Unit - 4

Introduction to Economics

Economy. . .

. . . The word *economy* comes from a Greek word for "***one who manages a household***."

What Economics Is

- ***Economics*** is the study of how human beings coordinate their wants and desires, given the decision-making mechanisms, social customs, and political realities of the society.

Or in simple terms

How scarce resources are used to satisfy people's unlimited wants.

What Economics Is

- ***Scarcity*** exists because individuals want more than can be produced.
    - ***Scarcity*** – the goods available are too few to satisfy individuals’ desires.

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?

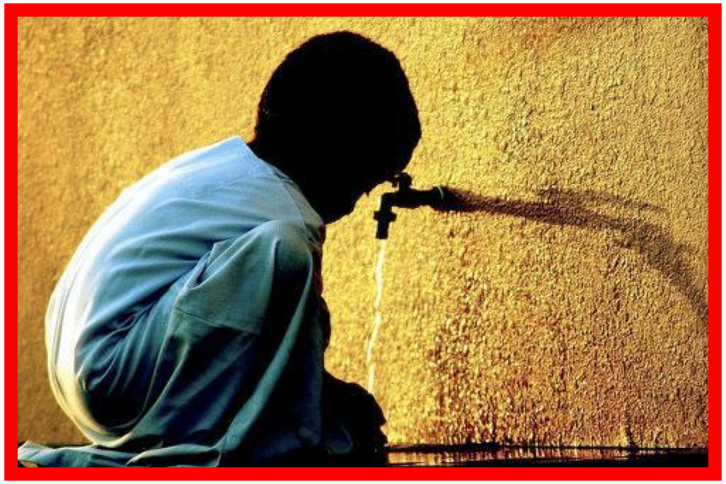
What Economics Is

- The degree of scarcity is constantly changing.

    - The quantity of goods, services, and usable resources depends on technology and human action.

Problem of Scarcity

<u>Scarcity</u>: The condition in which human wants are forever greater than the available supply of time, goods, and resources.



<u>3 Economic Questions</u>

What will be Produced?

How will it be Produced?

For whom will it be produced?

Scarce Economic Resources

<u>Factors of Production (FOP)</u>: The resources used to create goods and services

<u>Land</u>: Any natural resource provided by nature.

<u>Labor</u>: The mental and physical capacity of workers to produce goods and services.

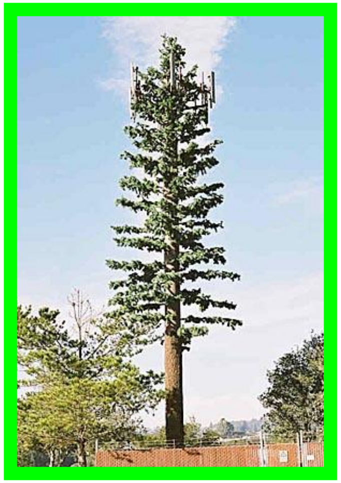
<u>Capital</u>: Any physical man-made good used to produce other goods.

<u>Entrepreneurship</u>: Vision, skills, and risk-taking needed to create and run a business.

Definition

<u>Economics</u>: The study of how society chooses to allocate its scarce resources in order to satisfy unlimited wants

<u>Microeconomics</u>: Branch of economics that studies decision-making by a single individual, household, firm, industry or level of government.



<u>Macroeconomics</u>: Branch of economics that studies decision-making for the economy as a whole

Microeconomics and Macroeconomics

- *Microeconomics* focuses on the individual parts of the economy.
  - How households and firms make decisions and how they interact in specific markets
- *Macroeconomics* looks at the economy as a whole.
  - Economy-wide phenomena, including inflation, unemployment, and economic growth

Positive vs. Normative

<u>Positive Economics</u>: An analysis limited to statements that are verifiable ***<u>(objective approach, relied on facts)</u>***

"Government-funded healthcare surges public expenditures"

<u>Normative Economics</u>: An analysis based on value judgment ***<u>(ideological, perspective-based, opinion-oriented statements)</u>***

"The government should make available fundamental healthcare to every citizen"

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.

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

Decisions usually involve a value judgment

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 on a date?
  - Whether to go to class or sleep in?

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

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.

Opportunity Cost

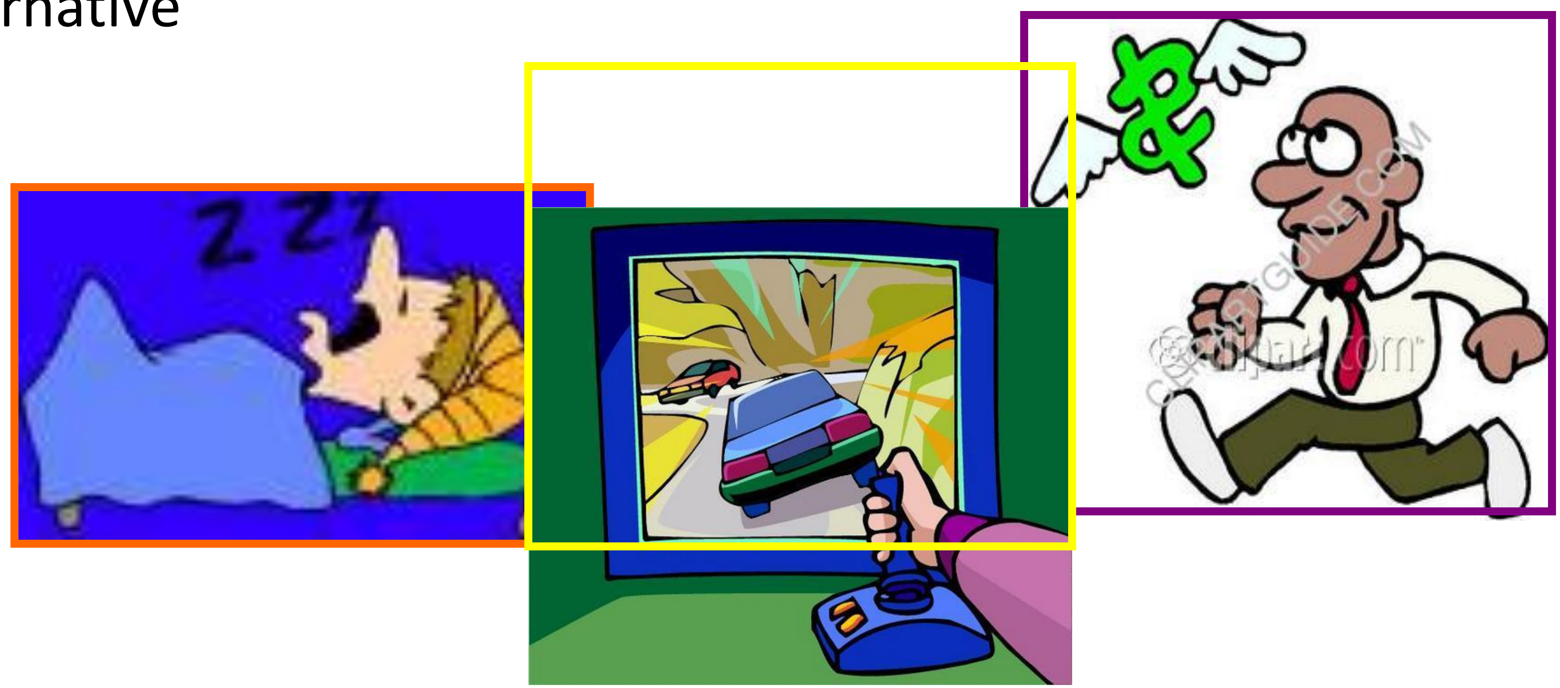
Definition – the cost expressed in terms of the next best alternative sacrificed

Helps us view the true cost of decision making

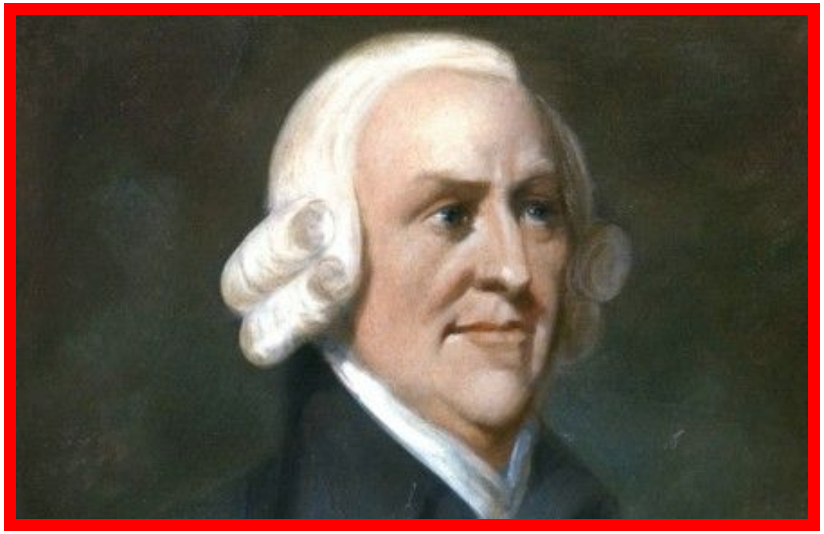
Implies valuing different choices

Trade-off: Any alternative that could be chosen

Opportunity Cost: The best alternative sacrificed for a chosen alternative



Adam Smith: Scottish Economist (1723-1790)



The Invisible Hand Theory

"It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest

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.

Unfortunately, we are not rational all of the time.

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.

Components of a Theoretical Model

- **Variables**
  Considerations on which the model focuses
- **Assumptions**
  Conditions held to be true in the model
- **Data**
  Information used to describe the behavior of the variables
- **Conclusions**
  Results of the model

FIGURE 1-3
Economic Theory and Models

The Role of Assumptions

- Economists make assumptions in order to make the world easier to understand.
- The art in scientific thinking is deciding which assumptions to make.
- Economists use different assumptions to answer different questions.

Data

- Department of Commerce
  - http://www.commerce.gov
- Bureau of Labor Statistics
  - http://www.bls.gov
- Congressional Budget Office
  - http://www.cbo.gov
- Federal Reserve Board
  - http://www.federalreserve.gov

Economic Models

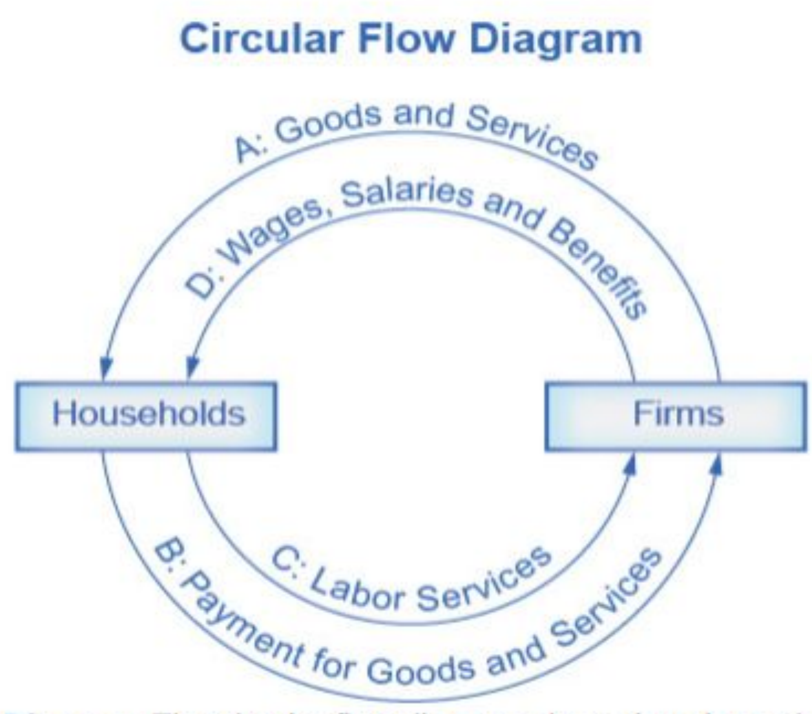
- Economists use models to simplify reality in order to improve our understanding of the world.
- Two of the most basic economic models are:
  - The Circular Flow Diagram
  - The Production Possibilities Frontier

First Model: The Circular-Flow Diagram

- Firms
  - Produce and sell goods and services
  - Hire and use factors of production
- Households
  - Buy and consume goods and services
  - Own and sell factors of production

First Model: The Circular-Flow Diagram

- Markets for Goods and Services
  - Firms sell
  - Households buy
- Markets for Factors of Production
  - Households sell
  - Firms buy



First Model: The Circular-Flow Diagram

- Factors of Production
  - Inputs used to produce goods and services
  - Land, labor, capital, and entrepreneurship
    - Labor includes all human effort, both physical an mental.
    - Capital are the tools used to produce goods
    - Land is the land itself and all of the raw materials that originate in nature
    - Entrepreneurship is the function of organizing the factors together

Microeconomics and Macroeconomics

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Our Second Model: The Production Possibilities Frontier

- The *production possibilities frontier* is a graph that shows the combinations of output that the economy can possibly produce given the available factors of production and the available production technology.

Our Second Model: The Production Possibilities Frontier

- Concepts illustrated by the production possibilities frontier
  - Efficiency
  - Trade-offs
  - Opportunity cost
  - Economic growth

THE ECONOMIST AS POLICY ADVISOR

- When economists are trying to explain the world, they are scientists.
- When economists are trying to change the world, they are policy advisors.

Positive versus Normative Analysis

- *Positive statements* are statements that attempt to describe the world as it is.
  - Called descriptive analysis
- *Normative statements* are statements about how the world should be.
  - Called prescriptive analysis

Positive Versus Normative Analysis

- Are the following positive or normative statements?
  - An increase in the minimum wage will cause a decrease in employment among the least-skilled.
  - Higher federal budget deficits will cause interest rates to increase.

Positive Versus Normative Analysis

- Are the following positive or normative statements?
  - The income gains from a higher minimum wage are worth more than any slight reductions in employment.
  - State governments should be allowed to collect from tobacco companies the costs of treating smoking-related illnesses among the poor.