Chapter 1

Economics is the social science that studies the *choices* that individuals, businesses, governments, and entire societies make as they cope with *scarcity* and *incentives* that influence and reconcile those choices.

Scarcity:

- All economic questions arise because we want more than we can get.
- Our inability to satisfy all our wants is called **scarcity**.

Choice:

- Because we face scarcity, we must make ***choices***.
- The choices we make depend on the incentives we face.

Incentive

- An **incentive** is a reward that encourages an action or a penalty that discourages an action.

Economics as a Social Science

Economists distinguish between two types of statement:

- Positive statements
- Normative statements

A *positive* statement is about “what is”.

- It can be tested by checking it against facts.

A *normative* statement is about “what ought to be”.

- It expresses an opinion and cannot be tested.

The task of economic science is to discover positive statements that are consistent with what we observe in the world and that enable us to understand how the economic world works.

Economists create and test economic models.

An **economic model** is a description of some aspect of the economic world that includes only those features that are needed for the purpose at hand.

A model is tested by comparing its predictions with the facts.

But testing an economic model is difficult, so economists also use

- Natural experiments
- Statistical investigations
- Economic experiments

Economics divides in two main parts:

- Microeconomics
- Macroeconomics

Microeconomics is the study of choices that individuals and businesses make, the way those choices interact in markets, and the influence of governments.

Macroeconomics is the study of the performance of the national and global economies.

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 get produced?

- When do choices made in the pursuit of ***self-interest*** also promote the ***social interest***?

What, How, and For Whom?

What?

Goods and services are the objects that people value and produce to satisfy human wants. This equates to the “what” in the question.

How?

Goods and services are produced by using productive resources that economists call factors of production.

Factors of production are grouped into four categories:

- Land
- Labor
- Capital
- Entrepreneurship

The “gifts of nature” that we use to produce goods and services are **land**.

The work time and work effort that people devote to producing goods and services is **labor**.

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.

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

The human resource that organizes land, labor, and capital is **entrepreneurship**.

For Whom?

Who gets the goods and services depends on the incomes that people earn.

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

Does the Pursuit of Self-Interest Unintentionally Promote the Social Interest?

Every day, about 35 million Canadians and 6.9 billion people in other countries make economic choices that result in *What*, *How*, and *For Whom* goods and services are produced.

These choices are made by people who are pursuing their self-interest.

Are they promoting the social interest?

Self-Interest

You make choices that are in your self-interest—choices that you think are best for you.

Social Interest

Choices that are best for society as a whole are said to be in the **social interest**.

The Economic Way of Thinking

Six key ideas define the economic way of thinking:

- A choice is a *tradeoff*.
- People make *rational choices* by comparing *benefits and costs*.
- *Benefit* is *what you gain* from something.
- *Cost* is what you *must give up* to get something.
- Most choices are *“how-much”* choices made at the *margin*.
- Choices respond to *incentives*.

A Choice Is a Tradeoff

The *economic way of thinking* places *scarcity* and its implication, *choice*, at center stage.

You can think about every choice as a **tradeoff**—an exchange—giving up one thing to get something else.

On Saturday night, will you study or have fun?

Whatever you choose, you could have chosen something else. Your choice is a tradeoff.

Making a Rational Choice

- A **rational choice** is one that compares costs and benefits and achieves the greatest benefit over cost for the person making the choice.

- Only the wants of the person making a choice are relevant to determine its rationality.

- The idea of rational choice provides an answer to the first question: *What* goods and services will be produced and in what quantities?

- The answer is: Those that people rationally choose to buy!

How do people choose rationally? The answers turn on benefits and costs.

Benefit: What you Gain

The **benefit** of something is the gain or pleasure that it brings and is determined by preferences.

Preferences are what a person likes and dislikes and the intensity of those feelings.

Cost: What you *Must* Give Up

The **opportunity cost** of something is the highest-valued alternative that *must* be given up to get it.

What is your opportunity cost of going to a live concert?

Opportunity cost has two components:

1. The things you can't afford to buy if you purchase the concert ticket.
2. The things you can't do with your time if you attend the concert.

How Much? Choosing at the Margin

- You can allocate the next hour between studying and instant messaging your friends.
- The choice is not all or nothing, but you must decide how many minutes to allocate to each activity.
- To make this decision, you compare the benefit of a little bit more study time with its cost—you make your choice at the margin.
- To make a choice at the margin, you evaluate the consequences of making *incremental changes* in the use of your time.
- The benefit from pursuing an incremental increase in an activity is its marginal benefit.
- The opportunity cost of pursuing an incremental increase in an activity is its marginal cost.
- If the marginal benefit from an incremental increase in an activity exceeds its marginal cost, your *rational choice* is to do more of that activity.

Choices Respond to Incentives

- A change in marginal cost or a change in marginal benefit changes the incentives that we face and leads us to change our choice.

- The central idea of economics is that we can predict how choices will change by looking at changes in incentives.

- Incentives are also the key to reconciling self-interest and the social interest.