What Is Economics?
After studying this chapter you will be able to

- Define economics and distinguish between microeconomics and macroeconomics
- Explain the two big questions of economics
- Explain the key ideas that define the economic way of thinking
- Explain how economists go about their work as social scientists and policy advisers
Definition of Economics

- All economic questions arise because we want more than we can get.
- Our inability to satisfy all our wants is called **scarcity**.
- Because we face scarcity, we must make **choices**.
- The choices we make depend on the incentives we face.
- An **incentive** is a reward that encourages an action or a penalty that discourages an action.
Definition of Economics

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

Economics is broadly classified into:

- **Microeconomics**
- **Macroeconomics**
Definition of Economics

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

Topics in micro:

- Consumer behavior
- Producer behavior
- Market analysis
- etc.

Q. Why are people buying more e-books and fewer hard copy books?
Macroeconomics is the study of the performance of the national and global economies.

Topics in micro
Unemployment
Economic growth rate
Inflation rate
etc.

Q. Why is the unemployment rate in Canada so high?
Two Big Economic Questions

a. How do choices end up determining *what*, *how*, and *for whom* goods and services get produced?

b. When do choices made in the pursuit of *self-interest* also promote the *social interest*?
Two Big Economic Questions

What, How, and For Whom?

Goods and services are the objects that people value and produce to satisfy human wants.

What?

In Canada, agriculture accounts for 2 percent of total production, manufactured goods for 20 percent, and services (retail and wholesale trade, health care, and education are the biggest ones) for 78 percent.

In China, agriculture accounts for 11 percent of total production, manufactured goods for 49 percent, and services for 40 percent.
Two Big Economic Questions

Figure 1.1 shows these numbers Canada and China.

It also shows the numbers for Brazil.

What determines these patterns of production?

How do choices end up determining the quantity of each item produced in Canada and around the world?
Two Big Economic Questions

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
- Labour
- Capital
- Entrepreneurship (organization)
Two Big Economic Questions

Figure 1.2 shows a measure of the growth of human capital in Canada over the last century—the percentage of the population that has completed different levels of education.

Economics explains these trends.
Two Big Economic Questions

For Whom?

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

- Land earns rent.
- Labour earns wages.
- Capital earns interest.
- Entrepreneurship earns profit.
Two Big Economic Questions

Can the Pursuit of Self-Interest Promote the Social Interest?

Every day, 34 million Canadians and 7 billion people in other countries make economic choices that result in *What, How, and For Whom* goods and services are produced.

- Do we produce the right things in the right quantities?
- Do we use our factors of production in the best way?
- Do the goods and services go to those who benefit most from them?
Two Big Economic Questions

Self-Interest

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

Adam Smith (1723-1790)
In *The Wealth of Nations*, Smith was the first to develop this insight fully: “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.”
Social Interest
Choices that are best for society as a whole are said to be in the social interest.

Social interest has two dimensions:

- Efficiency
- Equity
Two Big Economic Questions

**Efficiency** is achieved when the available resources are used to produce goods and services:

1. At the lowest possible price and
2. In quantities that give the greatest possible benefit.

Equity is fairness, but economists have a variety of views about what is fair.

**The Big Question**

Can choices made in self-interest promote the social interest?
Two Big Economic Questions

Four topics that generate discussion and that illustrate tension between self-interest and social interest are:

- Globalization
- The information-age economy
- Global warming
- Economic instability
The Economic Way of Thinking

Six key ideas define the economic way of thinking:

a. A choice is a *tradeoff*.

b. People make *rational choices* by comparing benefits and costs.

c. *Benefit* is what you gain from something.

d. *Cost* is what you must give up to get something.

e. Most choices are “how-much” choices made at the *margin*.

f. Choices respond to *incentives*. 
The Economic Way of Thinking

a. Choice Is a Tradeoff

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

*Opportunity cost!!*

Q. On Saturday night, will you study or have fun?
b. 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!
The Economic Way of Thinking

How do people choose rationally?

The answers turn on benefits and costs.

c. 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.
The Economic Way of Thinking

d. 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 an AC/DC concert?

Opportunity cost has two components:

1. The things you can’t afford to buy if you purchase the AC/DC ticket.
2. The things you can’t do with your time if you go to the concert.
e. How Much? Choosing at the Margin

You can allocate the next hour between studying and instant messaging your friends.

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.
The Economic Way of Thinking

f. 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.

Incentives are also the key to reconciling self-interest and the social interest.
Economists distinguish between two types of statement:

- **Positive statements** - *What is*
  - A positive statement can be tested by checking it against facts.

- **Normative statements** - *What ought to be*
  - A normative statement 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