

# Chapter 1

## Limits, Alternatives, and Choices

- ❖ Economics: studies how individuals, institutions, and society makes the optimal or best choices under conditions of *scarcity*
  - Economic wants are unlimited
  - The means and resources to satisfy these needs are limited
- ❖ The Economic Perspective: envisions individuals and institutions making rational decisions by comparing the marginal benefits and marginal costs associated with their actions
  - Scarcity requires choices. Choices mean opportunity cost: the amount of other products that must be forgone or sacrificed to produce a unit of a product
  - People are purposeful decision makers, choose based on self-interests
    - Seek to increase satisfaction (utility) from good or service
  - Uses marginal analysis to asses how marginal costs of a decision compare to marginal benefits
    - Marginal cost: the extra (additional) cost of producing 1 more unit of output
    - Marginal benefit: the extra benefit of consuming 1 more unit of some good or service, the change in total benefit when 1 more unit is consumed
- ❖ Economics relies on the scientific method for analysis
  - Terms:
    - A *hypothesis* is a proposition that's tested and used to develop an economic *theory*
    - Economic principle: (*law*) highly tested and reliable economic theory
      - Theories, principles, and laws can be used to predict the likely outcome of an action or event
      - Generalizations that show effect
      - The other-things-equal assumption is used to limit the influence of other factors when making a generalization
        - Other-things-equal assumption: (*ceteris paribus*) factors other than those being considered are held constant
    - An economic *model* is several economic laws or principles are used to explain or describe reality
      - Many can be illustrated graphically, making them simplified representations of economic reality
- ❖ Two Levels of Economics
  - Microeconomics: studies economic behavior of individuals, particular markets, firms, and industries
  - Macroeconomics: looks at entire economy or its major aggregates or sectors
    - Aggregates: specific economic units treated as one
      - Households, businesses, or government
  - Both of these levels can be sorted into:
    - Positive economics: focuses on facts and is concerned with *what is*, or the scientific analysis of economic behavior
    - Normative economics: suggests what ought to be and answers policy questions based on judgments.
      - Most disagreements involve this
- ❖ An economizing problem can arise when wants > means.
  - Individuals have limited income
  - Virtually unlimited wants for more, better quality
  - Can be illustrated with budget line
    - Budget Line: shows graphically the combinations of two products a consumer can purchase with their income
      - Inside=attainable
      - Outside=unattainable
      - Causes a trade-off with an opportunity cost
      - Changes in income shift the line
- ❖ Society faces an economic problem due to scarcity

- Economic resources: scarce, natural, human, or manufactured inputs used to produce goods and services
  - Sometimes called factors of production
    - Land: natural resources
    - Labor: contributed time and abilities of people producing goods and services
    - Capital: (capital goods) machine, tools, and equipment used to make other goods
      - Purchase of capital is an investment
    - Entrepreneurial ability: special human talents of individuals who combine the other factors of production
  
- ❖ Macroeconomic model of production illustrates economizing problem for society
  - Four assumptions usually made:
    1. There's full service of available resources
    2. The quantity and quality of resources are fixed
    3. State of technology does not change
    4. There are 2 types of goods being produced (capital and consumer)
      - Consumer goods: satisfy human wants directly
      - Capital goods: human made resources used to produce goods and services
        - Buildings, machinery, equipment
  - Production possibilities table: alternative combos of goods an economy is capable of producing
    - Production possibilities curve: A curve showing the different combinations of 2 goods that can be produced in *full-employment, full production* economy where the available supplies of resources and technology are fixed
      - Each point shows max output of the 2 goods
      - The opportunity cost of producing an additional unit of one good, is the amount of the other good that is sacrificed
        - Law of increasing opportunity costs: the opportunity cost of producing 1 more unit of good, increases as more of the good is produced
          - This is why curve starts at origin
          - This is because resources are not completely adaptable to alternative uses
          - Causes marginal-cost curve for a good increase,
          - The marginal-benefit curve decreases because the consumption of the good yields less satisfaction
      - Optimal allocation: resources are devoted to best mix of goods to maximize satisfaction in society. Determined by assessing marginal costs and benefits
        - Benefit > cost → incentive to produce more
        - Benefit < cost → there's an incentive to produce less
        - Benefit = cost → optimal or efficient allocation is achieved
  
  - ❖ Different outcomes occur when assumptions underlying production possibilities are relaxed
    - Unemployment—when the economy is operating at a point inside production possibility, it means they're not fully employed
    - Economic growth—causes the curve to shift outward because resources are not fixed and technology improves
      - Contributed by quantity and quality of resources
      - Advancement in technology
      - Choosing to produce more capital goods can cause economic growth in the future
    - Trade—causes a nation to obtain more than production possibility indicated from domestic economy
  
  - ❖ In order to reason with economics, one must avoid:
    - Bias—preconceived belief or opinion
    - Loaded terminology—using terms that appeal to emotion
    - The fallacy of composition—assuming that what is true of the part, is true of the whole
    - The post hoc fallacy—thinking that since one event was before another, the first caused the second
    - Confusing correlation with causation—two related factors are not necessarily cause and effect

# Chapter 2

## The Market System and the Circular Flow

- ❖ Economics system: set of institution and a coordinating mechanism to respond to the economizing problem for economy
  - Command system: (socialism or communism) based on extensive public ownership of resources and the use of central planning and most economic decision making
  - Market system: (capitalism) has extensive private ownership of resources, uses markets and prices to coordinate and direct economic activity
    - In pure *laissez-faire* capitalism, there's a limited government role in economy
    - In capitalism, like the US, government plays a large role, but private property and markets dominate
    - The 9 characteristics of a market system
      - Private property: the right of private persons to control their property and resources by means of the institution
      - Freedom of choice: the right for owners to employ and dispose of their property as they see fit, workers to enter any line of work for which they're qualified, and consumers to spend their money in ways which they see as appropriate
        - Freedom of enterprise: freedom of firms to obtain economic resources, to use them to produce whatever they choose, and to sell in the market of their choice
      - Competition: freedom to enter and leave markets and freedom of the buyer and seller to make own choices
        - This spreads economic power and limits its potential abuse
      - Market: a place, institution, or process where buyers and sellers interact with each other
        - Used to communicate and coordinate decisions of buyers and sellers
      - Employs complicated and advanced methods of production, new technology, and large amounts of capital equipment to produce efficiently
      - Specialization: the use of resources of an individual, a firm, a region, or a nation to concentrate production on 1 or a small number of goods or services
        - Also called, Division of labor: separation of work required to produce into a number of different tasks that are performed by different workers
          - Geographic specializations allow nations to produce what they do best and trade with other nations for what they want
      - Uses money exclusively to facilitate trade and specialization
        - Money functions as a medium of exchange: any item that sellers generally accept and buyers generally use to pay for goods and services
        - More efficient than barter for trading goods
      - Government has an active but limited role
- ❖ The system of prices, markets, and choices furnish the market economy with answers to the Five Fundamental Questions
  1. *What goods and services will be produced?*
    - Consumer sovereignty: determination by consumers of the types and quantities of goods and services that will be produced with the scarce resources of the economy; consumers' direction of production through their *dollar* votes
      - This because consumer are in command and express their wishes through dollar votes
        - The demand from consumers and desires of businesses for max profits determine each product produced and its price
  2. *How will the services and goods be produced?*
    - Desire of business to have max profits & competition, causes them to use most efficient techniques producing
  3. *Who will get the goods and services?*
    - Income determines the quantity of goods they will purchase
  4. *How will the system accommodate change?*
    - Allows it to accommodate itself in consumer tastes, technology, and resource supplies