Concepts, Methods and Issues in Economics: An Introduction

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SCARCITY AND EFFICIENCY: THE TWIN THEMES OF ECONOMICS

- What is economics?
- Over the last half century, the study of economics has experienced to include a vast range of topic.
- What are the major definitions of these growing subjects?
- The important ones are that economics:

Economics…

- analyzes how a society's institutions and technology affects prices and the allocation of resources among different uses.
- explores the behaviour of the financial markets, including interest rates and stock prices.
- examines the distribution of income and suggests that the poor can be helped without harming the performance of economy.
- studies the business cycle and examines how monetary policy can be used to moderate the swings in unemployment and inflation.

Economics

- studies the pattern of trade among nations and analyzes the impact of trade barriers.
- looks at growth in developing countries and proposes the way to encourage the efficient use of resources.
- asks how government policies can be used to pursue important goals such as rapid economic growth, efficient use of resources, full employment, price stability and fair distribution of income.

And….

- This list is a good one, yet you could extend it many times over. But if we boil down all these definitions, we find one common theme:

Economics is the study how societies use scarce resources to produce valuable commodities and distribute theme among different people

Three basic questions: [1]

- ***What* commodities are produced and in what quantities?**
- A society must determine how much of each of the many possible goods and services it will make and when they will be produced.
- Will we produce pizzas or shirts today?
- A few high-quality shirts or many cheap shirts?
- Will we use scarce resources to produce many consumption goods (like pizzas)?
- Or we will produce few consumption goods and more investment goods (pizza making machine), which will boost production and consumption tomorrow.

Three basic questions: [2]

- ***How*** are goods produced?
- A society must determine how will do the production, with what resources, and what production technique they will use.
- Who farms and who teaches?
- Is electricity generated from oil, from coal or from the sun?
- Will factories be run by people or by robots?

Three basic questions: [3]

- ***For whom*** are produced?
- Who gets to eat the fruit of economic activity? Is the distribution of income and wealth is fair and equitable?
- How is the national product divided among different households?
- Are many people poor and a few rich?
- Do high incomes go to teachers or athletes or autoworkers or Internet entrepreneurs?
- Will society provide minimal consumption to the poor, or must people work if they are to eat?

TEN PRINCIPLES OF ECONOMICS

A household and an economy face many decisions:

- Who will work?
- What goods and how many of them should be produced?
- What resources should be used in production?
- At what price should the goods be sold?

TEN PRINCIPLES OF ECONOMICS

- Society and Scarce Resources:
  - The management of society's resources is important because resources are scarce.
  - *Scarcity*. . . means that society has limited resources and therefore cannot produce all the goods and services people wish to have.

TEN PRINCIPLES OF ECONOMICS

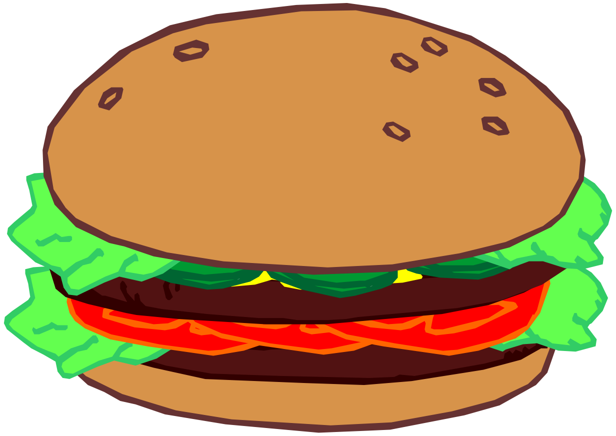
Economics is the study of how society manages its scarce resources.

HOW PEOPLE MAKE DECISIONS

- People face trade-offs.
- The cost of something is what you give up to get it.
- Rational people think at the margin.
- People respond to incentives.

Principle #1: People Face Trade-offs.

- "There is no such thing as a free lunch!"



Principle #1: People Face Trade-offs.

- To get one thing, we usually have to give up another thing.
  - Guns v. butter
  - Food v. clothing
  - Leisure time v. work
  - Efficiency v. equity

Making decisions requires trading off one goal against another.

Principle #1: People Face Trade-offs

- Efficiency v. Equity
  - *Efficiency* means society gets the most that it can from its scarce resources.
  - *Equity* means the benefits of those resources are distributed fairly among the members of society.

Principle #2: The Cost of Something Is What You Give Up to Get It.

- Decisions require comparing costs and benefits of alternatives.
  - Whether to go to college or to work?
  - Whether to study or go out to watch a movie?
  - Whether to go to class or sleep in hostel/play?

- The *opportunity cost* of an item is what you give up to obtain that item.

Principle #2: The Cost of Something Is What You Give Up to Get It.

- Basketball star LeBron James understands opportunity costs and *incentives.* He chose to skip college and go straight from high school to the pros where he earns millions of dollars.

Principle #3: Rational People Think at the Margin.

- *Marginal changes* are small, incremental adjustments to an existing plan of action.

People make decisions by comparing costs and benefits at the margin.

Principle #4: People Respond to Incentives.

- Marginal changes in costs or benefits motivate people to respond.

- The decision to choose one alternative over another occurs when that alternative's marginal benefits exceed its marginal costs!

HOW PEOPLE INTERACT

- Trade can make everyone better off.
- Markets are usually a good way to organize economic activity.
- Governments can sometimes improve economic outcomes.

Principle #5: Trade Can Make Everyone Better Off.

- People gain from their ability to trade with one another.
- Competition results in gains from trading.
- Trade allows people to specialize in what they do best.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- A *market economy* is an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.
  - Households decide what to buy and who to work for.
  - Firms decide who to hire and what to produce.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- Adam Smith made the observation that households and firms interacting in markets act as if guided by an "invisible hand."
  - Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social costs of their actions.
  - As a result, prices guide decision makers to reach outcomes that tend to maximize the welfare of society as a whole.

Principle #7: Governments Can Sometimes Improve Market Outcomes.

- Markets work only if property rights are enforced.
  - *Property rights* are the ability of an individual to own and exercise control over a scarce resource
- *Market failure* occurs when the market fails to allocate resources efficiently.
- When the market fails (breaks down) government can intervene to promote efficiency and equity.

Principle #7: Governments Can Sometimes Improve Market Outcomes.

- Market failure may be caused by:
  - an *externality*, which is the impact of one person or firm's actions on the well-being of a bystander.
  - *market power,* which is the ability of a single person or firm to unduly influence market prices.

HOW THE ECONOMY AS A WHOLE WORKS

- A country's standard of living depends on its ability to produce goods and services.
- Prices rise when the government prints too much money.
- Society faces a short-run trade-off between inflation and unemployment.

Principle #8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services.

- Standard of living may be measured in different ways:
  - By comparing personal incomes.
  - By comparing the total market value of a nation's production.

Principle #8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services.

- Almost all variations in living standards are explained by differences in countries' productivities.
- *Productivity* is the amount of goods and services produced from each hour of a worker's time.

Principle #8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services.

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Principle #9: Prices Rise When the Government Prints Too Much Money.

- *Inflation* is an increase in the overall level of prices in the economy.
- One cause of inflation is the growth in the quantity of money.
- When the government creates large quantities of money, the value of the money falls.

Principle #10: Society Faces a Short-run Trade-off between Inflation and Unemployment.

- The Phillips Curve illustrates the trade-off between inflation and unemployment:
  - Inflation or Unemployment
    - It's a short-run trade-off!
  - The trade-off plays a key role in the analysis of the *business cycle*—fluctuations in economic activity, such as employment and production

Thinking Like an Economist

Every field of study has its own terminology

- Mathematics
  - integrals ❖ axioms ❖ vector spaces
- Psychology
  - ego ❖ id ❖ cognitive dissonance
- Law
  - promissory ❖ estoppel ❖ torts ❖ venues
- Economics
  - supply ❖ opportunity cost ❖ elasticity ❖ consumer surplus ❖ demand ❖ comparative advantage ❖ deadweight loss

Thinking Like an Economist

Economics trains you to. . . .

- Think in terms of alternatives.
- Evaluate the cost of individual and social choices.
- Examine and understand how certain events and issues are related.

THE ECONOMIST AS A SCIENTIST

The economic way of thinking . . .

- Involves thinking analytically and objectively.
- Makes use of the scientific method.
- Uses abstract models to help explain how a complex, real world operates.
- Develops theories, collects and analyzes data to evaluate the theories.

Thank you

FOR YOUR ATTENTION