

Chapter 1: What is Economics?

Section 1: Scarcity and the Science of Economics

THE FUNDAMENTAL ECONOMIC PROBLEM

SCARCITY is the basic economic problem of how to meet people's seemingly unlimited wants with scarce resources. This basic problem affects almost every economic decision people make as buyers and as sellers. People's wants are unlimited but societies' resources are limited. **ECONOMICS** is the social science that studies how people satisfy seemingly unlimited and competing wants with the careful use of scarce resources.

When economists talk about people's unlimited wants, they are making a distinction between what people want and what they need. In economics, a **WANT** is something we would like to have but that is not necessary for survival, like a specific sneaker or particular type of house. A **NEED**, on the other hand, is a basic requirement for survival, such as food, clothing, and shelter.

Since all resources are limited, everything that meets a need or a want has a cost. Even when it seems as if something is "free," someone has to pay to produce it. That cost is ultimately passed on to consumers. Economists use the term **TINSTAAFL** to describe this concept. It means There Is No Such Thing As A Free Lunch.

THREE BASIC QUESTIONS

The problem of scarcity forces every society to answer the basic questions of what, how, and for whom to produce. A society cannot produce everything its members want because it has limited resources. Societies must make decisions about what kinds of goods and services to produce and provide. For example, societies assess how to defend themselves and how to take care of people with disabilities. In addition, societies have to consider how to produce goods and services. Sometimes it may be more important to create jobs. Other times it may be more important to produce goods as cheaply as possible. Lastly, a society must determine who will receive the goods and services.

THE FACTORS OF PRODUCTION

Factors of production are the resources used to make the goods and services we would like to have. The **FACTORS OF PRODUCTION** include land, capital, labor, and entrepreneurs.

In economics, land refers to natural resources or other "gifts of nature" not created by human effort. **LAND** consists of oil, gold, sun, rain, animals, fish, rivers, and pastures. **CAPITAL OR CAPITAL GOODS** are the second factor of production. Capital goods are the tools, equipment, and factories used in the production of goods and services. A third factor of production is **LABOR**, or people with all their efforts, abilities, and skills. Entrepreneurs are special laborers—risk-taking individuals in search of profits. **ENTREPRENEURS** start new businesses or bring new products to the market.

THE SCOPE OF ECONOMICS

The four key elements of the subject of economics are description, analysis, explanation, and prediction.

Section 2: Basic Economic Concepts

GOODS, SERVICES, AND CONSUMERS

Economic products command a price and satisfy wants and needs. Economic products include goods and services. A **GOOD** is a tangible economic product that is useful, relatively scarce, and transferable to others. Examples of goods include books, bicycles, and computers. A **CAPITAL GOOD** is a good producers use to make other goods and services, such as a machine in a factory. A **CONSUMER GOOD**, on the other hand, is intended for final use by consumers rather than businesses. **CONSUMERS** are the people who use, or consume, goods and services to satisfy their wants and needs.

Goods can be further grouped into two categories: durable and nondurable. A **DURABLE GOOD** lasts for at least three years when used regularly. Durable goods can include capital goods and consumer goods. A **NONDURABLE GOOD** is a good that lasts for fewer than three years when used regularly. Food and clothing are examples of nondurable goods.

Unlike a good, a **SERVICE** is an item that cannot be touched. A service is work or labor performed for someone else, such as the work performed by engineers, plumbers, or entertainers.

VALUE, UTILITY AND WEALTH

VALUE describes the monetary worth of a good or service as determined by the market. The **PARADOX OF VALUE** refers to the contradiction between the high value of some nonessential items and the low value of some essential items. For a good or service to have value, it must be scarce and have utility. **UTILITY** is a product's ability to be useful and to provide satisfaction.

People evaluate the utility of a particular good or service differently. When people or nations have a large number of valuable and tangible economic goods, they have **WEALTH**.

THE CIRCULAR FLOW OF ECONOMIC ACTIVITY

The exchange of goods and services between consumers and businesses forms a circle. In economics, a **MARKET** is any meeting place or mechanism that allows buyers and sellers to make an exchange. Individuals begin the circle in **FACTOR MARKETS**, or markets where the factors of production are bought and sold. There individuals earn income by selling their labor to businesses in the factor market. After individuals receive wages or salaries, they spend it in the **PRODUCT MARKETS**, or markets where goods and services are bought and sold. Businesses complete the circle when they use the funds generated by sales to produce more goods and services.

PRODUCTIVITY AND ECONOMIC GROWTH

ECONOMIC GROWTH is an increase in a nation's total output of goods and services over time. The most important influence of economic growth is productivity. **PRODUCTIVITY** is the measure of the amount of output of goods and services in a specific period of time. Productivity increases whenever more goods and services are produced with the same amount of resources. Education, division of labor, and specialization all improve productivity by increasing human capital. **DIVISION OF LABOR** is how firms divide work into a number of separate tasks to be performed by different workers. **SPECIALIZATION** is how firms assign tasks to the workers, factors, regions, or nations that can perform them more efficiently. The U.S. economy's high degree of **ECONOMIC INTERDEPENDENCE** is a result of specialization.

Section 3: Economic Choices and Decision Making

TRADE-OFFS AND OPPORTUNITY COSTS

Economists study how people make choices to satisfy their wants and needs with scarce resources. When people make choices, they consider their options. Every decision has tradeoffs. A **TRADE-OFF** is an alternative that is available whenever a choice is to be made. People can use a decision-making grid to systematically analyze alternatives when they make an economic decision. Decision-making grids show a number of alternatives and the criteria used to analyze the alternatives. For example, a decision-making grid could compare colleges based on the criteria of location, price, and expertise in a particular subject.

When economists evaluate the cost of a good or service, they consider more than just the price. They also consider the **OPPORTUNITY COST**, or the cost of the next-best alternative use of money, time, or resources.

PRODUCTION POSSIBILITIES

Another way to analyze economic choices is by plotting the possible production of two products on a graph called the **PRODUCTION POSSIBILITIES FRONTIER**. This graph represents the maximum combinations of goods and/or services an economy can produce when using all productive resources. All points on the production possibilities frontier show the maximum potential output at a given point in time. Output values to the right, or outside of the curve, cannot be reached without additional resources. Reaching only an output value to the left, or inside the curve, would indicate that resources are not being fully used or methods of production are inefficient. The production possibilities frontier shows the opportunity cost of making more of one good or service versus another. Economic growth is the result of more resources or greater productivity. This causes the curve to move outward, both up and to the right.

THINKING LIKE AN ECONOMIST

Economists can analyze choices by using economic models, such as the production possibilities frontier, or by using a cost-benefit analysis. An **ECONOMIC MODEL** is a simplified version of a complex concept or behavior expressed in the form of an equation, graph, or illustration. Economists create models based on assumptions, or factors they decide are true or constant. A **COST-BENEFIT ANALYSIS** helps people make decisions by comparing the cost of an action to its benefits. A decision-making grid is one example of a cost-benefit analysis.