Two Big Economic Questions

Two big questions summarize the scope of economics:

- How do choices end up determining *what, how*, and *for whom* goods and services are produced?
- Do the choices that people make in the pursuit of their own *self-interest* unintentionally promote the broader *social interest*?

What, How, and For Whom?

Goods and services are the objects that people value and produce to satisfy wants. *Goods* are physical objects such as cell phones and automobiles. *Services* are tasks performed for people such as cell-phone service and auto-repair service.

What? *What* we produce varies across countries and changes over time. In the United States today, agriculture accounts for 1 percent of total production, manufactured goods for 22 percent, and services (retail and wholesale trade, health care, and education are the biggest ones) for 77 percent. In contrast, in China today, agriculture accounts for 10 percent of total production, manufactured goods for 47 percent, and services for 43 percent. Figure 1.1 shows these numbers and also the percentages for Brazil, which fall between those for the United States and China.

What determines these patterns of production? How do choices end up determining the quantities of cell phones, automobiles, cell-phone service, auto-repair service, and the millions of other items that are produced in the United States and around the world?

How? *How* we produce is described by the technologies and resources that we use. The resources used to produce goods and services are called **factors of production**, which are grouped into four categories:

- Land
- Labor
- Capital
- Entrepreneurship

Land The "gifts of nature" that we use to produce goods and services are called **land**. In economics, *land* is what in everyday language we call *natural resources*. It includes land in the everyday sense together with minerals, oil, gas, coal, water, air, forests, and fish.

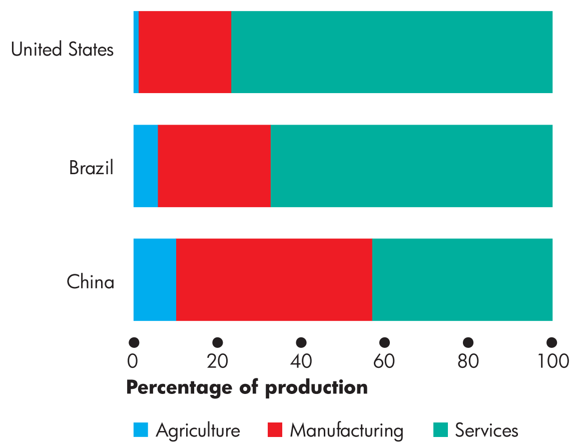
Our land surface and water resources are renewable and some of our mineral resources can be recycled. But the resources that we use to create energy are nonrenewable—they can be used only once.

Labor The work time and work effort that people devote to producing goods and services is called **labor**. Labor includes the physical and mental efforts of all the people who work on farms and construction sites and in factories, shops, and offices.

The *quality* of labor depends on **human capital**, which is the knowledge and skill that people obtain from education, on-the-job training, and work experience. You are building your own human capital right now as you work on your economics course, and your human capital will continue to grow as you gain work experience.

Human capital expands over time. Today, 88 percent of the adult population of the United States have completed high school and 30 percent have a college or university degree. Figure 1.2 shows these measures of human capital in the United States and its growth over the past 110 years.

FIGURE 1.1 What Three Countries Produce



Agriculture and manufacturing are small percentages of production in rich countries such as the United States and large percentages of production in poorer countries such as China. Most of what is produced in the United States is services.

Source of data: CIA Factbook 2012, Central Intelligence Agency.

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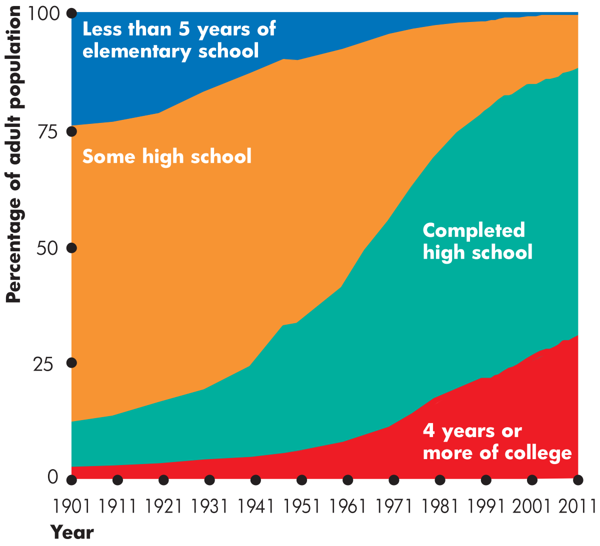
FIGURE 1.2 A Measure of Human Capital



In 2011, 30 percent of the population had 4 years or more of college, up from 2 percent in 1901. A further 58 percent had completed high school, up from 10 percent in 1901.

Source of data: U.S. Census Bureau, *Statistical Abstract of the United States*, 2012.

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Capital The tools, instruments, machines, buildings, and other constructions that businesses use to produce goods and services are called **capital**.

In everyday language, we talk about money, stocks, and bonds as being "capital." These items are *financial capital*. Financial capital plays an important role in enabling businesses to borrow the funds that they use to buy physical capital. But financial capital is not used to produce goods and services and it is not a factor of production.

Entrepreneurship The human resource that organizes labor, land, and capital is called **entrepreneurship**. Entrepreneurs are the drivers of economic progress. They develop new ideas about what and how to produce, make business decisions, and bear the risks that arise from these decisions.

What determines how the factors of production are used to produce each good and service?

For Whom? *Who* consumes the goods and services that are produced depends on the incomes that people earn. People with large incomes can buy a wide range of goods and services. People with small incomes have fewer options and can afford a smaller range of goods and services.

People earn their incomes by selling the services of the factors of production they own:

- Land earns **rent**.
- Labor earns **wages**.
- Capital earns **interest**.
- Entrepreneurship earns **profit**.

Which factor of production earns the most income? The answer is labor. In 2011, wages were 68 percent of total income and the incomes from land, capital, and entrepreneurship 32 percent. These shares have been remarkably constant over time.

Knowing how income is shared among the factors of production doesn't tell us how it is shared among individuals. And the distribution of income among individuals is extremely unequal. You know of some people who earn very large incomes: Angelina Jolie earns $10 million per movie; and the New York Yankees pays Alex Rodriguez $27.5 million a year.

You know of even more people who earn very small incomes. Servers at McDonald's average around $7.25 an hour; checkout clerks, cleaners, and textile and leather workers all earn less than $10 an hour.

You probably know about other persistent differences in incomes. Men, on average, earn more than women; whites earn more than minorities; college graduates earn more than high-school graduates.

We can get a good sense of who consumes the goods and services produced by looking at the percentages of total income earned by different groups of people. The 20 percent of people with the lowest incomes earn about 5 percent of total income, while the richest 20 percent earn close to 50 percent of total income. So on average, people in the richest 20 percent earn more than 10 times the incomes of those in the poorest 20 percent. There is even huge inequality within the richest 20 percent and the top 1 percent earns almost 15 percent of total income.

Why is the distribution of income so unequal?

Economics provides some answers to all these questions about *what, how*, and *for whom* goods and services are produced and much of the rest of this book will help you to understand those answers.

We're now going to look at the second big question of economics: Does the pursuit of self-interest unintentionally promote the social interest?