1

The Big Ideas

Learning Objectives

After completing this chapter students should:

**>** know the Ten Big Ideas in economics.

**>** appreciate that economics is not just about business and stock markets, but it can help them understand many things they encounter in their everyday lives.

**>** see that economics can be fun!

Chapter Outline

The chapter is organized around 10 “Big Ideas”:

Big Idea One: Incentives Matter

Big Idea Two: Good Institutions Align Self-Interest with the Social Interest

Big Idea Three: Trade-offs Are Everywhere

Opportunity Cost

Big Idea Four: Thinking on the Margin

Big Idea Five: The Power of Trade

Big Idea Six: The Importance of Wealth and Economic Growth

Big Idea Seven: Institutions Matter

Big Idea Eight: Economic Booms and Busts Cannot Be Avoided but Can Be Moderated

Big Idea Nine: Inflation Is Caused by Increases in the Supply of Money

Big Idea Ten: Central Banking Is a Hard Job

The Biggest Idea of All: Economics Is Fun

Chapter Narrative

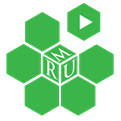
This chapter briefly introduces 10 big ideas in economics that the students will learn more thoroughly in later chapters. Each big idea is explained, and then its importance is illustrated by showing how it explains some real-world phenomenon that the students should find interesting. The chapter aims to excite students about economics while giving them a quick introduction to the big ideas.

The chapter opens by explaining how the British government rewarded ship captains for transporting convicts to Australia in the eighteenth century. At first, the captains were paid per convict who boarded the ship. The sailors treated the prisoners inhumanely, and their death rates were extraordinarily high. Then, when the government changed the payment system so that it paid captains according to how many prisoners walked off their ship in Australia, rather than how many walked on in England, suddenly the prisoners’ survival rate shot up to 99 percent. This illustration leads into the first big idea: incentives matter.

Big Idea One: Incentives Matter

Incentives are rewards or penalties that influence behavior.

Changing the incentives changed how the captains treated their prisoners. Under the first payment system, there was no monetary reward for delivering the prisoners alive. In fact, if they didn’t feed the prisoners, the captains could sell the prisoners’ rations and earn even more money. Captains’ incentives were to treat prisoners poorly. Once they were paid according to how many healthy passengers they delivered, their incentives and thus their behavior changed for the better.

The MRU video *Introduction to Economics* introduces economics in general and discusses the importance of incentives in particular using the story of British prisoner transports to Australia. This video might provide a nice opening to your first lecture.

Monetary rewards are one major incentive in our society. As Adam Smith said, “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.”

*Teaching Tip:* It’s easy to illustrate this idea to students quickly. Glance around the room and see who just recently purchased something, such as a Coke or coffee. Ask about the transaction. Who sold it? What was the seller’s name? Did the seller know the student’s name? Why was that product available there? What was the seller’s incentive? Emphasize the number of things that students need from people who have no incentive to help them other than the monetary reward.

Not all incentives are monetary—fame, power, reputation, sex, and love are all important incentives. Emphasize that economics can explain things motivated by these incentives as well. Students should come away realizing that economics is not limited to explaining things that are paid for in money.

Big Idea Two: Good Institutions Align Self-Interest with the Social Interest

The story of how ships’ captains changed their behavior relates to the second big idea. Incentives are not fixed in stone. Different institutions or rules can engender different incentives and behaviors. An institution is good when it aligns an individual’s self-interest with society’s interest. An institution is bad, and so are the outcomes, when individuals’ incentives run counter to society’s interest.

Under the right conditions, markets align self-interest and social interest. It’s good that business people make money by pleasing consumers. Self-interest on their part can be good for society.

*Teaching Tip:* Ask students if they ever worked overtime at a job. Why did they do it? Get them to explain that they wanted to earn the extra money. They were acting out of self-interest. But then emphasize how their self-interest made them provide more services to someone else than they would have otherwise.

Be sure to point out that self-interest is neither good nor bad because it is how we progress as a species. What is important is the institutions. The captains’ greed led to bad outcomes (poorly treated passengers) when institutions were bad. But that same greed, or desire for self-interest, led to good outcomes (more passengers making it to Australia) when the institutions changed. Greed’s goodness (or usefulness) depends on the institutions. Markets with mutual voluntary interaction make self-interest useful most of the time.

Big Idea Three: Trade-offs Are Everywhere

Students are first introduced to opportunity cost (without using that term) by the somewhat shocking conclusion that economists worry that pharmaceutical drugs could be too safe. In 2004, Merck withdrew the arthritis drug Vioxx from the market after a study showed that it could cause heart attacks and strokes. Yet the FDA had approved the drug five years earlier, and millions had used it. Students will be tempted to conclude that the FDA should be more careful studying new drugs so that drugs like Vioxx never reach the market.

Making drugs safer necessitates a trade-off: fewer companies will develop drugs because it would be more costly. This is known as drug loss. It will also take longer for good drugs to make it to market, causing people to miss out on the drug’s beneficial effect in the interim. This is known as drug lag. It takes an average of 12 years and $900 million to bring a new drug to market in the United States. The trade-off society faces for safer drugs is fewer drugs and getting them more slowly. Such trade-offs are inevitable in a world of scarcity—that is, when there are not enough resources to satisfy all of our wants. How we use our scarce resources to satisfy as many of our wants as possible is what the authors refer to as the “great economic problem.” Scarcity, trade-offs, and the great economic problem bring us to a key concept in economics: opportunity cost. The opportunity cost of a choice is the value of the opportunities lost because of that choice.

*Teaching Tip:* Students are used to thinking of costs as monetary costs. Take some time to illustrate opportunity costs with examples that they can relate to. For example, what is the opportunity cost of going to a movie one night? How would that opportunity cost change if you had an exam the next day? The textbook provides another nice example:

What is the cost of going to college? Tuition, books, lost wages, room and board. Ask students which of these is not an opportunity cost. Ask them if they considered lost wages when they decided to attend. Then explain why college enrollment is affected by the business cycle.

*Teaching Tip:* You can have some fun with examples of opportunity cost by asking students questions that relate to everyday life. Try asking the following:

**>** In a social situation, have you ever walked up to two attractive people, looking for a date? You have to choose who to focus on. The opportunity cost of talking to the person you chose is loss of the opportunity to talk to the other person. (This leads nicely to the joke: an economist was asked how his wife was. He answered, “Compared to whom?”)

**>** Does anyone play basketball? If you’re on a fast break and you pull up for a three-pointer, what is your opportunity cost?

**>** If you weren’t here in my class today, what would you be doing?

Keep drilling them with questions until they seem to get it.

Big Idea Four: Thinking on the Margin

Most choices are made on the margin. Should we do a little more of an activity or a little less? This concept is introduced in the book with a brief discussion of a driver making incremental changes to his speed as he travels down the highway. When he hasn’t seen a police cruiser in a while, he increases his speed a little more. When he finally spots one as he approaches a big city, he decreases his speed a little. Just like many decisions in life, the driver’s decision about his speed is not made once and for all upon starting his car. Rather, when it is beneficial to do so, he speeds up a little, until the benefits of speeding up a little no longer outweigh the costs (the increased likelihood of a ticket).

*Teaching Tip:* Here is a fun illustration of marginal thinking from students’ everyday lives. Ask if they have ever chosen to go out with their friends instead of with their boyfriend or girlfriend and heard the objection, “You care more about them than you do me.” At least one hand will go up. Then explain that they now have an answer: “Not in an absolute sense. You are more important, but given that I already spend so much time with you, seeing them tonight is more important to me only on the margin.”

Big Idea Five: The Power of Trade

The benefits of trade go much further than the simple benefits of exchange. Through specialization, trade can increase productivity, and higher productivity leads to more output. One way that specialization increases productivity is through the division of knowledge. A producer who specializes in the production of just a few goods can become an expert in the production of those goods, learning things that would not have been learned if every person produced just a small amount of every good for his or her own use. Likewise, specialization allows producers to take advantage of economies of scale, the cost savings that can be achieved when goods are produced in higher quantities.

The theory of *comparative advantage* maintains that specialization and trade can benefit everyone involved. The key is for producers (individuals, firms, or countries) to focus on the goods they can produce for the lowest opportunity cost and then trade with each other. The text uses the example of Martha Stewart, who, although likely a very skilled ironer, hires someone to do her ironing. The reason? The opportunity cost of her ironing is running her company (Martha Stewart Living Omnimedia). If the profits from her company that she foregoes when she spends an hour ironing is greater than the value of ironing, then she should spend time running her company and use those higher profits to pay someone to iron her clothes.

Big Idea Six: The Importance of Wealth and Economic Growth

Some students will be tempted to discount the importance of wealth and economic growth because they associate it only with material standards of living. Now’s the time to drive home the point that increases in wealth give us more of many of the things we all value. A few quick examples from the text:

**>** In 2007, more than half a billion people around the world contracted malaria, and about 1 million died of it. We think of it as a tropical disease, but people used to get it in the United States frequently until the 1940s. Better drainage, removal of mosquito breeding sites, and insecticides all contributed to wiping malaria out. We needed to grow wealthy enough to pay for these things before malaria could be eradicated.

**>** In the United States, 993 in 1,000 children born survive until at least age five years. In Liberia, one of the world’s poorest countries, the survival rate is only 765 in 1,000.

Most things people care about—like life expectancy, nutrition, and literacy—are all easier to get when you are wealthier.

It is also helpful to point out the circular relationship between these ideas. As wealth increases, there is more free time to pursue specialization. This specialization leads to more efficient production methods, which increases economic growth or the ability to produce more goods and service. This increases wealth, further leading to more free time and so on. A good example of this is how better and cheaper sources of light allowed more work past sunset, leading to more efficient forms of light generation.

Big Idea Seven: Institutions Matter

If wealth is so important, this naturally leads us to ask how to get wealth. This was the focus of much of Adam Smith’s seminal book *An Inquiry into the Nature and Causes of the Wealth of Nations.*

Wealthy countries tend to have lots of physical and human capital and use them with the best technology available to produce goods and services more efficiently. But this still raises the question of why some countries have more than others and why they use it more efficiently.

It all comes back to Big Idea One: Incentives Matter. Entrepreneurs, investors, and savers need the right incentives to save and invest in physical and human capital, innovation, and efficient organization. The institutions most important in supporting good incentives for these are property rights, political stability, honest government, a dependable legal system, and competitive and open markets.

*Teaching Tip:* Ask the students how many of them came to college because they expect to earn more. How have the institutions in the United States given them the confidence to make that investment in their human capital?

North Korea and South Korea provide a striking example of how different institutions affect wealth creation. The two countries have a common culture and geography and were equally poor in 1950. South Korea embraced property rights and markets, while North Korea did not. Today South Korea has more than 10 times the per capita income of North Korea.

*Teaching Tip:* If you have access to the Internet in the classroom, pull up a satellite image of the Korean peninsula at night and show them the difference in light emissions between the two countries as an indicator of development.

Big Idea Eight: Economic Booms and Busts Cannot Be Avoided but Can Be Moderated

Booms and busts are part of the normal response to changing economic conditions. Not all booms and busts are the same, though. The Great Depression was the worst economic downturn the United States has ever had. Output dropped by 30 percent, unemployment rose above 20 percent, and the stock market lost a third of its value. This was not a normal recession. Most economists believe that if the government had acted differently, the Depression would have been less severe.

Monetary and fiscal policies affect the length and severity of economic booms and busts. At one time, economists believed that government policy could be used to end the economy’s boom and bust cycle. But most economists no longer believe that, and we’ve learned that when these policies are used poorly, they make recessions worse and the economy more volatile.

An example you can use is ships on the ocean. Waves on the ocean cannot be stopped, they are just part of nature. If you are on a small boat you are constantly being tossed by these waves. If you are on a cruise ship you will likely forget you are on the ocean. The waves are still there; however, the builders of the ship have installed technology to mitigate the impact of the waves on the ship. Monetary and fiscal policy work in much the same way by mitigating the impact of the natural business cycle on the economy.

Big Idea Nine: Inflation Is Caused by Increases in the Supply of Money

Inflation is an increase in the general level of prices in an economy. Increases in the money supply cause inflation. Milton Friedman famously said, “Inflation is always and everywhere a monetary phenomenon.”

*Potential Pitfall:* Although inflation comes from increases in the money supply, students are likely to think oil or greedy businessmen cause inflation. It’s worth stressing the monetary causes and how other factors influence relative prices but not the general level of prices.

Inflation has negative consequences. Emphasize how inflation makes it hard to figure out the real value of goods and services. Most students in the United States have not experienced the chaos of serious inflation, whereas Zimbabwe recently had an inflation rate of over 531 billion percent. Money in that situation becomes virtually worthless and must be spent as soon as it’s earned, making organized trade harder. In Zimbabwe, people started buying things with prepaid cell phone minutes and gas cards instead of the national currency.

You can highlight this idea by having the students assume you hand out envelopes with between one and five dollars in them. Now assume you are holding an auction for something the students want (such as answers to the exam) and ask the students what is the highest price one person can bid. Now assume the envelopes had up to ten dollars in them. Now what is the highest possible bid? Note to the students that the good being auctioned has not changed, only the price because there is more money.

Big Idea Ten: Central Banking Is a Hard Job

The Federal Reserve controls monetary policy in the United States. But there is a lag—often months—from when the Fed makes a decision to when the effects of that decision are known. When it prints too much money, we get inflation. If it prints too little, we get falling prices. And often as prices and wages fall, the adjustment does not go smoothly. But because of the lag, the Fed is always shooting at an unknown moving target.

Most economists believe the Fed does more good than harm, but when the Fed does its difficult job poorly, it can cause great harm.

Biggest Idea of All: Economics Is Fun

The whole point of the first chapter, and your first lecture of the semester, is to excite students about economics. We need to show the students that:

**>** economics is all around them in their daily lives.

**>** economics is crucial for understanding the world and how to make it a better place.

**>** these principles of economics hold everywhere across the globe and through time.

The motto of the book is “See the Invisible Hand. Understand Your World.” Chapter 1 and your lectures should arouse a desire in students to do that.