Chapter One
Economics: The World Around You

What is Economics? (Continued)
• Economics is a 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 and inputs.
- They are:
  - **Land** (includes natural resources)
  - **Labor** (physical and intellectual services of people)
  - **Capital** (plant, machinery, equipment used in production)

Resources in Production

Economics is the study of how people choose to use their resources in attempts to satisfy their unlimited wants.

Scarcity and Choice

- **Scarcity** necessitates making choices.

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.