

Chapter One

Economics: The World Around You

What is Economics? (Continued)

- Economics is form of **applied logic** (reasoning).
 - Economists study the reasoning that drives economic decisions and outcomes.
 - One might think of economics as the study of **unintended consequences**.
 - Understanding causes and effects is critical to:
 - understanding the ultimate consequences of economic events and
 - effective and responsible policy making.

Definition of Economics

- **Economics** is the study of how scarce resources are allocated among unlimited wants.
- To understand this definition, we must examine the concepts of **scarcity**, **economic choice**, and **rational self-interest**.

Human Nature and Reality

- People have **unlimited wants**.
- People have **limited** resources to acquire the things they want.
- As a result, they must make **choices**.
- Choices involve pursuing some things while **forgoing** others.

Scarcity, Goods and Bads

- An item that costs something is called **scarce**.
 - Anything with a price on it is called an **economic good**—these include **goods** and **services**.
 - A **free good** is a good for which there is no scarcity.
- An **economic bad** is anything you want to get rid of (pollution, disease, garbage)

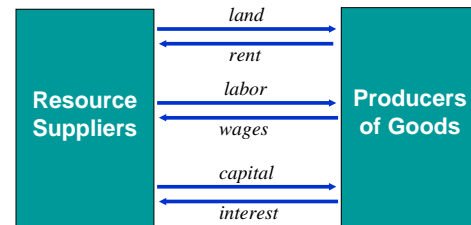
Clarifying Concepts

- **Scarcity** means that not enough is available for free.
- A **shortage** occurs when not enough is available at the current price. *A shortage is a problem of price.*
- **Poverty** occurs when the goods are scarce, and those who need them do not have the income to obtain them. *Poverty is a problem of income.*

Goods to Produce Goods

- **Resources** are the elements needed to produce goods. Resources are also called
 - **factors of production**
 - **inputs**
- They are:
 - **Land** (includes natural resources)
 - **Labor** (physical and intellectual services of people)
 - **Capital** (plant, machinery, equipment used in production)

Resources in Production



Scarcity and Choice

- **Scarcity** necessitates making **choices**.
- Economics is the study of how people choose to use their resources in attempts to satisfy their unlimited wants.*

Rational Self-Interest

- Economists believe that people choose options that give them the greatest satisfaction.
- This means that people:
 - use all available time and information,
 - weigh the costs and benefits of all available alternatives,
 - and choose the alternative that they believe will bring them the most benefit at the lowest cost. This is the alternative that they believe will bring them the most satisfaction.
- This does **not** mean that people are innately selfish. Self-interest is **not** greed.

Limits to Rationality

- Depends upon
 - Information available (and/or its cost)
 - Ability to process the information
 - Your perception of what constitutes your “best interests”
- This leads to the theory of **bounded rationality**.
- In practice, this means that people compare costs and benefits to make a decision.

Implications

- People weigh the costs and benefits of various alternatives, choosing the alternative that makes them best off.
 - This behavior is called “**economic decision making**”.
- Costs and benefits are sometimes referred to as negative and positive **incentives**. Hence **incentives matter**.

Positive vs. Normative Economics

- **Positive Economics**
 - Focuses on “**what is**”.
 - Analyzes actual, measurable outcomes.
 - Does **not** impose value judgments, person feelings or convictions.
 - Positive economics is economics as a science.
- **Normative Economics**
 - Focuses on what someone thinks “**ought to be**” or “**should be**”.
 - Makes ethical judgments—value judgments.

Common Analytical Mistakes (Logical Fallacies)

- **Fallacy of Composition**
 - The mistaken assumption that what is true of a part is also true of the whole.
- **Association is not Causation**
 - The mistaken assumption that because two events occur together, one must cause the other. Also given as “correlation is not causation”.
- **Violation of *Ceteris Paribus***
 - *Ceteris Paribus*: Latin for “all else equal”.
 - This occurs when one attempts to analyze the effect of one thing while holding everything else constant, when in fact other things **have** changed.

Micro vs. Macro

- **Microeconomics**
 - Studies the economy at the level of individual consumers, workers, firms, goods, and markets
- **Macroeconomics**
 - Studies the economy at the aggregate level, at the level of the economy as a whole.
 - Examines total consumer behavior, total employment, total production, total sales, etc.