Chapter 1
What is Economics?
Economics, Scarcity, and Choice

- A good definition of economics
  - Study of choice under conditions of scarcity

- Scarcity
  - Situation in which the amount of something available is insufficient to satisfy the desire for it
There are an unlimited variety of scarcities, however they are all based on two basic limitations:
- Scarce time
- Scarce spending power

Limitations force each of us to make choices.
Economists study choices we make as individuals, and consequences of those choices.
Economists also study more subtle and indirect effects of individual choice on our society.
Scarcity and Social Choice

The problem for society is a scarcity of resources

- Scarcity of Labor
  - Time human beings spend producing goods and services

- Scarcity of Capital
  - Something produced that is long-lasting, and used to make other things that we value
    - Human capital
    - Capital stock

- Scarcity of land
  - Physical space on which production occurs, and the natural resources that come with it

- Scarcity of entrepreneurship
  - Ability and willingness to combine the other resources into a productive enterprise

As a society our resources—land, labor, and capital—are insufficient to produce all the goods and services we might desire

- In other words, society faces a scarcity of resources
Scarcity and Economics

The scarcity of resources—and the choices it forces us to make—is the source of all of the problems studied in economics

- Households allocate limited income among goods and services
- Business firms choices of what to produce and how much are limited by costs of production
- Government agencies work with limited budgets and must carefully choose which goals to pursue

Economists study these decisions to

- Explain how our economic system works
- Forecast the future of our economy
- Suggest ways to make that future even better
Microeconomics

- **Micro**
  - Micro comes from Greek word *mikros*, meaning “small”

- **Microeconomics**
  - Study of behavior of individual households, firms, and governments
    - Choices they make
    - Interaction in specific markets

- Focuses on individual parts of an economy, rather than the whole
Macroeconomics

- **Macro**
  - Macro comes from Greek word, *makros*, meaning “large”

- **Macroeconomics**
  - Study of the economy as a whole

- Focuses on big picture and ignores fine details
Positive Economics

- Study of how economy works
- Statements about how the economy works are positive statements, whether they are true or not
- Accuracy of positive statements can be tested by looking at the facts—and just the facts
Normative Economics

- Study of what should be
  - Used to make value judgments, identify problems, and prescribe solutions
  - Statements that suggest what we should do about economic facts, are normative statements
    - Based on values
  - Normative statements cannot be proved or disproved by the facts alone
Why Economists Disagree

- In some cases, the disagreement may be positive in nature because
  - Our knowledge of the economy is imperfect
  - Certain facts are in dispute

- In most cases, the disagreement is normative in nature because
  - While the facts may not be in dispute
    - Differing values of economists lead them to dissimilar conclusions about what should be done
Why Study Economics

- To understand the world better
  - You’ll begin to understand the cause of many of the things that affect your life

- To gain self-confidence
  - You’ll lose that feeling that mysterious, inexplicable forces are shaping your life for you
Why Study Economics

- To achieve social change
  - You’ll gain tools to understand origins of social problems and design more effective solutions

- To help prepare for other careers
  - You’ll discover that a wide range of careers deal with economic issues on many levels

- To become an economist
  - You’ll begin to develop a body of knowledge that could lead you to become an economist in the future
The Methods of Economics

- Economics relies heavily on modeling
  - Economic theories must have a well-constructed model

- While most models are physical constructs
  - Economists use words, diagrams, and mathematical statements

- What is a model?
  - Abstract representation of reality
The Art of Building Economic Models

- Guiding principle of economic model building
  - Should be as simple as possible to accomplish its purpose
- Level of detail that would be just right for one purpose will usually be too much or too little for another
- Even complex models are built around a simple framework
Assumptions and Conclusions

- Types of assumptions in an economic model
  - Simplifying assumptions
    - Way of making a model simpler without affecting any of its important conclusions
  - Critical assumptions
    - Affect conclusions of a model in important ways
    - If critical assumptions are wrong model will be wrong

- All economic models have one or more critical assumptions
Two Fundamental Assumptions

- The economy is complex
- Economists make sense of all this activity in two steps
  - First, the decision makers in the economy are divided into three broad groups:
    - Households
    - Business
    - Government agencies
  - In Microeconomic models
    - Individual households
    - firms
    - Government agencies
  - In Macroeconomic models
    - Household sector
    - Business sector
    - Government sector
    - Foreign sector
- The next step in understanding the economy is to make two critical assumptions about decision makers
First Fundamental Assumption

Every economic decision maker tries to make the best out of any situation

- Typically, making the best out of a situation means maximizing some quantity
- While economists often have spirited disagreements about what is being maximized, there is virtually unanimous agreement that any economic model should begin with the assumption that someone is maximizing something
- The first fundamental assumption seems to imply that we are all engaged in a relentless, conscious pursuit of narrow goals
  - An implication contradicted by much of human behavior
  - In truth, we only rarely make decisions with conscious, hard calculations
  - Why, then, do economists assume that people make decisions consciously, when, in reality, they often don’t?
First Fundamental Assumption

- This is an important question
  - Economists answer it this way
    - The ultimate purpose of building an economic model is to understand and predict behavior
      - The behavior of households, firms, government, and the overall economy
    - As long as people behave as if they are maximizing something, then we can build a good model by assuming that they are

- One last thought about the assumption that people maximize something
  - It does not imply that people are selfish or that economists think they are

- Economics also recognizes that people often care about their friends, their neighbors, and the broader society in which they live
Every economic decision maker faces constraints

- Society’s overall scarcity of resources constrains each of us individually in much the same way as the overall scarcity of space in a crowded elevator limits each rider’s freedom of movement.

- Together, the two fundamental assumptions help define the approach economists take in answering questions about the world.
  - Economists always begin with the same three questions:
    - 1. Who are the individual decision makers?
    - 2. What are they maximizing?
    - 3. What constraints do they face?
  - This approach is used so heavily by economists that it is one of the basic principles of economics you will learn in this book.
Math, Jargon, and Other Concerns…

- What is economic jargon?
  - Special words that allow economists to more precisely express themselves

- What about math?
  - Basic economics only requires high school level algebra and geometry
  - Appendix at end of this chapter covers some of the basic concepts that you will need
The Basic Principles of Economics

The Eight Basic Principles of Economics

- Basic Principle #1: Maximization Subject to Constraints
- Basic Principle #2: Opportunity Cost
- Basic Principle #3: Specialization and Exchange
- Basic Principle #4: Markets and Equilibrium
- Basic Principle #5: Policy Tradeoffs
- Basic Principle #6: Marginal Decision Making
- Basic Principle #7: Short-Run versus Long-Run Outcomes
- Basic Principle #8: The Importance of Real Values

You may want to flip back to this list from time to time to refresh your memory about the principles when referred to
How to Study Economics

- Following alone in class and learning are two different things
  - Economics must be studied actively, not passively

- What does active studying mean?
  - Closing the book periodically and reproducing what you have learned
  - Reading with a pencil in your hand and a blank sheet of paper in front of you
  - Listing the steps in each logical argument
  - Retracing the cause-and-effect steps in each model
  - Drawing the graphs that represent the model
  - Thinking about the basic principles of economics and how they relate to what you are learning
End…

Any questions?