Ten Lessons from Economics

Economics- the study of how society manages its scarce resources.

- Scarcity- the limited nature of society's resources.

Economists study how people make decisions, how people interact with one another, and finally analyse forces and trends that affect the economy as a whole.

- **How people make decisions**

Lesson 1: People face trade-offs

To get one thing that we like, we must give up another thing that we like. Making decisions requires trading off one goal against another.

For example, a student must decide how to allocate her time, she can spend all her time studying economics, or all her time studying maths, or simply divide her time. For every hour she spends studying economics, she gives up one hour she could have spend studying maths.

Another trade-off society faces is between efficiency and equity. Getting the most out of the resources it has and still distributing it fairly among society's members.

Acknowledging life's trade-offs is important because people are likely to make good decisions only if they understand the options that they have available.

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

The cost of going to university is the time that you give up to achieve a higher paid job in the future.

Opportunity cost- whatever must be given up to obtain some item.

When making any decision, such as going to uni, decision makers should be aware of the opportunity costs that accompany each possible action. For example, some young athletes can make millions of dollars if they forgo uni and play sports professionally. Their opportunity costs of uni are very high.

Lesson 3: Rational people think at the margin

Rational people- purposefully do the best that they can to achieve their objectives, given the opportunities that they have.

Economists use the term 'marginal change' to describe a small incremental adjustment to an existing plan of action. Margin means 'edge', so marginal changes are adjustments around the edge of what you are doing.

Rational people often make decisions by comparing marginal benefits and marginal costs.

Marginal decision making is helpful. The reason that a person is willing to pay more for a good is based on the marginal benefit that an extra unit of the good would yield. For example, although water

is essential, the marginal benefit of an extra cup is small because water is plentiful. By contrast, no one needs diamonds to survive, but because they are so rare, people consider the marginal benefit of an extra diamond to be large.

Lesson 4: People respond to incentives

An incentive is something that induces a person to act, such as the prospect of a punishment or a reward. Because rational people make decisions by comparing costs and benefits, they respond to incentives.

Incentives are crucial to analysing how markets work. For example, if the price of apples rise, consumers will eat less, though produces will hire more staff to harvest apples. A higher price in a market provides an incentive for customers to buy less and incentives for sellers to produce more.

A good example is policy makers introducing the seat belt law. Due to this law less driver deaths have occurred. However, because of increased driver confidence with the feeling of safety, there have been more accidents and also more pedestrian deaths. This shows people respond to incentives.

- **How people interact**

Lesson 5: Trade can make everyone better off

Trade between two countries can make each country better off and, hence, workers (on average) better off.

For example, each family competes against all other families when they go shopping, because each family want to buy the best goods at the lowest prices. Despite this competition, your family would not be better off isolating itself from others as it would mean growing your own food, making your own clothes. Clearly, family gains much more from its ability to trade with others.

Trade allows countries to specialise in what they do best and to enjoy a greater variety of goods and services.

Lesson 6: Markets are usually a good way to organise economic activity

Market economy- an economy that allocates resources through the decentralised decisions of many firms and households as they interact in markets for goods and services.

Firms decide whom to hire and what to make. Households decide which firms to work for and what to buy with their incomes.

Economist Adam Smith notes in his book, that households and firms interacting in markets act as if they are guided by an ‘invisible hand’ that leads them to desirable market outcomes.

Invisible hand- The idea that buyers and sellers freely interacting in a market economy will create an outcome that allocates goods and services to those people who value them most highly and makes the best use of our scarce resources.

Lesson 7: Governments can sometimes improve market outcomes

The 'invisible hand' can work only if the government enforces the rules and maintains the institutions that are key to a market economy.

Markets work only if property rights are enforced so individuals can own and control scarce resources. For example, a farmer won't grow food if he expects his crop to be stolen.

There are two broad reasons why governments intervene in the economy and change the allocation of resources; to promote efficiency and equity.

Market failure- a situation in which a market left on its own fails to allocate resources efficiently. One possible cause of this is an externality. An externality is the impact of one person's actions on the wellbeing of a bystander.

Example; if a chemical factory does not bear the entire cost of smoke it emits, it is likely to emit too much. The government can raise economic wellbeing through environmental regulation.

Another possible cause of market failure is market power. This refers to the ability of a single person to have substantial influence on market prices.

Equity

Many public policies, such as the tax and social welfare systems, aim to achieve a more equitable distribution of economic wellbeing.

- **How the economy as a whole works**

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

Almost all variation in living standards is attributable to differences in counties' productivity.

Productivity- the quantity of goods and services produced from each hour of a workers' time.

In nations where workers can produce a large quantity of goods and service per unit of time, most people enjoy a high standard of living, and vice versa.

The relationship between productivity and living standards also has profound implications for public policy. When thinking about how any policy will affect living standards, the key question is how it will affect our ability to produce goods and services.

To boost living standards, policy makers need to raise productivity by ensuring workers are well educated, have the necessary tools and have access to the best technology.

Lesson 9: Prices rise when the government prints too much money

Inflation- an increase in the overall level of prices in the economy.

Because high inflation imposes various costs on society, keeping inflation at a low level is a goal of economic policy makers around the world.

Growth in the quantity of money causes inflation. When a government creates large quantities of a nations money, the value of the money falls.

Lesson 10: Society faces a short-term trade-off between inflation and unemployment

Reducing inflation is often thought to cause a temporary rise in unemployment.

Phillips curve- short-term trade-off between inflation and unemployment. This trade-off arises because some prices are slow to adjust, for example, it takes years before restaurants print new menus, all unions make wage concessions, etc. Prices are said to be sticky in the short term.

This trade-off is only temporary, but it can last for several years. Policymakers can exploit this trade-off using various policy instruments; changing the amount that governments spend, amount it takes and amount of money it prints. They can, in the short term, influence the combination of inflation and unemployment that the economy experience.