

1.1 Economics: A Brief Introduction

■ What is Economics?



Economics

The study of the allocation of our scarce resources to satisfy our unlimited wants

The scarce resources used in the production of goods and services are:

- land
- labour
- capital
- entrepreneurship (enterprise)

Why Study Economics?

- Develops a disciplined method of thinking
- Provides problem-solving tools for both personal and professional life
- Sheds light on many social issues such as education, discrimination, crime, and unemployment

A photograph of a forest with a single tall tree standing out against a blue sky with white clouds. The forest is dense with green trees, and the sky is bright blue with scattered white clouds. The text is overlaid on the top left and bottom of the image.

Microeconomics vs. Macroeconomics

**Microeconomics looks at each of the trees;
Macroeconomics looks at the forest.**

Microeconomics

- Deals with the smaller units within the economy.
- Attempts to understand the decision making behaviour of firms & households & their interaction in markets for particular goods & services
- Looks at topics like consumer behaviour, costs and production decisions, market structures, & individual markets

Macroeconomics

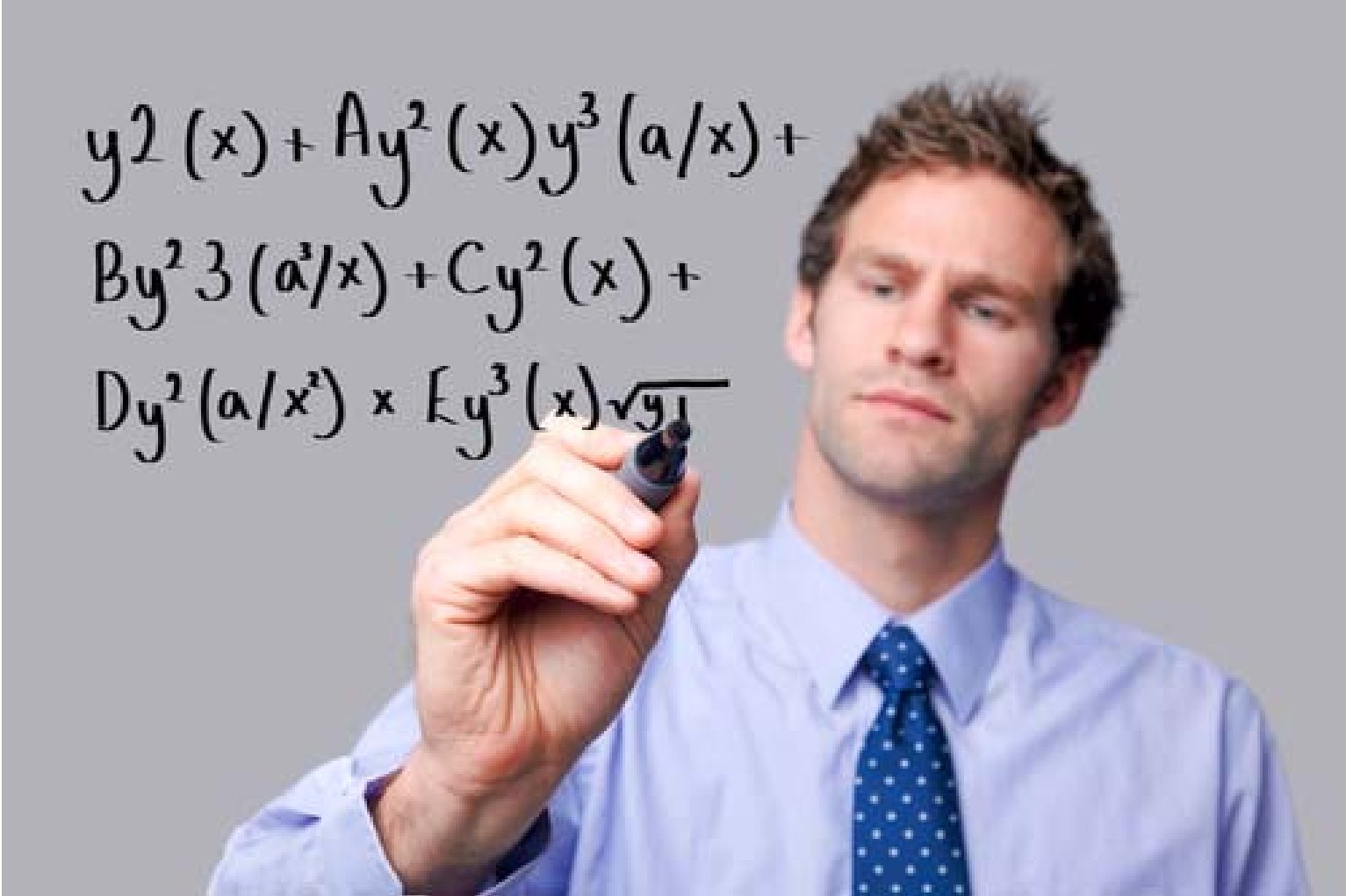
- The study of the aggregate, or total economy
- Looks at the economic problems as they influence the whole society
- Includes topics such as inflation, business cycles, unemployment, and economic growth.

Section Check

- Economics is the study of the allocation of our limited resources to satisfy our unlimited wants.
- Economics is a problem-solving science that teaches you how to ask intelligent questions.
- Macroeconomics deals with the aggregate, or total, economy, while microeconomics focuses on smaller units within the economy.

1.2 Economic Theory

■ What are Economic Theories?



$y^2(x) + Ay^2(x)y^3(a/x) +$
 $By^2 3(a^2/x) + Cy^2(x) +$
 $Dy^2(a/x^2) \times [y^3(x)\sqrt{y}]$

Economic Theories are...

- Statements used to explain and predict behavior in the real world.
- Economists focus on the most important parts of a problem.
- Like maps: show most important information, exclude minor details

Think of a road map as an abstract picture of the community



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Hypothesis

A testable proposition about how people will behave or react to a change in economic circumstances

Ceteris Paribus

Latin for “holding everything else constant”. Means isolating a variable to assess its effect.

Why are observations and predictions harder in the social sciences?

- Social sciences often involve looking at human behaviour
- Controlled experimentation is seldom possible in economics.
- Economists' predictions usually refer to the collective behaviour of large groups;

Correlation vs. Causation



Correlation: icy roads, reduced speeds, more accidents

Causation: reduced speeds do not cause more accidents; icy roads do

Fallacy of Composition

Incorrect view that what is true for the individual is also true for the group

Positive Analysis vs. Normative Analysis

- **Positive Analysis** is an objective, testable statement
- **Normative Analysis** is a subjective, non-testable item about what *should be* (involves value judgments and opinions)

Section Check

- Economic theories are statements used to explain and predict patterns of human behaviour.
- Economic theories, through abstraction, provide a broad view of human economic behaviour.
- A hypothesis makes a prediction about human behaviour and is then tested.

Section Check

- In order to isolate the effects of one variable on another, we use the *ceteris paribus* assumption.
- With its focus on human behaviour, which is more variable and less predictable, observation and prediction are more difficult in the social sciences.
- The fact that two events are related does not mean that one caused the other to occur.

Section Check

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1.3 Scarcity

- **What is Scarcity?**



What is Scarcity?

Scarcity means that our wants exceed our limited resources. It forces us to make choices.

Entrepreneurs

- Combine labour, land and capital to produce goods and services.
- Look for ways to improve production techniques, create new products.

What are goods, services and bads?

- **Goods:** physical, tangible items that we value or desire.
- **Services:** intangible acts for which people are willing to pay (legal services, medical advice, cooking (but not the food) etc.)
- **Bads:** those items that we do not desire or want.

Section Check

- Scarcity exists when our wants exceed the available resources of land, labour, capital, and entrepreneurship.
- Goods and services are things that we value.

1.4 Opportunity Cost

- **What is Opportunity Cost?**



Opportunity Cost

The highest of best foregone opportunity resulting from a decision.

Why do we have to make choices?

- Scarcity forces us to make choices;
- To get more of anything that is desirable, you must accept less of something else;

Because the production of any good uses up some of society's resources, there is no such thing as a free lunch



Section Check

- Scarcity means we all have to make choices.
- When we are forced to choose, we give up the next highest-valued alternative.
- Because the production of any good uses up some of society's resources, there is no such thing as a free lunch.

1.5 Marginal Thinking

- **What is Marginal Thinking?**



Marginal Thinking

Involves focusing on the additional, or incremental, choices

What would you be willing to give up to eliminate the rush hour congestion you face?



The Rule of Rational Choice

- People will alter their behaviour if they expect that the marginal benefit differs from the marginal cost.
- Expected Marginal Benefit: $E(MB)$
- Expected Marginal Cost: $E(MC)$
- Individuals will only do something if:
 - $E(MB) > E(MC)$
- Net Benefit: Difference between $E(MB)$ & $E(MC)$

1.5 Marginal Thinking

What is the 'rule of rational choice'?

- For example: consider 'pollution'
 - we must weigh expected marginal benefits of a cleaner environment against the expected marginal costs of a cleaner environment
 - zero pollution levels would be too costly in terms of what we would have to give up
 - all forms of travel
 - grow your own food, etc.

Section Check

- Economists are usually interested in the effects of additional, or marginal, changes in a given situation.
- The rule of rational choice states that individuals will pursue an activity if they expect the marginal benefits to be greater than the marginal costs, or $E(MB) > E(MC)$.
- People make decisions based on what they expect to happen.
- The optimal (best) levels of pollution, crime, and safety are greater than zero.

1.6 Incentives Matter

- **What are Incentives?**



People Respond to Incentives:

- If the benefits of an activity, like crime, rise and/or the costs fall, economists expect the amount of that activity to rise.
- If the benefits of an activity fall and/or if the costs rise, economists expect the amount of that activity to fall.

Positive Incentives
encourage
consumption
or production



Negative Incentives
discourage consumption
or production



A subsidy on hybrid electric vehicles (HEVs) would be a positive incentive that would encourage greater production and consumption of these vehicles.



Section Check

- People respond to incentives in predictable ways,
- A positive incentive decreases costs or increases benefits, thus encouraging consumption or production; while,
- A negative incentive increases costs or reduces benefits, thus discouraging consumption or production.

1.7 Specialization and Trade

- **What are specialization and trade?**



Specialization

Concentrating on the production of one, or a few, goods.

Comparative Advantage

Producing a good or service at a lower opportunity cost than other producers.

Advantages of Trade:

- increases wealth by making both parties better off (or they wouldn't trade).
- allows a person or nation to specialize in products that it produces better and trade for products that others produce better.

Section Check

- Specialization is important for individuals, businesses, regions, and nations. It allows them to make the best use of their limited resources.
- Specialization and trade increase wealth by allowing a person, a region, or a nation to specialize in those products that it produces at a lower opportunity cost and to trade for those products that others produce at a lower opportunity cost.

1.8 Market Prices Coordinate Activity

■ Why Do Market Prices Coordinate Activity



Market System

- one method of allocating resources among competing uses
- buyers and sellers indicate their wants through action and inaction.

Price Controls

Government-mandated minimum or maximum prices.

Market Failure

When the economy fails to allocate resources efficiently on its own

**Inequitable
Distribution:**

**No guarantee that a
market economy will
provide everyone
with adequate food,
shelter and health
care.**



Section Check

- Through voluntary exchange and the price system, the market system provides a way for producers and consumers to allocate scarce resources.
- Price controls sometimes force prices above or below what they would be in a market economy.
- A market failure occurs when an economy fails to allocate resources efficiently on its own.

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