but wants a Big Mac, fries, and a soft drink. A person in Kuwait, needs food but wants chicken or meat “Machboos”. Wants are shaped by one’s society and are described in terms of objects that will satisfy those needs.
- When wants backed by buying power (purchasing power), wants become demands. (Kotler, 2018)
- A firm is an economic unit that hires factors of production and organizes them to produce and sell goods and services. (Parkin, 2023)
- Consumer goods are goods bought and used by consumers.

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KEY TERMS

- Resources are inputs used to produce other goods and services. These resources may include:
  - Natural Resources: Land, water, coal, oil, natural gas, minerals, metals etc.
  - Human Resource / Labor: The time, skills, and efforts that people devote to producing goods and services, e.g., people who work on farms and construction sites and in factories, shops, and offices.
  - Capital goods: the tools, instruments, machines, and office buildings that firms use to produce goods and services are called capital goods.
- All the above resources are also called **factors of production.** (Parkin, 2023)

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INTRODUCTION: WHAT ECONOMICS IS ALL ABOUT

- **Origin of the Term "Economy"**
- Derived from the Greek word *oikonomos*, meaning "one who manages a household (home)."
- Households and economies share similar decision-making processes.
- **Decision-Making in Households vs. Societies**
- **Households**: Allocate tasks and resources among members based on abilities, efforts, and desires.
- **Societies**: Decide on job roles, production of goods/services, and distribution of resources.
- **The Challenge of Scarcity**
- Resources are **limited** and cannot satisfy all wants.
- Just as a household must prioritize needs, **society must allocate resources efficiently**.
- Not everyone can attain the highest standard of living they desire.

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INTRODUCTION: WHAT ECONOMICS IS ALL ABOUT

- **Scarcity**: the limited nature of society's resources
- **Economics**: the study of how society manages its scarce resources, e.g.
  - People: How people decide what to buy, how much to work, save, and spend.
  - Firms: How firms decide how much to produce and how many workers to hire.
  - Society: How society decides how to divide its resources between national defense, consumer goods, protecting the environment, and other needs.

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There are ten key principles of economics centered around:

- *How people make decisions*
- *How people interact*
- *How the economy works as a whole*

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The principles of
HOW PEOPLE MAKE DECISIONS

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PRINCIPLE #1:
People Face Tradeoffs

- **Trade-off** is an exchange - giving up one thing to get something else.
- All decisions involve tradeoffs.

Examples:

- Going out with friends the night before your exam leaves less time for studying.
- Having more money to buy things requires working longer hours, which leaves less time for leisure.
- Protecting the environment requires resources that could otherwise be used to produce consumer goods.

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PRINCIPLE #1:
People Face Tradeoffs

- Society faces an important tradeoff:
  efficiency vs. equality
- **Efficiency**: when society gets the most from its scarce resources
- ✓ Optimum use of scarce resources to produce goods and services that minimize the cost of production.
- **Equality**: when prosperity is distributed uniformly among society's members
- There is a trade-off between efficiency and equality.
  - To achieve greater equality, we could redistribute income from wealthy to poor. But this reduces incentive to work or produce and shrinks the size of the economic "pie."

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

- People face trade-offs in decision-making.
- Making decisions requires comparing costs and benefits of alternative choices.
- The true cost of an action may not always be obvious at first.
- The **opportunity cost** of any item is whatever must be given up to obtain it.
- It is the relevant cost for decision making.

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

Examples:

The opportunity cost of…

…going to university 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.

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

Examples:

- What is the opportunity cost of a student spending three hours and $20 at the movies the night before an exam?
- ✓ Answer: The opportunity cost is time spent studying and that money ($20) to spend on something else.
- If you spend $4,000 a year to study and give up $21,000 a year of income, the cost of attending school is $25,000.

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PRINCIPLE #3:
Rational People Think at the Margin

Rational people

- ✓ systematically and purposefully do the best they can to achieve their objectives.
- ✓ make decisions by evaluating costs and benefits of **marginal changes**, incremental adjustments to an existing plan.
- ✓ Example: should I take another course this semester? should I study for another hour for tomorrow's exam?

- A rational decision maker takes an action if and only if the marginal benefit of the action exceeds the marginal cost.

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PRINCIPLE #3:
Rational People Think at the Margin

Examples:

- When students consider whether to go to university for an additional year, they compare the fees & foregone wages to the extra income they could earn with the extra year of education.
- When managers consider whether to increase output, they compare the cost of the extra labor and materials to the additional expected revenue.

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PRINCIPLE #3:
Rational People Think at the Margin

- Marginal decision-making helps explain confusing economic phenomena.
- ✓ Example: Water is cheap, while diamonds are expensive.
- ✓ Water is essential for survival, but diamonds are not.
- ✓ Despite this, people pay more for diamonds than for water.
- ✓ Willingness to pay depends on the "marginal benefit" of an extra unit.
- ✓ Marginal benefit decreases when a good is abundant (e.g., water).
- ✓ Diamonds are rare, so their marginal benefit is high.
- ✓ If water were scarcer, its marginal benefit and price would increase (as seen in some Arab countries).

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PRINCIPLE #4:
People Respond to Incentives

- **Incentive**: something that induces a person to act.
- Rational people respond to incentives such as rewards and forfeits.

  Examples:
  - When gas prices rise, consumers buy more hybrid and smaller cars and fewer large cars.
  - When cigarette taxes increase, the number of people smoking falls.

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Class Activity

- Class Activity: Access and read the assigned case study on Moodle. Then, carefully analyze the content and respond to the following questions.

1. What are the main factors contributing to the shortage of affordable housing in GCC countries, and how do they impact residents?
2. What incentives can governments introduce to encourage private developers to build more affordable housing?
3. What lessons can GCC countries learn from international examples, such as Morocco and Bahrain, to improve access to affordable housing?

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ACTIVE LEARNING 1

Applying the principles

You are selling your car. You have already spent $1000 on repairs.

At the last minute, the transmission dies. You can pay $600 to have it repaired, or sell the car "as is."

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

A. If you could sell for $6500 if transmission works, $5700 if it doesn't

B. If you could sell for $6000 if transmission works, $5500 if it doesn't

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ACTIVE LEARNING 1

Answers

Cost of fixing transmission = $600

A. If you could sell for $6500 if transmission works, $5700 if it doesn't

Benefit of fixing the transmission = $800 ($6500 – 5700).

It's worthwhile to have the transmission fixed.

B. If you could sell for $6000 if transmission works, $5500 if it doesn't

Benefit of fixing the transmission is only $500.

Paying $600 to fix transmission is not worthwhile.

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ACTIVE LEARNING 1

Observations

- The $1000 you previously spent on repairs is irrelevant. What matters is the cost and benefit of the *marginal* repair (the transmission).
- The change in incentives from scenario A to scenario B caused your decision to change.

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The principles of
HOW PEOPLE INTERACT

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PRINCIPLE #5:
Trade Can Make Everyone Better Off

- Trade is the action of buying and selling goods and services.
- Trade and global business are frequently discussed in news reports.
- ✓ Venezuela and Saudi Arabia compete in the oil market for customers.
- ✓ Firms in the Arab world compete with international companies.
- Examples of competition:
- ✓ Airlines: Emirates Airline vs. British Airways (London-Dubai route).
- ✓ Automobiles: Ford vs. Toyota.
- ✓ Digital music players: Apple vs. Sony.

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PRINCIPLE #5:
Trade Can Make Everyone Better Off

- Rather than being self-sufficient, people can specialize in producing one good or service and exchange it for other goods.
- Countries also benefit from trade and specialization:
  - Get a better price abroad for goods they produce.
  - Buy other goods more cheaply from abroad than could be produced at home.

PRINCIPLE #6:
Markets Are Usually A Good Way to Organize Economic Activity

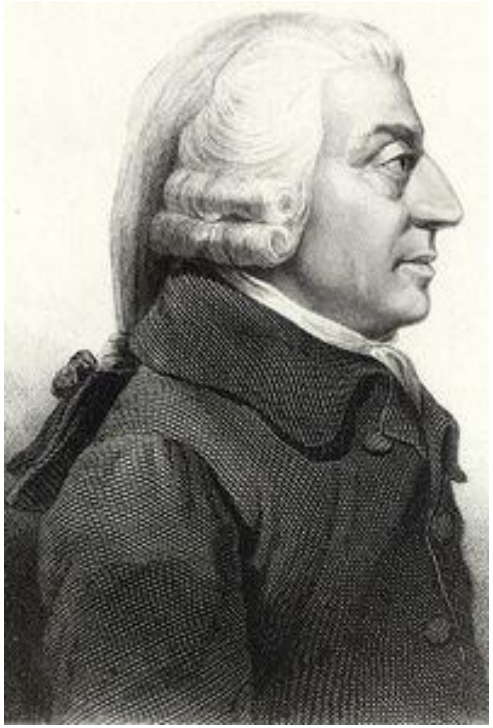
- **Market**: a group of buyers and sellers (need not be in a single location).
- "Organizing economic activity" means determining
  - what goods to produce.
  - how to produce them.
  - how much of each to produce.
  - who gets them.
- Many countries that once had centrally planned economies have abandoned this system for market economies.

PRINCIPLE #6:
Markets Are Usually A Good Way to Organize Economic Activity

- A **command or planned economy** occurs when the government controls all major resources of the economy and makes all the major production decisions. Example North Korea.
- A **market economy** allocates resources through the decentralized decisions of many households and firms as they interact in markets.
- In a market economy firms decide whom to hire and what to produce. Households decide which firm to work for and what to buy with their incomes.
- Many countries that once had centrally planned economies have abandoned this system for market economies.

PRINCIPLE #6:
Markets Are Usually A Good Way to Organize Economic Activity

- Adam Smith in *The Wealth of Nations* (1776):
- Each of these households and firms acts as if "led by **an invisible hand**" to promote general economic well-being.



PRINCIPLE #6:
Markets Are Usually A Good Way to Organize Economic Activity

- The invisible hand works through the price system:
  - The interaction of buyers and sellers determines prices.
  - Each price reflects the good's value to buyers and the cost of producing the good.
  - Prices guide self-interested households and firms to make decisions that, in many cases, maximize society's economic well-being.

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PRINCIPLE #7:
Governments Can Sometimes Improve Market Outcomes

- The invisible hand will only work if governments **enforce property rights** (with police, courts)
  - Definition of **property rights:** the ability of an individual to own and exercise control over scarce resources.
  - People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.
- A government can interfere with the economy to promote efficiency (where there is market failure) and equity.

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PRINCIPLE #7:
Governments Can Sometimes Improve Market Outcomes

- **Market failure:** when the market fails to allocate society's resources efficiently.
- Causes of market failure:
  - **Externalities**, when the production or consumption of a good affects bystanders (e.g. pollution)
  - **Market power**, a single buyer or seller has substantial influence on market price (e.g. monopoly).
- Public policy may **promote efficiency**.

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PRINCIPLE #7:
Governments Can Sometimes Improve Market Outcomes

- A Government may also alter market outcome to **promote equity**.
  - If the market's distribution of economic well-being is deemed not desirable, tax or welfare policies can change how the economic "pie" is divided.
- The invisible hands doesn't make sure that everyone has sufficient food, decent clothing and adequate healthcare, there will be an unequal distribution of economic well-being.
- In practice many public policies, such as tax or welfare system, aim to achieve a more equal distribution of economic wellbeing.

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ACTIVE LEARNING 2

Discussion Question

In each of the following situations, what is the government's role? Does the government's intervention improve the outcome?

a. Workplace safety regulations

b. Public highways

c. Patent laws, which allow drug companies to charge high prices for life-saving drugs.

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The principles of
HOW THE ECONOMY AS A WHOLE WORKS

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PRINCIPLE #8:
A Country's Standard of Living Depends on Its Ability to Produce Goods & Services

- There is huge variation in living standards across countries and over time:
  - Average income in rich countries is more than ten times average income in poor countries.
  - The U.S. standard of living today is about eight times larger than 100 years ago.

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PRINCIPLE #8:
A Country's Standard of Living Depends on Its Ability to Produce Goods & Services

- The most important determinant of living standards is **productivity**: the amount of goods and services produced from each unit of labor input.
  - High productivity implies high living standards.
  - Productivity 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.

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PRINCIPLE #9:
Prices Rise When the Government Prints Too Much Money

- **Inflation**: an increase in the general level of prices in the economy.
  - 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 Tradeoff Between Inflation and Unemployment

- In the short-run (1–2 years), many economic policies push inflation and unemployment in opposite directions.
  - A monetary injection raises prices and lowers unemployment.
  - This short-run trade-off between inflation and unemployment plays a key role in the analysis of the business cycle.
  - The **business cycle:** fluctuations in economic activity, such as employment and production.
  - Policymakers may stimulate demand when there is a severe downturn in the economy, but risk inflation.

FYI: How to Read Your Textbook

1. Read before class.
   You'll get more out of class.
2. Summarize, don't highlight.
   Highlighting is a passive activity that won't improve your comprehension or retention.

   Instead, summarize each section in your own words. Then, compare your summary to the one at the end of the chapter.

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FYI: How to Read Your Textbook

3. Test yourself.
   Try the "Quick Quiz" that follows each section before moving on to the next section.
   Write your answers down, compare them to the answers in the back of the book. If your answers are incorrect, review the section before moving on.

4. Practice, practice, practice.
   Work through the end-of-chapter review questions and problems. They are often good practice for the exams. And the more you use your new knowledge, the more solid it will become.

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FYI: How to Read Your Textbook

5. Go online.
   The book comes with excellent web resources, including practice quizzes, tools to strengthen your graphing skills, helpful video clips, and other resources to help you learn the textbook material more easily and effectively. Visit: cengage.co.uk/education *and*

   cengage.com /education/Mindtap/

6. Study in groups.
   Get together with a few classmates to review each chapter, quiz each other, and help each other understand the material.

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FYI: How to Read Your Textbook

7. Teach someone.
   The best way to learn something is to teach it to someone else, such as a study partner or friend.
8. Don't skip the real world examples.
   Read the Case Studies and "In The News" boxes in each chapter. They will help you see how the new terms, concepts, models, and graphs apply to the real world. As you read the newspaper or watch the evening news, see if you can find the connections with what you're learning in the textbook.

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SUMMARY

The principles of decision making are:

- People face tradeoffs.
- The cost of any action is measured in terms of foregone opportunities.
- Rational people make decisions by comparing marginal costs and marginal benefits.
- People respond to incentives.

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SUMMARY

The principles of interactions among people are:

- Trade can be mutually beneficial.
- Markets are usually a good way of coordinating trade.
- Government can potentially improve market outcomes if there is a market failure or if the market outcome is inequitable.

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SUMMARY

The principles of the economy as a whole are:

- Productivity is the ultimate source of living standards.
- Money growth is the ultimate source of inflation.
- Society faces a short-run tradeoff between inflation and unemployment.

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