PART I  INTRODUCTION TO ECONOMICS

The Scope and Method of Economics

CHAPTER OUTLINE

Why Study Economics?
To Learn a Way of Thinking
To Understand Society
To Understand Global Affairs
To Be an Informed Citizen

The Scope of Economics
Microeconomics and Macroeconomics
The Diverse Fields of Economics

The Method of Economics
Descriptive Economics and Economic Theory
Theories and Models
Economic Policy
Economics is the study of how individuals and societies choose to use the scarce resources that nature and previous generations have provided. The key word in this definition is choose. Economics is a behavioral, or social, science. In large measure, it is the study of how people make choices. The choices that people make, when added up, translate into societal choices.
Why Study Economics?

• To Learn a Way of Thinking
  • Fundamental concepts:
    ▪ **Opportunity cost**: The best alternative that we forgo when we make a decision.
    ▪ **Marginalism**: analyzing additional costs or benefits arising from a choice or decision.
    ▪ **Sunk cost**: costs that cannot be avoided because they have already been incurred.
    ▪ **Efficient markets**

• To Understand Society

• To Understand Global Affairs

• To Be an Informed Citizen
The Scope of Economics

- Microeconomics and Macroeconomics

**Microeconomics** The branch of economics that examines the functioning of individual industries and the behavior of individual decision-making units—that is, firms and households.

**Macroeconomics** The branch of economics that examines the economic behavior of aggregates—income, employment, output, and so on—on a national scale.

Microeconomics looks at the individual unit—the household, the firm, the industry. It sees and examines the “trees.”

Macroeconomics looks at the whole, the aggregate. It sees and analyzes the “forest.”
The Scope of Economics

- **Microeconomics and Macroeconomics**

<table>
<thead>
<tr>
<th>Divisions of Economics</th>
<th>Production</th>
<th>Prices</th>
<th>Income</th>
<th>Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Microeconomics</strong></td>
<td>Production/output in individual industries and businesses</td>
<td>Price of individual goods and services</td>
<td>Distribution of income and wealth</td>
<td>Employment by individual businesses and industries</td>
</tr>
<tr>
<td></td>
<td>How much steel</td>
<td>Price of medical care</td>
<td>Wages in the auto industry</td>
<td>Jobs in the steel industry</td>
</tr>
<tr>
<td></td>
<td>How much office space</td>
<td>Price of gasoline</td>
<td>Minimum wage</td>
<td>Number of employees in a firm</td>
</tr>
<tr>
<td></td>
<td>How many cars</td>
<td>Food prices</td>
<td>Executive salaries</td>
<td>Number of accountants</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Apartment rents</td>
<td>Poverty</td>
<td></td>
</tr>
<tr>
<td><strong>Macroeconomics</strong></td>
<td>National production/output</td>
<td>Aggregate price level</td>
<td>National income</td>
<td>Employment and unemployment in the economy</td>
</tr>
<tr>
<td></td>
<td>Total industrial output</td>
<td>Consumer prices</td>
<td>Total wages and salaries</td>
<td>Total number of jobs</td>
</tr>
<tr>
<td></td>
<td>Gross domestic product</td>
<td>Producer prices</td>
<td>Total corporate profits</td>
<td>Unemployment rate</td>
</tr>
<tr>
<td></td>
<td>Growth of output</td>
<td>Rate of inflation</td>
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</table>
### The Diverse Fields of Economics

#### TABLE 1.2 The Fields of Economics

<table>
<thead>
<tr>
<th>Field</th>
<th>Description</th>
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<tbody>
<tr>
<td>Behavioral economics</td>
<td>uses psychological theories relating to emotions and social context to help understand economic decision making and policy.</td>
</tr>
<tr>
<td>International economics</td>
<td>studies trade flows among countries and international financial institutions.</td>
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<tr>
<td>Econometrics</td>
<td>applies statistical techniques and data to economic problems in an effort to test hypotheses and theories.</td>
</tr>
<tr>
<td>Economic development</td>
<td>focuses on the problems of low-income countries. Important concerns include population growth, provision for basic needs, and strategies for international trade.</td>
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<tr>
<td>Economic history</td>
<td>traces the development of the modern economy.</td>
</tr>
<tr>
<td>Public economics</td>
<td>examines the role of government in the economy. What are the economic functions of government, and what should they be?</td>
</tr>
<tr>
<td>Finance</td>
<td>examines the ways in which households and firms actually pay for, or finance, their purchases. It involves the study of capital markets</td>
</tr>
<tr>
<td>Health economics</td>
<td>analyzes the health care system and its players: government, insurers, health care providers, and patients.</td>
</tr>
<tr>
<td>The history of economic thought</td>
<td>studies the development of economic ideas and theories over time, from Adam Smith to the works of economists such as Malthus, Marx, and Keynes.</td>
</tr>
<tr>
<td>Industrial organization</td>
<td>looks carefully at the structure and performance of industries and firms within an economy. How do businesses compete? Who gains and who loses?</td>
</tr>
</tbody>
</table>
The Method of Economics

**positive economics**  An approach to economics that seeks to understand behavior and the operation of systems without making judgments. It describes what exists and how it works.

**normative economics**  An approach to economics that analyzes outcomes of economic behavior, evaluates them as good or bad, and may prescribe courses of action. Also called *policy economics*.

**descriptive economics**  The compilation of data that describe phenomena and facts.

**economic theory**  A statement or set of related statements about cause and effect, action and reaction.

- Model
- Variable
- Ceteris Paribus (All else equal)
Every society has some system or process that transforms its scarce resources into useful goods and services. In doing so, it must decide what gets produced, how it is produced, and to whom it is distributed.

The primary resources that must be allocated are land, labor, and capital.
Scarcity, Choice, and Opportunity Cost

The Economic Problem

The three basic questions facing all economic systems:

(1) What gets produced?

(2) How is it produced?

(3) Who gets it?

Given scarce resources, how do large, complex societies go about answering the three basic economic questions?
inputs (or resources) Anything provided by nature or previous generations that can be used directly/indirectly to satisfy human wants.

factors of production (or factors) The inputs into the process of production. Another term for resources.

The primary resources are land, labor, and capital.

capital Things that are produced and then used in the production of other goods and services.

production The process that transforms scarce resources into useful goods and services.

outputs Goods and services of value to households.
Scarcity, Choice, and Opportunity Cost

- The concepts of *constrained choice* and *scarcity* are central to the discipline of economics.

**opportunity cost** The best alternative that we give up, or forgo, when we make a choice or decision.
The Production Possibility Frontier

consumer goods  Goods produced for present consumption.

investment  The process of using resources to produce new capital.

Production Possibility Frontier (ppf)  A graph that shows all the combinations of goods and services that can be produced if all of society’s resources are fully employed used efficiently.
Scarcity, Choice, and Opportunity Cost

The Production Possibility Frontier

All points **below and to the left** of the curve represent combinations of capital and consumer goods that are **possible** for the society given the resources available and existing technology: **ATTAINABLE**

Points **above and to the right** of the curve, such as point $G$, represent combinations that **cannot be reached**: **UNATTAINABLE**

Points **on the PPF** are points of both full resource employment and production efficiency

**Production efficiency** is a state in which a given mix of output is produced at least cost
Periods of **unemployment** correspond to points inside the ppf, such as point $D$. Moving onto the frontier from a point such as $D$ means achieving full employment of resources.

Although an economy may be operating with full employment of its land, labor, and capital resources, it may still be operating inside its ppf, at a point such as $D$. The economy could be using those resources *inefficiently*. 
The opportunity cost of producing more capital goods is fewer consumer goods.

Moving from $E$ to $F$, the number of capital goods increases from 550 to 800, but the number of consumer goods decreases from 1,300 to 1,100.

MRT is negative.
Scarcity, Choice, and Opportunity Cost

The Production Possibility Frontier

The Law of Increasing Opportunity Cost

**TABLE 2.1 Production Possibility Schedule for Total Corn and Wheat Production in Ohio and Kansas**

<table>
<thead>
<tr>
<th>Point on ppf</th>
<th>Total Corn Production (Millions of Bushels per Year)</th>
<th>Total Wheat Production (Millions of Bushels per Year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>700</td>
<td>100</td>
</tr>
<tr>
<td>B</td>
<td>650</td>
<td>200</td>
</tr>
<tr>
<td>C</td>
<td>510</td>
<td>380</td>
</tr>
<tr>
<td>D</td>
<td>400</td>
<td>500</td>
</tr>
<tr>
<td>E</td>
<td>300</td>
<td>550</td>
</tr>
</tbody>
</table>

**FIGURE 2.7 Corn and Wheat Production in Samsun and Konya**

The ppf illustrates that the opportunity cost of corn production increases as we shift resources from wheat production to corn production. Moving from point E to D, we get an additional 100 million bushels of corn at a cost of 50 million bushels of wheat. Moving from point B to A, we get only 50 million bushels of corn at a cost of 100 million bushels of wheat. The *cost per bushel* of corn—measured in lost wheat—has increased.
Scarcity, Choice, and Opportunity Cost

The Production Possibility Frontier

Economic Growth

economic growth An increase in the total output of an economy. It occurs when a society acquires new resources or when it learns to produce more using existing resources.
Productivity increases have enhanced the ability of Turkey to produce both corn and wheat.

Productivity increases were more dramatic for corn than for wheat. Thus, the shifts in the PPF were not parallel.
Scarcity, Choice, and Opportunity Cost

Sources of Growth and the Dilemma of Poor Countries

FIGURE 2.9 Capital Goods and Growth in Poor and Rich Countries

Rich countries find it easier than poor countries to devote resources to the production of capital, and the more resources that flow into capital production, the faster the rate of economic growth.

Thus, the gap between poor and rich countries has grown over time.