

GLOBAL
EDITION



Essential Foundations of Economics

SEVENTH EDITION

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ALWAYS LEARNING

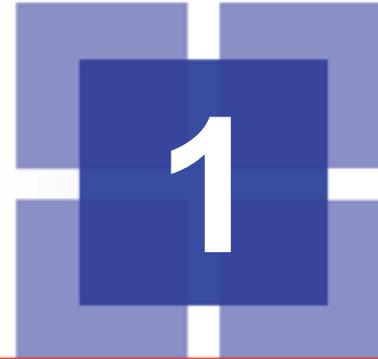
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You're in school!

Did you make the right decision?

Getting Started



CHAPTER CHECKLIST

When you have completed your study of this chapter, you will be able to

- 1** Define economics and explain the kinds of questions that economists try to answer.
- 2** Explain the ideas that define the economic way of thinking.

1.1 DEFINITION AND QUESTIONS

All economic questions and problems arise because human wants exceed the resources available to satisfy them.

<Scarcity

Scarcity is the condition that arises because wants exceeds the ability of resources to satisfy them.

Faced with scarcity, we must make *choices*—we must *choose* among the available alternatives.

The choices we make depend on the incentives we face.

1.1 DEFINITION AND QUESTIONS

< Economics Defined

Economics is the social science that studies the choices that individuals, businesses, governments, and entire societies make as they cope with *scarcity*, the *incentives* that influence those choices, and the arrangements that coordinate them.

1.1 DEFINITION AND QUESTIONS

Economics divides into two parts:

Microeconomics: The study of the choices that individuals and businesses make and the way these choices interact and are influenced by governments.

Macroeconomics: The study of the aggregate (or total) effects on the national economy and the global economy of the choices that individuals, businesses, and governments make.

1.1 DEFINITION AND QUESTIONS

Two big economic questions:

- How do choices determine what, how, and for whom goods and services get produced?
- When do choices made in *self-interest* also promote the *social interest*?

1.1 DEFINITION AND QUESTIONS

<What, How, and For Whom?

Goods and services are the objects (goods) and actions (services) that people value and produce to satisfy human wants.

What goods and services get produced and in what quantities?

How are goods and services produced?

For Whom are the various goods and services produced?

1.1 DEFINITION AND QUESTIONS

<Can the Pursuit of Self-Interest Be in the Social Interest?

The choices that are best for the individual who makes them are choices made in the pursuit of **self-interest**.

The choices that are best for society as a whole are choices made in the **social interest**.

1.1 DEFINITION AND QUESTIONS

Can choices made in self-interest also serve the social interest?

Let's illustrate with four topics:

1 Globalization

Globalization—the expansion of international trade and the production of components and services by firms in other countries—has been going on for centuries.

1.1 DEFINITION AND QUESTIONS

But in recent years, its pace accelerated.

Microchips, satellites, and fiber-optic cables have lowered the cost of communication.

This explosion of communication has globalized production decisions.

For example, Nike produces shoes in Malaysia; Toyota produces cars in the United States.

Globalization is in the interest of the owners of multinational firms that profit, but is it in the social interest?

1.1 DEFINITION AND QUESTIONS

2 The “Information Age”

Makers of computer chips and programs developed products in their self-interest, but did they develop their products in the social interest?

3 Climate Change

The choices we make concerning how to produce and use energy are made in our self-interest, but do they serve the social interest?

1.1 DEFINITION AND QUESTIONS

4 Government Budget Deficit and Debt

Every year since 2001, the U.S. government has run a budget deficit—on average, \$1.6 billion a day. The government's debt has increased each day by that amount.

Over the 12 year period from 2002 to 2013, government debt increased by \$6.85 trillion.

Your personal share of this debt is \$22,000.

This large deficit and debt is just the beginning of an even bigger problem.

1.1 DEFINITION AND QUESTIONS

From about 2020 onwards, the retirement and health-care benefits to which older Americans are entitled are going to cost increasingly more than taxes can cover.

With no changes in tax or benefit rates, the budget deficit will increase and the debt will swell ever higher.

Debts must be repaid. Who will repay them?

When we make our voter choices, we pursue our self-interest. Do our choices serve the social interest?

Do the choices made by politicians promote the social interest, or do they serve their self-interests?

1.2 THE ECONOMIC WAY OF THINKING

< Economic Ideas:

Six ideas define the economic way of thinking:

- Choice is a tradeoff
- Cost is what you must give up to get something
- Benefit is what you gain from something
- People make rational choices by comparing benefits and costs
- Most choices are “how much” choices made at the margin
- Choices respond to incentives

1.2 THE ECONOMIC WAY OF THINKING

<A Choice Is a Tradeoff

Because we face scarcity we must make choices.

To make a choice we select from alternatives.

Whatever choice you make, you could have chosen something else.

You can think about your choices as tradeoffs.

A **tradeoff** is an exchange—giving up one thing to get something else.

1.2 THE ECONOMIC WAY OF THINKING

< Cost: What You *Must* Give Up

Opportunity cost is the best thing that you *must* give up to get something—the highest-valued alternative forgone.

< Benefit: What You Gain

Benefit is the gain or pleasure that something brings.

Benefit is measured by what you are *willing to give up*.

1.2 THE ECONOMIC WAY OF THINKING

<Rational Choice

A **rational choice** is a choice that uses the available resources to best achieve the objective of the person making the choice.

We make rational choices by comparing *costs* and *benefits*.

1.2 THE ECONOMIC WAY OF THINKING

< How Much? Choosing at the Margin

A choice made at the **margin** is a choice made by comparing *all* the relevant alternatives systematically and incrementally.

1.2 THE ECONOMIC WAY OF THINKING

Marginal Cost

Marginal cost is the opportunity cost of a one-unit increase in an activity.

The marginal cost of something is what you *must* give up to get *one additional* unit of it.

Marginal Benefit

Marginal benefit is what you gain when you get one more unit of something.

The marginal benefit of something is *measured* by what you *are willing* to give up to get *one additional* unit of it.

1.2 THE ECONOMIC WAY OF THINKING

Making a Rational Choice

You make a rational choice when you take those actions for which marginal benefit exceeds or equals marginal cost.

<Choices Respond to Incentives

An **incentive** is a reward or a penalty—a “carrot” or a “stick”—that encourages or discourages an action.

1.2 THE ECONOMIC WAY OF THINKING

<Economics as Social Science

Economists try to understand and predict the effects of economic forces by using the *scientific method* first developed by physicists.

The scientific method is a common sense way of systematically checking what works and what doesn't work.

An economist begins with a question or a puzzle about cause and effect arising from some observed facts.

1.2 THE ECONOMIC WAY OF THINKING

Economic Models

An economist's second step is to build a model that provides a possible answer to the question of interest.

An **economic model** is a description of some feature of the economic world that includes only those features assumed necessary to explain the observed facts.

Check Models Against Facts

An economist's third step is to check the proposed model against the facts.

1.2 THE ECONOMIC WAY OF THINKING

To check an economic model against the facts, economists use

- Natural experiments
- Statistical investigations
- Economic experiments

Natural experiments: A situation that arises in the ordinary course of economic life in which the one factor of interest is different and other things are equal.

1.2 THE ECONOMIC WAY OF THINKING

A statistical investigation looks for a correlation.

Correlation is the tendency for the values of two variables to move together in a predictable and related way.

An economic experiment puts people in a decision-making situation and varies the influence of one factor at a time to discover how they respond.

1.2 THE ECONOMIC WAY OF THINKING

Disagreement: Normative versus Positive

Economists sometimes disagree about assumptions and models and also about what policy to use.

Some disagreements can be settled by appealing to further facts, but others cannot.

Disagreements that can't be settled by facts are *normative statements*—statements about what *ought to be*.

Disagreements that *can* be settled by facts are *positive statements*—statements about *what is*.

1.2 THE ECONOMIC WAY OF THINKING

<Economics as Policy Tool

Economics provides a way of approaching problems in all aspects of our lives:

- Personal
- Business
- Government

Should you take out a student loan?

Is Clayton Kershaw worth \$11 million?

How can the government balance its budget?



EYE on the BENEFIT AND COST OF SCHOOL

Did You Make the Right Decision?

Does school provide a big enough benefit to justify its cost?

The **benefits** of being in school include the present enjoyment of student life and a higher future income.

The **costs** of being in school for a full-time student include tuition, books, other study costs, and forgone earnings.

Is school always best?

The costs are incurred now, but the benefits accrue over a working lifetime.

For most people, the net benefit is big!



EYE on the BENEFIT AND COST OF SCHOOL

Did You Make the Right Decision?

Is school always best?

Bill Gates quit Harvard; Mick Jagger quit the London School of Economics; Clayton Kershaw turned down a scholarship at Texas A & M!

All three expected the benefit from school to be less than the opportunity cost of being in school.