

## Chapter 1 What Economics is About



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### In This Lesson I

- Goods and Bads and Resources
- Scarcity
- Opportunity Costs
- Costs and Benefits
- Decisions Made at the Margin



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### In This Lesson II

- Incentives
- Efficiency
- Unintended Effects
- Exchange
- Ceteris Paribus

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### In This Lesson III

- The market and the Government
- Theory
- Economic Categories

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### Building A Definition of Economics ~ Goods and Bads ~

- Good - Anything from which individuals receive utility or satisfaction
- Utility - The satisfaction one receives from a good
- Bad - Anything from which individuals receive disutility or dissatisfaction
- Disutility - The dissatisfaction one receives from a bad

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### Building A Definition of Economics ~ Resources ~

Land - All natural resources, such as minerals, forests, water, and unimproved land



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## Building A Definition of Economics ~ Resources ~

Labor - The physical and mental talents people contribute to the production process



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## Building A Definition of Economics ~ Resources ~

Capital - Produced goods that can be used as inputs for further production, such as factories, machinery, tools, computers, and buildings

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## Building A Definition of Economics ~ Resources ~

Entrepreneurship - The particular talent that some people have for:

- organizing the resources of land, labor, and capital to produce goods
- seeking new business opportunities
- developing new ways of doing things

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## Scarcity

The condition in which our wants are greater than the limited resources available to satisfy those wants

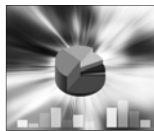


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## Economics, the Science of Scarcity

The science of how individuals and societies deal with the fact that wants are greater than the limited resources available to satisfy those wants.



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## Self Test

**1. Scarcity is the condition of finite resources. True or false? Explain your answer.**

False. It takes two things for scarcity to exist: finite resources and infinite wants. If people's wants were equal to or less than the finite resources available to satisfy their wants, there would be no scarcity. Scarcity exists only because people's wants are greater than the resources available to satisfy their wants. Scarcity is the condition of infinite wants clashing with finite resources.

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## Self Test

### 2. How does competition arise out of scarcity?

Because of scarcity, there is a need for a rationing device. People will compete for the rationing device. For example, if dollar price is the rationing device, people will compete for dollars.

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## Self Test

### 3. How does choice arise out of scarcity?

Because our unlimited wants are greater than our limited resources—that is, because scarcity exists—some wants must go unsatisfied. We must choose which wants we will satisfy and which we will not.

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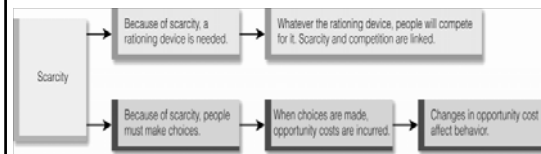
## Opportunity Costs

- The most highly valued opportunity or alternative forfeited when a choice is made.
- Economists believe that a change in opportunity cost can change a person's behavior.
- The higher the opportunity cost of doing something, the less likely it will be done.

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## Scarcity, Choice and Opportunity Costs



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## Marginal Benefits

Additional benefits. The benefits connected to consuming an additional unit of a good or undertaking one more unit of an activity.

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## Marginal Costs

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## Decisions at the Margin

Decision making characterized by weighing the additional (marginal) benefits of a change against the additional (marginal) costs of a change with respect to current conditions

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## Graphing Workshop Working with Graphs

Click graph to watch tutorial

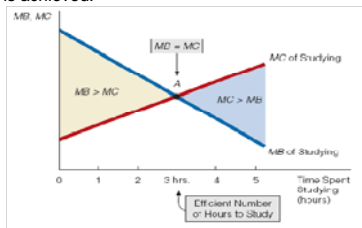


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## Efficiency

$MB$  = marginal benefits and  $MC$  = marginal costs. In the exhibit, the  $MB$  curve of studying is downward sloping and the  $MC$  curve of studying is upward sloping. As long as  $MB > MC$ , the person will study. The person stops studying when  $MB = MC$ . This is where efficiency is achieved.



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## Study or Play



Benefit

Cost



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## Incentives

Something that encourages or motivates a person to take an action.



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## Unintended Effects

A positive or negative outcome that was not anticipated



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## Exchange/Trade

The process of giving up one thing for another.



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## Self Test

1. Give an example to illustrate how a change in opportunity cost can affect behavior.

A. Every time a person is late to history class, the instructor subtracts one-tenth of a point from the person's final grade. If the instructor raised the opportunity cost of being late to class—by subtracting one point from the person's final grade—economists predict there would be fewer persons late to class. In summary, the higher the opportunity cost of being late to class, the less likely people will be late to class.

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## Self Test

2. Studying has both costs and benefits. If you continue to study (say, for a test) as long as the marginal benefits of studying are greater than the marginal costs and stop studying when the two are equal, will your action be consistent with having maximized the net benefits of studying? Explain your answer.

Yes. To illustrate, suppose the marginal benefits and costs (in dollars) are as follows for various hours of studying. (see next slide)

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## Self Test

Hours	Marginal Benefits	Marginal Costs
First hour	\$20.00	\$10.00
Second hour	\$14.00	\$11.00
Third hour	\$13.00	\$12.00
Fourth hour	\$12.10	\$12.09
Fifth hour	\$11.00	\$13.00

Clearly, you will study the first hour because the marginal benefits are greater than the marginal costs. In this case, you will study through the fourth hour.

You will not study the fifth hour because it is not worth it; the marginal benefits of studying the fifth hour are less than the marginal costs. In short, there is a net cost to studying the fifth hour. (next slide)

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## Self Test

Stated differently, there is a net benefit of \$10 (the difference between the marginal benefits of \$20 and the marginal costs of \$10) for studying the first hour. If you stop studying after the first hour and do not proceed to the second, then you will forfeit the net benefit of \$3 for the second hour. To maximize your net benefits of studying, you must proceed until the marginal benefits and the marginal costs are as close to equal as possible. (In the extreme, this is an epsilon away from equality. However, economists simply speak of "equality" between the two for convenience.)

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## Self Test

3. You stay up an added hour to study for a test. The intended effect is to raise your test grade. What might be an unintended effect of staying up an added hour to study for the test?

You might feel sleepy the next day, you might be less alert while driving, and so on.

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## The Market and Government Addressing Issues

- Financial problems in the banking sector
- The economic effects of falling real estate prices
- Growing federal budget deficits
- A fall in economic activity, as measured by the total output of goods and services produced in the country
- Rising unemployment
- The looming crisis in Social Security
- Health-care issues
- Issues related to climate change and the environment
- The proper role of monetary policy
- The proper role of government regulatory policy in the economy, and much more

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## The Market and Government

When it comes to economic problems, the national debate usually proceeds along these lines:

- First, the problem is *identified and defined or described*.
- Second, individuals attempt to identify the *cause of the problem*.
- Third, individuals propose *solutions to the problem*.

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## The Market and Government

With respect to both the cause and the solution, we often hear two words mentioned: the “market” and “government.”

- Either: The market (or capitalism) is the cause of the problem.
- Or: The government is the cause of the problem.
- Either: The market (or capitalism) is the solution to the problem.
- Or: The government is the solution to the problem.

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## Ceteris Paribus

A Latin term meaning “all other things constant” or “nothing else changes.”

Ceteris paribus is an assumption used to examine the effect of one influence on an outcome while holding all other influences constant.

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## Abstract

The process (used in building a theory) of focusing on a limited number of variables to explain or predict an event.



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## Theory

Economists build theories to answer questions that do not have obvious answers.

Cause → Effect

Theory is an abstract representation of the real world designed with the intent to better understand the world.

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## Self Test

### 1. What is the purpose of building a theory?

The purpose of building a theory is to explain something that is not obvious. For example, the cause of changes in the unemployment rate is not obvious, and so the economist would build a theory to explain changes in the unemployment rate.

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## Self Test

### 2. How might a theory of the economy differ from a description of it?

A theory of the economy seeks to explain why certain things in the economy happen. For example, a theory of the economy might try to explain why prices rise or why output falls. A description of the economy is simply a statement of what exists in the economy. For example, we could say that the economy is growing or contracting or that more jobs are available this month than last month. A description doesn't answer questions; it simply tells us what is. A theory tries to answer a why question, such as, "Why are more jobs available this month than last month?"

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## Self Test

### 3. Why is it important to test a theory? Why not simply accept a theory if it sounds right?

If you do not test a theory, you will never know whether you have accomplished your objective in building the theory in the first place. In other words, you will not know if you have accurately explained something. We do not simply accept a theory if it sounds right because what sounds right may actually be wrong. For example, no doubt during the time of Columbus, the theory that the earth was flat sounded right to many people and the theory that the earth was round sounded ridiculous. The right-sounding theory turned out to be wrong, though, and the ridiculous-sounding theory turned out to be right.

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## Self Test

### 4. Your economics instructor says, "If the price of going to the movies goes down, people will go to the movies more often." A student in class says, "Not if the quality of the movies goes down." Who is right, the economics instructor or the student?

Unless stated otherwise, when economics instructors identify the relationship between two variables, they implicitly make the *ceteris paribus* assumption. In other words, the instructor is really saying, "If the price of going to the movies goes down, people will go to the movies more often—assuming that nothing else changes, such as the quality of movies, and so on." (continued on next slide)

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## Self Test (continued)

Instructors don't always state "*ceteris paribus*" because if they did, they would be using the term every minute of a lecture. So the instructor is right, although a student new to economics might not know what the instructor is assuming but not saying.

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## Economic Categories Positive vs. Normative Economics

**Positive** - The study of "what is" in economic matters.

Cause → Effect

**Normative** - The study of "what should be" in economic matters

Judgment and Opinion

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## Economic Categories Microeconomics

Microeconomics deals with human behavior and choices as they relate to relatively small units—an individual, a business firm, an industry, a single market.



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## Microeconomic Questions

- How does a market work?
- What level of output does a firm produce?
- What price does a firm charge for the good it produces?
- How does a consumer determine how much of a good he or she will buy?
- Can government policy affect business behavior?
- Can government policy affect consumer behavior?

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## Economic Categories Macroeconomics

Macroeconomics deals with human behavior and choices as they relate to highly aggregate markets (e.g., the goods and services market) or the entire economy.



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## Macroeconomic Questions

- How does the economy work?
- Why is the unemployment rate sometimes high and sometimes low?
- What causes inflation?
- Why do some national economies grow faster than other national economies?
- What might cause interest rates to be low one year and high the next?
- How do changes in the money supply affect the economy?
- How do changes in government spending and taxes affect the economy?

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## Wall Street Journal

The Wall Street Journal is a rich source of information which provides real life examples of micro- and macro economic activities. Check today's issue to see the most current news.

<http://www.wsj.com>



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## Other Useful Sources of Current Economic News

New York Times

<http://www.nytimes.com/pages/business/index.html>

Financial Times

<http://www.ft.com/home/us>

The Economist

<http://www.economist.com/index.html>

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