

## 8 Principals of Economics

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## **Eight Principles of Economics**

### *How People Make Decisions*

1. People face tradeoffs
2. The cost of something is what you give up to get it (*opportunity cost*)
3. Rational people think at the margin
4. People respond to incentives

## **Eight Principles of Economics**

### *How People Interact*

5. Trade can make everyone better off
6. Markets are usually a good way to organize economic activity
7. Governments can sometimes improve economic outcomes
8. The Standard of Living depends on Economic production

### *How People Make Decisions*

## **1. People face tradeoffs**

- There is no such thing as a free lunch!
- Our wants will always exceed our ability to deliver.



To get one thing, we usually have to give up another thing.

- ◆ Military spending v. Social Programs
- ◆ Food v. Biofuels
- ◆ Leisure time v. Work
- ◆ Efficiency v. Fairness

*making decisions involve trading off one goal against another*

### *How People Make Decisions*

## **2. The cost of any thing is what you give up to obtain it**

Decisions require comparing costs and benefits of alternatives.

- ◆ Whether to go to school or to work
- ◆ Whether to study or go out on a date
- ◆ Whether to go to class or sleep in

The *opportunity cost* of an item is what you give up to obtain that item

Examples:

To grow an acre of corn

I lose the opportunity to grow an acre of soybeans

I invest in my education

I miss the earnings I could have had from working

## How People Make Decisions

### 3. Rational people think at the margin

- **Marginal changes** are small, incremental adjustments to an existing plan of action
- People make decisions by comparing costs and benefits **at the margin**

## How People Make Decisions

### 4. People respond to incentives

- ◆ Marginal changes in costs and benefits motivate people to respond
- ◆ The decision to choose one alternative over another occurs when the alternative's marginal benefits exceed its marginal costs

## How People Interact

### 5. Trade can make everyone better off

- ◆ People gain from trading with one another
- ◆ Trade allows people to **specialize** in what they do best (comparative advantage)

## How People Interact

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

- ◆ In a **market economy**, households decide what to buy and whom to work for
- ◆ Firms decide whom to hire and what to produce

Adam Smith made the observation that households and firms interacting in markets act as if guided by an "**invisible hand**"

**We're all better off when individuals are left to serve their own economic self interests.**



## How People Interact

### 7. Governments can sometimes improve market outcomes

When the market fails (breaks down) Government can intervene to promote efficiency and equity

Can you name examples of government intervention in the past year?

## Efficiency v. Equity

- ◆ Efficiency means getting the most we can from our scarce resources.
- ◆ Equity means the benefits of scarce resources are distributed among the members of society in an evenhanded manner.

## Market failure is caused by...

- Externality which means the impact of one person's actions impact the well-being of another person. Also known as third-party shifted costs or benefits,  
e.g., pollution or  
(Mortgage / Credit Crisis)
- Market power which is the ability of a single person or firm to unduly influence market prices, e.g., monopolies and oligopolies.

## Forces that Affect the Economy as a Whole

### 8. Our standard of living depends on a country's production

Standard of living is measured in different ways:

- ◆ In terms of personal income (USDA Farm Inc.)
- ◆ By comparing the total market value of a nation's production (Gross Domestic Product)



Almost all variations in living standards are explained by differences in countries' levels of productivity

Productivity is the amount of goods and services produced from each unit of a worker's time

## Higher productivity ⇒ Higher standard of living

- Can you think of agricultural technologies that have led to higher productivity?
  - Skid Steers?
  - TMR technologies?
  - Yield Monitors?
  - Triple stacked seed corn?
  - Robotic milkers?
  - Electronic Animal ID?

## Deficit Spending

- When government spends more than it receives in taxes, it is called “Deficit Spending”
- The Deficit is financed by selling bonds to citizens and foreign governments.
- When Deficits become too large, the currency declines in value

## Government Deficits

- Deficit Spending can contribute to:
  - Inflation
  - Currency Devaluation
  - Higher Interest Rates
  - Higher Unemployment
- Who are the largest buyers of US Debt?
  - Foreign Governments (China)
  - Individual Investors