

WHAT IS ECONOMICS?



Objectives

After studying this chapter, you will be able to:

- Define economics and distinguish between microeconomics and macroeconomics
- Explain the big questions of economics
- Explain the key ideas that define the economic way of thinking
- Explain how economists go about their work as social scientists

Definition of Economics

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

Definition of Economics

Microeconomics

Microeconomics is the study of choices made by individuals and businesses, and the influence of government on those choices.

Macroeconomics

Macroeconomics is the study of the effects on the national and global economy of the choices that individuals, businesses, and governments make.

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 wants.

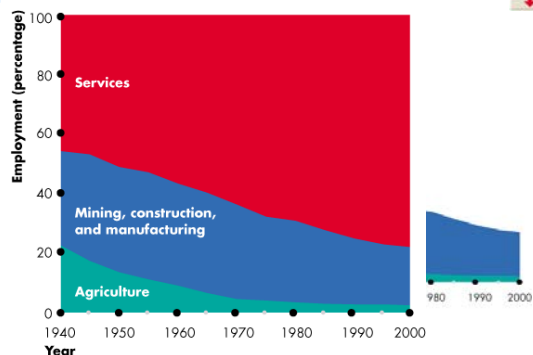
What?

What we produce changes over time.

Sixty years ago, almost 25 percent of Americans worked on farms: Today that number is 3 percent.

Today, almost 80 percent of Americans provide services.

Two Big Economic Questions



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 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.

Two Big Economic Questions

The tools, instruments, machines, buildings, and other equipment that are used 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

Answering the What, How, For Whom?

- Free market versus command economy
- Democrats versus Republicans

Two Big Economic Questions

When is the Pursuit of Self-Interest in the Social Interest?

Every day, 6.3 billion people make economic choices that result in “What,” “How,” and “For Whom” goods and services get produced.

- Do we produce the right things in the right quantities?
- Do we use our factors of production in the best way?
- Do the goods and services go to those who benefit most from them?

Two Big Economic Questions

Some issues in today’s world that illustrate the importance of individual versus collective decision making

- Does public ownership and central planning do a better job than private business and free markets?
- Is globalization a benefit or a problem?
- Do the technological advances in the “new economy” bring benefits to all?
- Should something be done about the price of gasoline?

Two Big Economic Questions

- Should drug companies be forced to make drugs available to poor people at a low cost?
- Are the world’s water resources being managed properly?

The Economic Way of Thinking

Choices and Tradeoffs

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.

The Economic Way of Thinking

What, How, and For Whom Tradeoffs

The questions what, how, and for whom become sharper when we think in terms of tradeoffs.

“What?” Tradeoffs arise when people choose how to spend their incomes, when governments choose how to spend their tax revenues, and when businesses choose what to produce.

The Economic Way of Thinking

“How?” Tradeoffs arise when businesses choose among alternative production technologies.

“For Whom?” Tradeoffs arise when choices change the distribution of buying power across individuals. Government redistribution of income from the rich to the poor creates the **big tradeoff**— the **equity-efficiency tradeoff**.

The Economic Way of Thinking

Choices and Economic Growth

- More capital goods and fewer consumer goods
- Less leisure time or fewer goods and services today versus more education and training.
- If businesses produce less and devote resources to research and developing new technologies, they can produce more in the future.

Why are some countries so much richer than others?

The Economic Way of Thinking

Opportunity Cost

Thinking about a choice as a tradeoff emphasizes cost as an opportunity forgone.

The highest-valued alternative that we give up to get something is the **opportunity cost** of the activity chosen.

The Economic Way of Thinking

Choosing at the Margin

People make choices at the **margin**, which means that they evaluate the consequences of making *incremental changes* in the use of their resources.

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**.

The Economic Way of Thinking

Responding to Incentives

Our choices respond to incentives.

For any activity, if marginal benefit exceeds marginal cost, people have an incentive to do more of that activity

If marginal cost exceeds marginal benefit, people have an incentive to do less of that activity.

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

Economics: A Social Science

Social science

Economics is a social science.

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 cannot be tested.

Economics: A Social Science

Model Building

An **economic model** is a description of some aspect of the economic world that includes only those features of the world that are needed for the purpose at hand.

Testing Models

An **economic theory** is a generalization that summarizes what we think we understand about the economic choices that people make and the performance of industries and entire economies.

Economics: A Social Science

Obstacles and Pitfalls in Economics

Economists cannot easily do experiments and most economic behavior has many simultaneous causes.

To isolate the effect of interest, economists use the logical device called *ceteris Paribus* or “other things being equal.

Economics: A Social Science

Obstacles and Pitfalls in Economics

- The *fallacy of composition*:

- The *false conclusion that*

- what is true for the parts is true for the whole

- what is true for the whole is true for the parts.

- The *post hoc fallacy*

- the error of reasoning that a first event *causes* a second event because the first occurs *before* the second.