Chapter 1

The Big Ideas
Outline

Big ideas in economics:

1. Incentives Matter
2. Good Institutions Align Self-Interest with the Social Interest
3. Trade-offs Are Everywhere
4. Thinking on the Margin
5. The Power of Trade
6. The Importance of Wealth and Economic Growth
7. Institutions Matter
8. Economic Booms and Busts Cannot Be Avoided but Can Be Moderated
9. Prices Rise When the Government Prints Too Much Money
10. Central Banking Is a Hard Job
The Big Ideas

1. Incentives Matter

- People respond in predictable ways to incentives of all kinds.
- Fame, power, reputation, sex, and love are all important incentives.
Incentives:

Rewards and penalties that motivate behavior.

“Show me the incentive and I’ll show you the outcome.” – Charlie Munger
“Show me the incentive and I will show you the outcome.” – Charlie Munger

“Never, ever, think about something else when you should be thinking about the power of incentives.”

“I think I've been in the top 5 per cent of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it.”
Only when the ship captains began to be paid per living convict on arrival did the death rate fall from over 33% to less than 1%
“It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.”

Adam Smith, The Wealth of Nations
Which of the following is an incentive to read your economics text?

a. The title of the book.
b. The time it takes you to read a chapter.
c. Better grades in economics.

Answer: c – better grades are the expected reward for reading the text.
2. Good Institutions Align Self-Interest with the Social Interest

- When markets work well, individuals pursuing their own interest also promote social interest.
- It is as if the market is led by an “invisible hand.”
- When markets do not work well, government can change incentives with taxes, subsidies, or regulation.
The Big Ideas

“It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.”

-Adam Smith,
The Wealth of Nations

Adam Smith saw the invisible hand
3. Trade-offs are Everywhere

Example: drug testing
3. Trade-offs are Everywhere

- Example: drug testing (FDA)
- More testing means that approved drugs will have fewer side effects.
- Must balance the benefit with other trade-offs:
  - *Drug lag*: people are harmed when approval of a safe drug is delayed.
  - *Drug loss*: higher testing costs may mean a safe drug is never developed.
3. Trade-offs Are Everywhere

- Trade-offs are related to *opportunity costs*.
- Every choice involves something gained and something lost.
  - Example: The choice to attend college means losing the opportunity to work full-time.
- The great economic problem: how to arrange our resources to satisfy as many wants as possible
Opportunity Cost:
The opportunity cost of a choice is the value of the opportunities lost.

Scarcity:
A resource is scarce when there isn’t enough to satisfy all of our wants.
What is the opportunity cost of reading your economics text?

a. Spending time with friends or family.
b. The cost of the economics text.
c. Better grades in economics.

Answer: a – reading the text means you have less time to spend with friends or family.
There are no solutions; there are only trade-offs.

— Thomas Sowell —
4. Thinking on the Margin

- We make choices by considering the benefits and costs of a little more or a little less.
- “Marginal” means one more or one less.
- Marginal choices include marginal cost, marginal revenue, and marginal tax rates.
5. The Power of Trade

- The benefits of trade go beyond the benefits from exchange.
- Trade leads to increased production through specialization.
- It also allows us to take advantage of economies of scale.
5. The Power of Trade

Theory of comparative advantage:

When people or nations specialize in goods in which they have a low opportunity cost, they can trade to mutual advantage.
6. The Importance of Wealth and Economic Growth

- Economic growth creates wealth.
- Wealthier economies enable richer and healthier lives.

- "Civilization prospers with commerce (and cheap beer)."
Living in the Dark

COMMUNISM

YOU CAN SEE IT FROM SPACE
Discussion Question

Think about the things you do throughout your day. How many of them could you do in an underdeveloped economy with no services or infrastructure? (No right or wrong answer.)

a. All of them.
b. Most of them.
c. Some of them.
d. None of them.
GDP per capita and life satisfaction.

Image credit
World Poverty Rates – 1820 to 2015

Share of the World Population living in Absolute Poverty, 1820-2015 – by Max Roser

All incomes are adjusted for inflation over time and for price differences between countries (1985-PPP before 1970; 2011-PPP after 1970).


The interactive data visualisation is available at OurWorldinData.org. There you find the raw data and more visualisations on this topic. Licensed under CC-BY-SA by the author Max Roser.
7. Institutions Matter

- Institutions provide incentives to save and invest in:
  - Physical capital
  - Human capital
  - Innovation
  - Efficient organization
The Big Ideas

7. Institutions Matter

- The right institutions foster growth:
  - Property rights
  - Political stability
  - Honest government (corruption)
  - Dependable legal system
  - Competitive and open markets
Can you tell which country has better institutions?

North and South Korea at night
8. Economic Booms and Busts Cannot Be Avoided but Can Be Moderated

- Economies do not grow at a constant pace.
- Booms and busts are a normal response to changing economic conditions.
- In a downturn, output (GDP) drops and unemployment increases.
8. Economic Booms and Busts Cannot Be Avoided but Can Be Moderated

- The government can use fiscal and monetary policy to reduce the swings in output and unemployment.
- If used improperly, these tools can make the economy more volatile.

- Note: The government can influence but not control the economy. The President doesn’t “run” the economy, despite efforts to suggest otherwise.
9. Prices Rise When the Government Prints Too Much Money

- A country’s central bank regulates the supply of money.
- A sustained increase in the supply of money, without an increase in the supply of goods, causes prices to rise.
**Inflation:**

_An increase in the general level of prices._
9. Prices Rise When the Government Prints Too Much Money

- Inflation can make people poorer.
- Unpredictable inflation makes it harder for people to figure out the real values of goods, services, and investments.
- Excessive inflation can lead to economic disruption.
In Zimbabwe in early 2009, the inflation rate leaped to billions of percent per month.
10. Central Banking is a Hard Job

- The U.S. Federal Reserve (“The Fed”) is often called on to combat recessions.
- There may be a long lag between a decision and the effects of the decision.
- Too much money leads to inflation.
- Not enough money can lead to economic slowdown or recession.
Economics is Fun

- Economics is linked to everyday life.
- See the invisible hand, understand your world.
The basic principles of economics apply to all countries.

Economics is also linked to everyday life – your job, personal finances, debt, inflation, recession.

Economics teaches us how to make the world a better place.
In the economic sphere an act, a habit, an institution, a law produces not only one effect, but a series of effects.

Of these effects, the first alone is immediate; it appears simultaneously with its cause; it is seen.

The other effects emerge only subsequently; they are not seen; we are fortunate if we foresee them.
There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen.
\begin{itemize}
  \item Yet this difference is tremendous; for it almost always happens that when the immediate consequence is favorable, the later consequences are disastrous, and vice versa.
  
  Whence it follows that the bad economist pursues a small present good that will be followed by a great evil to come, while the good economist pursues a great good to come, at the risk of a small present evil.

  - Frederic Bastiat
\end{itemize}
Broken Window Fallacy (2:57)
https://www.youtube.com/watch?v=fMbhs9JG4fE&feature=youtu.be

Greed
https://www.youtube.com/watch?v=RWsx1X8PV_A&feature=youtu.be