



foundations of
MACROECONOMICS

Fourth Edition

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Getting Started

CHAPTER 1



CHAPTER CHECKLIST

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

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

1.1 DEFINITION AND QUESTIONS



- You Can't Always Get What You Want
- I Can't Get No Satisfaction

1.1 DEFINITION AND QUESTIONS

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

■ Scarcity

The condition that arises because the available resources are insufficient to satisfy wants.

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



- **Choices? What choices? I make all the decisions.**

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* and the *incentives* that influence and reconcile our choices,

Two big economic questions:

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

■ When Is the Pursuit of Self-Interest 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

■ **Self-interest** is not the same as being “selfish”

Economists assume that **all people** take any action if their **perceived benefits \geq perceived costs**.

Perceived benefits are subjective, and can depend on caring for others.

Challenge – find an example from your life experience of someone who ever made a choice not in self-interest.

1.1 DEFINITION AND QUESTIONS

■ **Social interest**

Society consists of many individuals, and often choices by some conflict with interests of others.

In other times, a choice made in self-interest benefits others.

In general, economists define an improvement in **social welfare** if some choices lead to improvement in the welfare of all individuals in the society.

1.2 THE ECONOMIC WAY OF THINKING

■ Core Economic Ideas:

- Rational choice
- Cost
- Benefit
- Margin
- Incentives

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.

A rational choice promotes **self-interest**.

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

In this course we assume that all people make rational choices, that is everybody acts in self interest.

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.

Sunk cost is a previously incurred and irreversible cost.

A sunk cost is not part of the opportunity cost of a current choice.

1.2 THE ECONOMIC WAY OF THINKING

■ Benefit: Gain Measured by What You Are *Willing to Give Up*

Benefit is the gain or pleasure that something brings (can include perceived benefit from caring about others).

■ On the Margin

Most choices we make are not **all-or-nothing**, but we choose the best amount. In this case, our comparison involves **marginal cost vs. marginal benefit**.

1.2 THE ECONOMIC WAY OF THINKING

Marginal Cost

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

Marginal Benefit

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

1.2 THE ECONOMIC WAY OF THINKING

Example: how much pizza should I eat during the Super Bowl?

Slice #	Marginal Benefit from a slice of pizza	Marginal Cost of a slice of pizza
1.	\$10	\$5
2.	\$7	\$5
3.	\$5	\$5
4.	\$1.25	\$5

1.2 THE ECONOMIC WAY OF THINKING

Making a Rational Choice

When we take those actions for which marginal benefit exceeds or equals marginal cost.

■ Responding 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



- “Make him an offer he can't refuse”

1.2 THE ECONOMIC WAY OF THINKING

■ Micro and Macro Views of the World

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.

1.2 THE ECONOMIC WAY OF THINKING

■ Economics as a Social Science

Economists distinguish between

- Positive statements: What *is*
- Normative statements: What *ought to be*

The main task of economic science:

To test **positive statements** about how the economic world works and to weed out those that are wrong.

1.2 THE ECONOMIC WAY OF THINKING

Unscrambling Cause and Effect

The central idea that economists use to unscramble cause and effect is *ceteris paribus*.

Ceteris paribus means “other things being equal.”

By changing one factor at a time and holding other relevant factors constant, we are able to investigate the effects of the factor.

1.2 THE ECONOMIC WAY OF THINKING

In the real world, we observe the outcomes of simultaneous operation of many factors.

To sort of the effects of each factor, 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

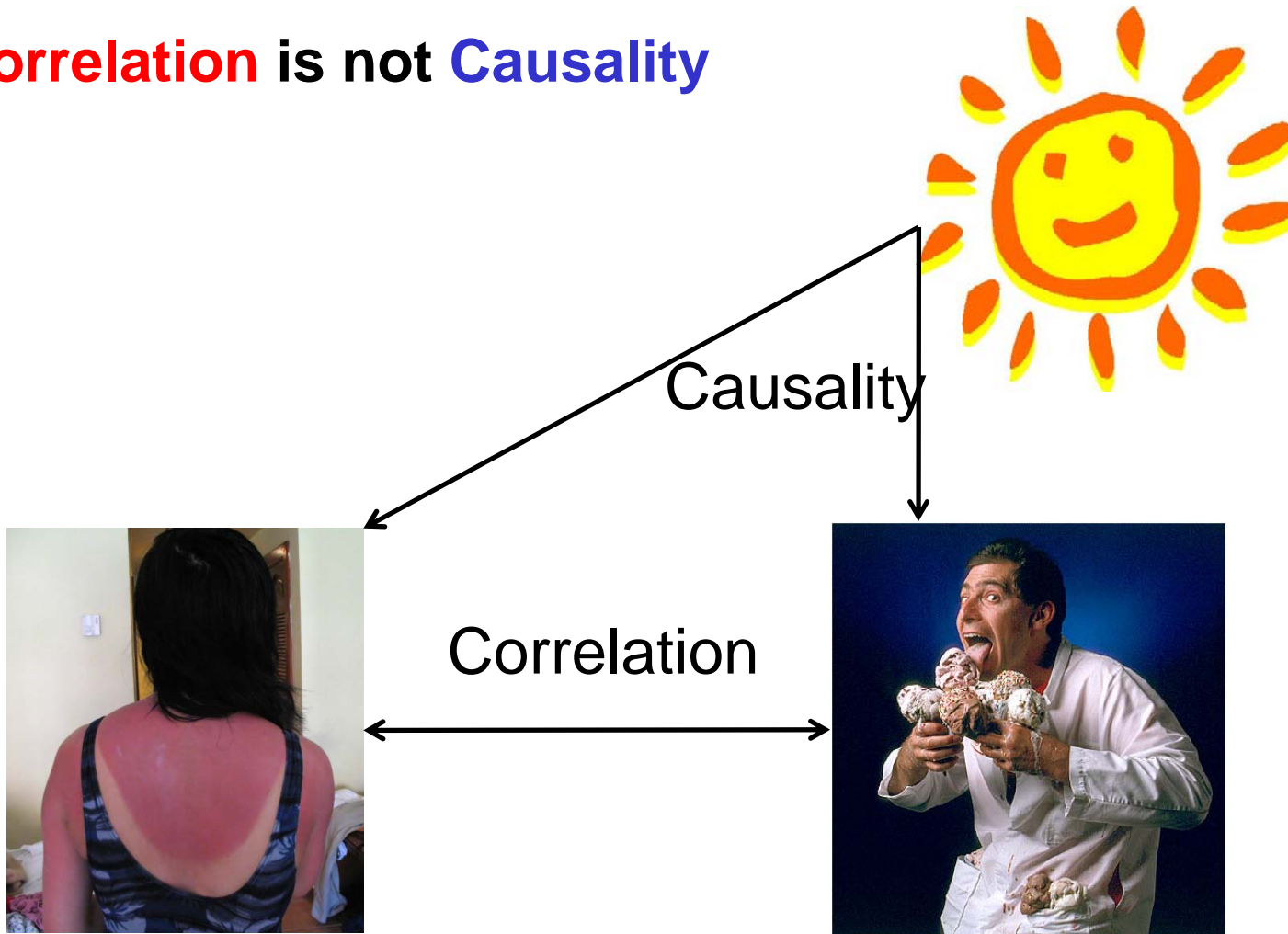
A statistical investigation looks for a correlation.

Correlation is the tendency for the values of two variables to move 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

Correlation is not **Causality**



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, and government.