Chapter 1:

What is Economics?
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
- Describe how economists go about their work as social scientists
Economics, the science of choice, has much to say about the enormous change, opportunity, and challenge that we face today.

New technologies like mobile phones and iTunes are making our lives easier and more fun, but global terrorism and other new challenges are providing a landscape that is rich with problems to be tackled, and choices to be understood.

Your economics course helps you to understand how different forces shape our world.
Definition of economics

- **Scarcity**
  - All economic questions arise because we are unable to satisfy all our wants.
  - Our inability to satisfy all our wants is called *scarcity*.
  - **Economics** is the social science that studies the choices that society make as we 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, the way these choices interact in markets, and the influence of governments.

- **Macroeconomics**
  - **Macroeconomics** is the study of the performance of the national economy and the global economy.
Two Big Economic Questions

1. **How** do the choices that people make end up determining *what, how, when, where* and *for whom* goods and services are produced?

2. **When** do choices made in the pursuit of self-interest also promote the social interest?
Two Big Economic Questions

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

- **Economics** seeks to understand what determines:
  - **What** goods and services are produced
  - **How** goods and services are produced
  - **When** goods and services are produced
  - **Where** goods and services are produced
  - **For whom** goods and services are produced
Two Big Economic Questions

How are goods and services produced?

- **Factors of production** are the resources that businesses use to produce goods and services.

- They are grouped into four categories:
  - Land
  - Labour
  - Capital
  - Entrepreneurship
Two big economic questions

- The “gifts of nature” that we use to produce goods and services are land commonly called natural resources.
- The work time and effort that people devote to producing goods and services is labour.
- The quality of labour 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 constructions that are used to produce goods and services are called capital.

- The human resource that organises land, labour, and capital is entrepreneurship.
Two Big Economic Questions

- For whom are goods and services produced?
  - Who gets the goods and services depends on the incomes that people earn.
    - Land earns rent
    - Labour earns wages
    - Capital earns interest
    - Entrepreneurship earns profit.
Two Big Economic Questions

- When is the pursuit of self-interest in the social interest?
  - **Self-interest** – choices that you think are best for you
  - **Social interest** – choices that are the best for the society as a whole
Two Big Economic Questions

- Ten topics that illustrate the big question: Do choices made in the pursuit of self-interest also promote the social interest?
  - Planning versus markets
  - Globalisation
  - The new economy
  - Corporate scandals
  - HIV/AIDS
  - Global warming
  - Water shortages
  - Unemployment
  - Deficits and debts
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 classic tradeoff is “guns versus butter.”
- “Guns” and “butter” stand for *any* two objects of value.
The Economic Way of Thinking

- **What, How, and For Whom** tradeoffs
  - The questions *what, how and for whom* involves a tradeoff.
  - “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.
What, How, and For Whom tradeoffs

“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 tradeoff between equality and efficiency.
Choices bring change—and tradeoffs

- As a society, we trade off current consumption for economic growth and higher future consumption.
- Education and training involves a tradeoff between leisure today and a higher future income.
- A business choice to allocate current resources to research and development involves a tradeoff of current production for greater future production.
Opportunity cost

Thinking about a choice as a tradeoff emphasises that every choice involves a cost—the cost of the alternative that was foregone

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 that arises 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.
Choosing at the margin

- Marginal benefit and marginal cost act as incentives—inducements to take a particular action.
- 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.
- Economists seek to predict choices by looking at changes in incentives.
The Economic Way of Thinking

- Human nature, incentives and institutions
  - All people - consumers, producers, politicians and civil servants - pursue their self-interest. Self-interested actions are not necessarily selfish actions.
  - Economics emphasises that incentives are the key to reconciling self-interest and the social-interest
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.
Social science

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.

This task is large and breaks into three steps:
1. Observation and measurement
2. Model building
3. Testing models
1. Observation and Measurement

- Economists observe and measure economic activity, keeping track of such things as:
  - Quantities of resources
  - Wages and work hours
  - Prices and quantities of goods and services produced
  - Taxes and government spending
  - Quantities of goods and services bought from and sold to other countries.
2. Building Models

- 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.
3. Testing Models

- An economic theory is a generalisation that summarises what we think we understand about the economic choices that people make and the performance of industries and entire economies.

- We develop theories by testing models.

- A theory is a bridge between a model and reality. It is a proposition about whether a certain model works.
Obstacles and pitfalls in economics

- Economists cannot easily do experiments, and most economic behaviour has many simultaneous causes.
- To isolate the effect of interest, economists use the logical device called *ceteris paribus*, or “other things being equal.”
- Economists try to isolate cause-and-effect relationship by changing only one variable at a time, holding all other relevant factors unchanged.
Obstacles and pitfalls in economics

Two common fallacies that economists try to avoid are:

1. The *fallacy of composition*, which is the false statement that “what is true for the parts is true for the whole” or that “what is true for the whole, is true for the parts”.

Economics: A Social Science
Obstacles and Pitfalls in Economics

2. The *post hoc fallacy* from the Latin phrase “*post hoc, ergo propter hoc*”—means “after this, therefore because of this”, which is the error of reasoning that a first event causes a second event because the first occurs *before* the second.
Agreement and disagreement

- Economists are often accused of contradicting each other as epitomised in the often quoted joke about economists:
  - “if you laid all the economists in the world end to end, they still wouldn’t reach a conclusion”
- In contrast to the popular image, economists find much common ground on a wide range of issues.
- Page 16 of the textbook lists eleven economic propositions that at least 80 percent of all economics professors agree on.
END

CHAPTER 1