WHAT IS ECONOMICS?
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.
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** - limited sources.

- Because we face scarcity, we must make choices.

- The choices we make depend on the incentives we face.

- An **incentive** => reward that encourages an action
  => penalty that discourages an action.
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.

What? What goods and services will be produced and in what quantities

Agriculture accounts for less than 1 percent of total U.S. production, manufactured goods for 22 percent, and services for 77 percent.

In China, agriculture accounts for 11 percent of total production, manufactured goods for 47 percent, and services for 43 percent.

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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

  “CELL”
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**. => **financial 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**.
  - People with large income will able to buy more.

“CELL = IPWR”
Two Big Economic Questions

Does the Pursuit of Self-Interest Unintentionally Promote the Social Interest?

Every day, 314 million Americans and 6.9 billion people in other countries make economic choices that result in *What*, *How*, and *For Whom* goods and services are produced.

These choices are made by people who are pursuing their self-interest.

Are they promoting the social interest?
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 suit for the sake of society as a whole are said to be in the social interest. i.e.

• Efficiency someone is better off while someone else is worse off
• Equity how to have “fair shares”?

=> Efficient – it is not possible to make someone better off without making someone else worse off.

=> Fair Share – every entities should be better off.
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 & 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

TRADEOFF : scarcity => exchange => choices

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 and have fun at the same time, so you must make a choice.

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

Opportunity cost has two components:

1. The things you can’t afford to buy if you purchase the concert ticket.
2. The things you can’t do with your time if you attend the concert.
The Economic Way of Thinking

How Much? Choosing at the Margin

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

The \textit{benefit from pursuing an incremental increase} in an activity is its \textit{marginal benefit}.

The \textit{opportunity cost of pursuing an incremental increase} in an activity is its \textit{marginal cost}.

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

- marginal benefit from an incremental increase > marginal cost
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.
**POSITIVE vs. NORMATIVE ECONOMICS**

**Positive economic statements**
states “what is” the situation
Statements that are based on data and fact.
Examples:
1. The U.S. unemployment rate was below 5 percent in 1998.
2. Last year the economy grew by 2%.

**Normative economic statements**
states “what ought to be”
Statements based on someone’s opinions and the way they believe things “should” be.
Examples:
1. The inflation rate in the United States is too high.
2. The minimum wage **should** be increased as a method of reducing poverty.
Economiast as Social Scientist

Economists distinguish between two types of statement:

- Positive statements
- Normative statements

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

- Global warming is due to the amount of coal that we consume.

A *normative* statement expresses an opinion and cannot be tested. => *what ought to be*

- By cutting off the usage of coal about 50%, we may manage to reduce it.
Economics: A Social Science and Policy Tool

- **Unscrambling Cause and Effect**
  - The task of economic science is to discover positive statements that are consistent with what we observe in the world and that enable us to understand how the economic world works. ⇒ “cause and effect”

- Economists create and test economic models.
  - An economic model is a description of some aspect of the economic world that includes only those features that are needed for the purpose at hand. ⇒ $y = c + l + G = GDP$
A model is tested by comparing its predictions with the facts.

But testing an economic model is difficult, so economists also use

- Natural experiments
- Statistical investigations
- Economic experiments
Economics: A Social Science and Policy Tool

- **Economist as Policy Adviser**

  - Economics is a toolkit for advising governments and businesses and for making personal decisions.

  - All the policy questions on which economists provide advice involve a blend of the positive and the normative.

  - Economics can’t help with the normative part—the goal.

  - But for a given goal, economics provides a method of evaluating alternative solutions—comparing marginal benefits and marginal costs.
After studying this chapter, you will be able to:

- Define economics and distinguish between microeconomics and macroeconomics
- Explain the two 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 and policy advisers