1

WHAT IS ECONOMICS?

You are studying economics at a time of extraordinary change.

Your life will be shaped by the challenges you face and the opportunities that you create.

But to face those challenges and seize the opportunities they present, you must understand the powerful forces at play.

The economics that you' re about to learn will become your most reliable guide.

Definition of Economics

All economic questions arise because we want more than we can get.

Our inability to satisfy all our wants is called **scarcity**.

Because we face scarcity, we must make ***choices***.

The choices we make depend on the incentives we face.

An **incentive** is a reward that encourages an action or a penalty that discourages an action.

Definition of Economics

Economics is the social science that studies the *choices* that individuals, businesses, governments, and entire societies make as they cope with *scarcity* and the *incentives* that influence and reconcile those choices.

Economics divides in to main parts:

- Microeconomics
- Macroeconomics

Definition of Economics

Microeconomics is the study of choices that individuals and businesses make, the way those choices interact in markets, and the influence of governments.

An example of a microeconomic question is: Why are people buying more e-books and fewer hard copy books?

Macroeconomics is the study of the performance of the national and global economies.

An example of a macroeconomic question is: Why is the unemployment rate in the United States so high?

Two Big Economic Questions

Two big questions summarize the scope of economics:

- How do choices end up determining ***what***, ***how***, and ***for whom*** goods and services get produced?
- When do choices made in the pursuit of ***self-interest*** also promote the ***social interest***?

Two Big Economic Questions

What, How, and For Whom?

Goods and services are the objects that people value and produce to satisfy human wants.

Two Big Economic Questions

How?

Goods and services are produced by using productive resources that economists call **factors of production**.

Factors of production are grouped into four categories:

- Land
- Labor
- Capital
- Entrepreneurship

Two Big Economic Questions

The “gifts of nature” that we use to produce goods and services are **land**.

The work time and work effort that people devote to producing goods and services is **labor**.

The *quality* of labor depends on **human capital**, which is the knowledge and skill that people obtain from education, on-the-job training, and work experience.

The tools, instruments, machines, buildings, and other constructions that businesses use to produce goods and services are **capital**.

The human resource that organizes land, labor, and capital is **entrepreneurship**.

Two Big Economic Questions

For Whom?

Who gets the goods and services depends on the incomes that people earn.

- Land earns **rent**.
- Labor earns **wages**.
- Capital earns **interest**.
- Entrepreneurship earns **profit**.

Two Big Economic Questions

Self-Interest

You make choices that are in your **self-interest**—choices that you think are best for you.

Social Interest

Choices that are best for society as a whole are said to be in the **social interest**.

Social interest has two dimensions:

- Efficiency
- Equity

Two Big Economic Questions

Efficiency is achieved when the available resources are used to produce goods and services:

1. At the lowest possible price and

2. In quantities that give the greatest possible benefit.

Equity is fairness, but economists have a variety of views about what is fair.

The Economic Way of Thinking

Six key ideas define the economic way of thinking:

- A choice is a *tradeoff*.
- People make *rational choices* by comparing benefits and costs.
- *Benefit* is what you gain from something.
- *Cost* is what you must give up to get something.
- Most choices are "how-much" choices made at the *margin*.
- Choices respond to *incentives*.

The Economic Way of Thinking

A Choice Is a Tradeoff

The *economic way of thinking* places *scarcity* and its implication, *choice*, at center stage.

You can think about every choice as a **tradeoff**—an exchange—giving up one thing to get something else.

On Saturday night, will you study or have fun?

You can' t study or have fun at the same time, so *y*ou must make a choice.

Whatever you choose, you could have chosen something else. Your choice is a tradeoff.

The Economic Way of Thinking

Making a Rational Choice

A **rational choice** is one that compares costs and benefits and achieves the greatest benefit over cost for the person making the choice.

Only the wants of the person making a choice are relevant to determine its rationality.

The idea of rational choice provides an answer to the first question: *What* goods and services will be produced and in what quantities?

The answer is: Those that people rationally choose to buy!

The Economic Way of Thinking

How do people choose rationally?

The answers turn on benefits and costs.

Benefit: What you Gain

The **benefit** of something is the gain or pleasure that it brings and is determined by preferences

Preferences are what a person likes and dislikes and the intensity of those feelings.

The Economic Way of Thinking

Cost: What you *Must* Give Up

The **opportunity cost** of something is the highest-valued alternative that *must* be given up to get it.

What is your opportunity cost of going to an AC/DC concert?

Opportunity cost has two components:

1. The things you can't afford to buy if you purchase the AC/DC ticket.

2. The things you can't do with your time if you spend at the concert.

The Economic Way of Thinking

How Much? Choosing at the Margin

You can allocate the next hour between studying and instant messaging your friends.

The choice is not all or nothing, but you must decide how many minutes to allocate to each activity.

To make this decision, you compare the benefit of a little bit more study time with its cost—you make your choice at the **margin**.

The Economic Way of Thinking

To make a choice at the margin, you evaluate the consequences of making *incremental changes* in the use of your time.

The benefit from pursuing an incremental increase in an activity is its **marginal benefit**.

The opportunity cost of pursuing an incremental increase in an activity is its **marginal cost**.

If the marginal benefit from an incremental increase in an activity exceeds its marginal cost, your rational choice is to do more of that activity.

The Economic Way of Thinking

Choices Respond to Incentives

A change in marginal cost or a change in marginal benefit changes the incentives that we face and leads us to change our choice.

The central idea of economics is that we can predict how choices will change by looking at changes in incentives.

Incentives are also the key to reconciling self-interest and the social interest.

Economics: A Social Science and Policy Tool

Economist as Social Scientist

Economists distinguish between two types of statement:

- What *is*—*positive* statements
- What *ought to be*—*normative* statements

A positive statement can be tested by checking it against facts.

A normative statement expresses an opinion and cannot be tested.