

Chapter 1

The Art and Science of Economic Analysis

**These slides supplement the
textbook, but should not
replace reading the textbook**

What is the economic problem?

Because we live in a world of scarce resources, but people have unlimited wants and needs, how do we meet their needs in this world of scarcity?

What assumption do we make?

People behave in
accordance to their
own self interest

What is **rational self interest**?

People select the alternatives they expect will yield the most satisfaction and happiness

What is macroeconomics?

The study of the
economic behavior
of entire economies

What is microeconomics?

The study of the economic behavior in particular markets, such as the market for computers

What is a good?

A tangible item that is used to satisfy wants



What is a service?

An intangible activity that is used to satisfy wants

What is a free good or service?

There is enough of a
good or service to go
around to everyone
who wants it for free

What is a Scarce Good or Service?

There is not enough of a good or service to go around to everyone who wants it for free

When is a good or service scarce?

When the amount people desire exceeds the amount available to them at a zero price

What is the allocation problem?

The allocation problem is who gets and who does not get when something is scarce

**How do we decide
who gets?**

The price mechanism

What is the price mechanism?

Those persons who get are those persons who want the scarce good the most and have the money to purchase it

What is the economic problem?

Because we live in a world of scarce resources, but people have unlimited wants and needs, how do we meet their needs in this world of scarcity?

What is a resource?

Something that is
used to produce
goods and services



What is a market?

A set of arrangements through which buyers and sellers carry out exchange at mutually agreeable terms

What is special about the market?

Unless there is a market transaction we are not concerned about it in economics

What are some examples of resources?

- Land
- Labor
- Capital
- Entrepreneurship

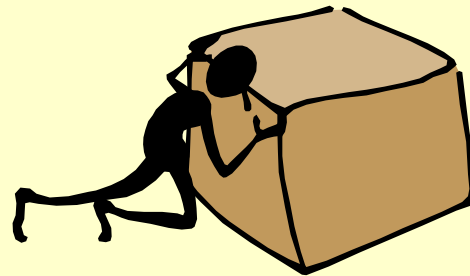
What is land?

Plots of ground and other natural resources used to produce goods and services



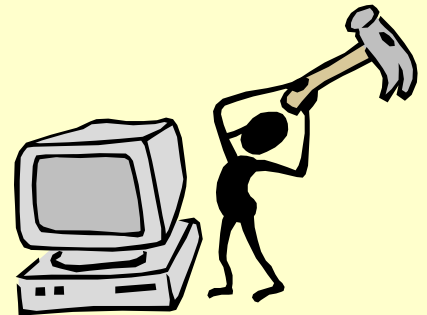
What is labor?

The physical and mental efforts of humans used to produce goods and services



What is capital?

Buildings, equipment,
and human skills
used to produce
goods and services



What is human capital?

The skills used to work with capital

What is entrepreneurial ability?

Managerial and organizational skills combined with the willingness to take risks



What is income called from resources?

- Land is rent
- Labor is wages
- Capital is interest
- Entrepreneurship is profit

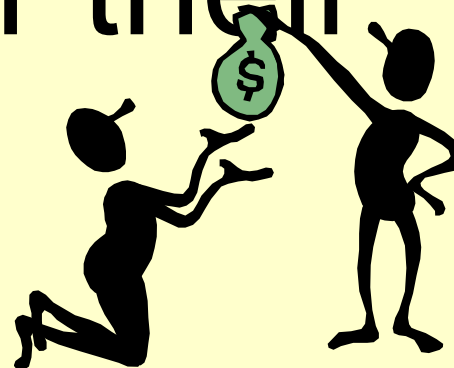
What is rent?

The payment resource owners receive for the use of their land



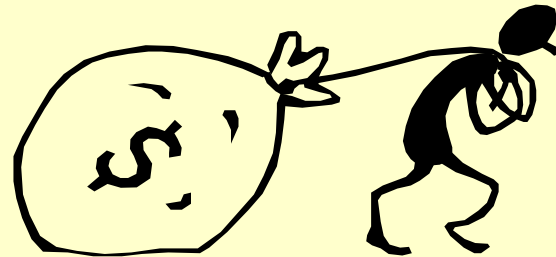
What are wages?

The payment
resource owners
receive for their
labor



What is interest?

The payment resource owners receive for the use of their capital



What is profit?

The return resource owners receive for their entrepreneurial ability

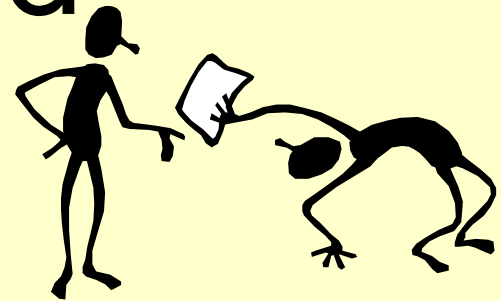


How is profit calculated?

Total revenue from sales
minus the total cost of
resources employed by
the entrepreneur

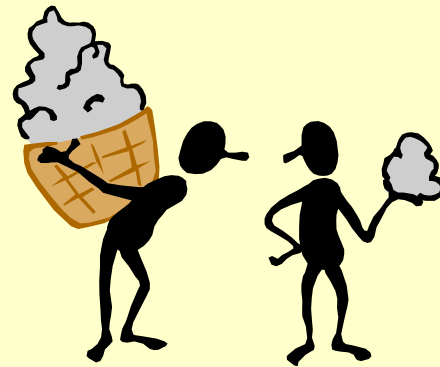
What is a product market?

A market in which goods and services are exchanged



What is a resource market?

A market in which resources are exchanged

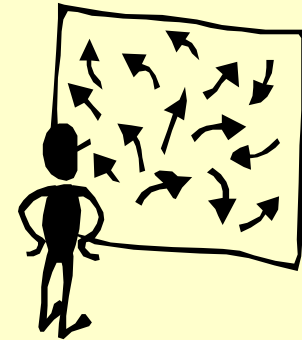


What does the term marginal mean?

A term used to describe the
result of a change in an
economic variable

What is an economic model or theory?

A simplified description of reality to understand and predict an economic event



What is a variable?

A measure, such as price or quantity, that can take on different possible values

What is the other-things-constant assumption?

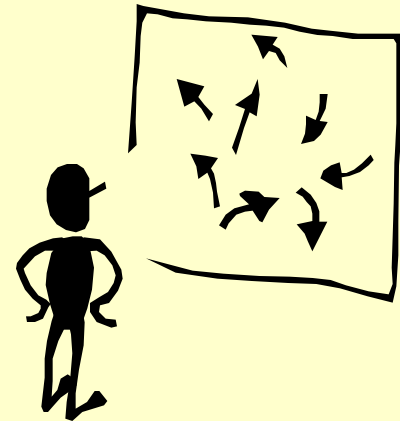
The assumption, when focusing on key economic variables, remains unchanged

What is the behavioral assumption?

An assumption that describes the expected behavior of economic actors

What is an hypothesis?

A statement about relationships among key variables



What is a positive economic statement?

A statement that can be proved or disproved by reference to facts

What is a normative economic statement?

A statement that represents an opinion, which cannot be proved or disproved

What are some pitfalls of economic analysis?

- Association-is-causation fallacy
- Fallacy of composition
- Secondary effects

What is the association-is-causation fallacy?

The incorrect idea that if two variables are associated in time, one must necessarily cause the other

What is fallacy of composition?

The incorrect belief that what is true for the individual, or part, must necessarily be true for the group, or whole

What are secondary effects?

Unintended consequences
of economic actions that
develop slowly over time
as people react to events

END