

## 1 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

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You are studying economics at a time of extraordinary change.

Your life will be shaped by the challenges you face and the opportunities that you create.

But to face those challenges and seize the opportunities they present, you must understand the powerful forces at play.

The economics that you're about to learn will become your most reliable guide.

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### 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.

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## 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 divides in to main parts:

- Microeconomics
- Macroeconomics

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## Definition of Economics

### Microeconomics

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

### Macroeconomics

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

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## 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**?

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## 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?

Agriculture accounts for less than 1 percent of total Canadian production, manufactured goods for 20 percent, and services for 80 percent.

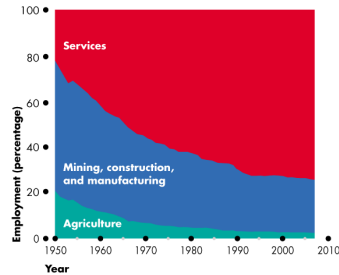
In China, agriculture accounts for 10 percent of total production, manufactured goods for 50 percent, and services for 40 percent.

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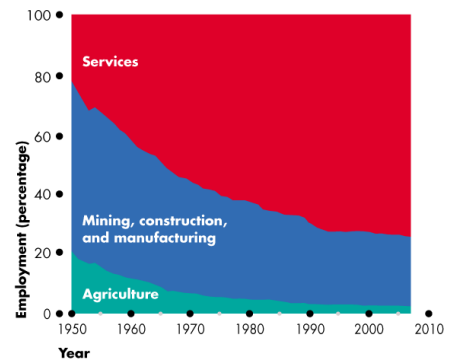
## Two Big Economic Questions

Figure 1.1 shows the trends in what the Canadian economy has produced over the past 60 years.

It shows the decline of agriculture, mining, construction, and manufacturing, and the expansion of services.



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## Two Big Economic Questions

The facts about **what** we produce raise the deeper question: What determines the quantities of timber, coal, automobiles, new homes, cable TV service, and dental service that we produce?

Economics provides some answers to these questions.

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## 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

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## Two Big Economic Questions

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 **labour**.

The *quality* of labour 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, labour, and capital is **entrepreneurship**.

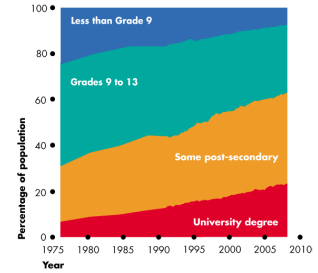
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## Two Big Economic Questions

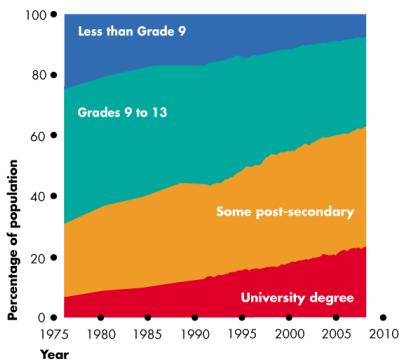


Figure 1.2 shows a measure of the growth of human capital in Canada over the past few decades—the percentage of the population that has completed different levels of education.

Economics explains these trends.



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## 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**.

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## Two Big Economic Questions

### When is the Pursuit of Self-Interest in the Social Interest?

Every day, 32 million Canadians and 6.7 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?

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## Two Big Economic Questions

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

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

An outcome is in the social interest if it uses resources efficiently and distributes goods and services fairly.

### The Big Question

Is it possible that when each one of us makes choices that are in our **self-interest**, it also turns out that these choices are also in the **social interest**?

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## Two Big Economic Questions

### Self-Interest in the Social Interest

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

- Globalization
- The information-age economy
- Global warming
- Natural resource depletion
- Economic instability

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## The Economic Way of Thinking

### Choices and Tradeoffs

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.

The classic tradeoff is “guns versus butter.”

“Guns” and “butter” stand for *any* two objects of value.

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## ▶ The Economic Way of Thinking

### **What, How, and For Whom Tradeoffs**

The questions what, how, and for whom become sharper when we think in terms of tradeoffs.

**What Tradeoffs** arise when people choose how to spend their incomes, when governments choose how to spend their tax revenues, and when businesses choose what to produce.

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**How Tradeoffs** arise when businesses choose among alternative production technologies.

**For Whom Tradeoffs** arise when choices change the distribution of buying power across individuals.

Government redistribution of income from the rich to the poor creates the **big tradeoff**—the tradeoff between equality and efficiency.

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### **Choices Bring Change**

What, how, and for whom goods and services get produced changes over time and the quality of our economic lives improve.

But the quality of our economic lives and the rate at which they improve depends on choices that involve tradeoffs.

We face three tradeoffs between enjoying current consumption and leisure time and increasing future production, consumption, and leisure time.

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If we save more, we can buy more capital and increase our production.

If we take less leisure time, we can educate and train ourselves to become more productive.

If businesses produce less and devote resources to research and developing new technologies, they can produce more in the future.

The choices we make in the face of these tradeoffs determine the pace at which our economic condition improves.

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### Opportunity Cost

Thinking about a choice as a tradeoff emphasizes cost as an opportunity forgone.

The highest-valued alternative that we give up to get something is the **opportunity cost** of the activity chosen.

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## ▶ The Economic Way of Thinking

### Choosing at the Margin

People make choices at the **margin**, which means that they evaluate the consequences of making *incremental changes* in the use of their resources.

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**.

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## ▶ The Economic Way of Thinking

### Responding to Incentives

Our choices respond to incentives.

For any activity, if marginal benefit exceeds marginal cost, people have an incentive to do more of that activity.

If marginal cost exceeds marginal benefit, people have an incentive to do less of that activity.

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

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## ▶ The Economic Way of Thinking

### Human Nature, Incentives, and Institutions

Economists take human nature as given and view people as acting in their self-interest.

Self-interested actions are not necessarily *selfish* actions.

But if human nature is given and people pursue self-interest, how can the social interest be served?

Economists answer by emphasizing the role of institutions in creating incentives to behave in the social interest.

Paramount: the rule of law that protects private property and facilitates voluntary exchange in markets.

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## ➤ Economics: A Social Science and Policy Tool

### Economics as Social Science

Economists distinguish between two types of statement:

- What *is*—*positive* statements
- What *ought to be*—*normative* statements

A positive statement can be tested by checking it against facts.

A normative statement cannot be tested.

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## ➤ Economics: A Social Science and Policy Tool

### Unscrambling Cause and Effect

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.

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## ➤ Economics: A Social Science and Policy Tool

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

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## ➤ Economics: A Social Science and Policy Tool

### Economics as Policy Tool

Economics is a way of approaching problems in all aspects of our lives. Three broad areas are

- Personal economic policy
- Business economic policy
- Government economic policy

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