Test Yourself: Core Concepts Part I

If all economists were laid end to end, they would still not reach a conclusion.

GB Shaw

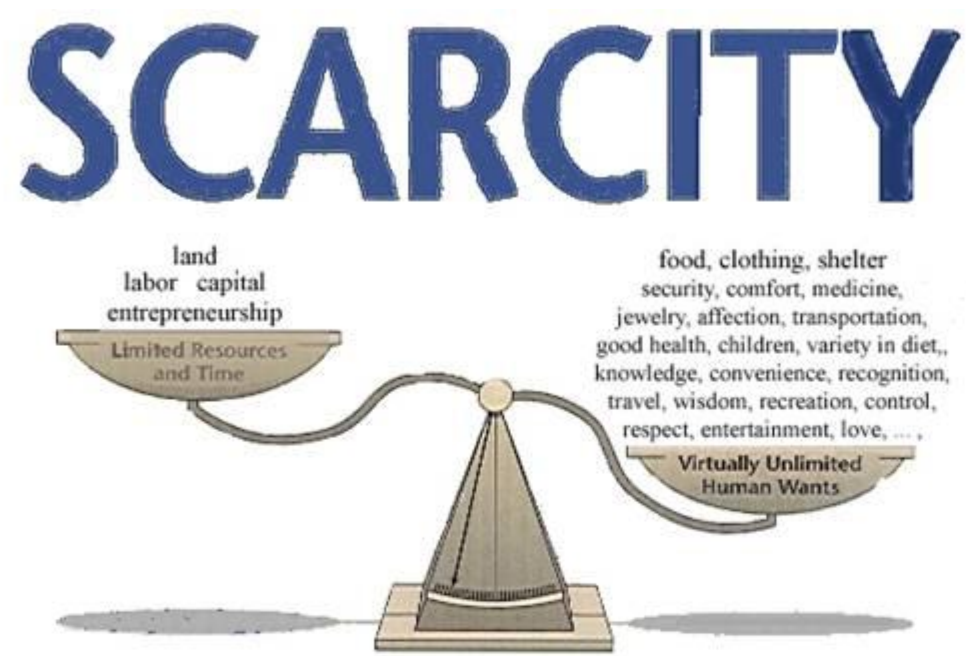
What is the
central problem of economics?

The central problem of economics is providing for people's wants and needs in a world of scarcity.

What is meant by scarcity?

Scarcity is the condition in which wants are always greater than the available supply of time, goods and resources.

Scarcity forces us to make choices.



What are resources?

Resources are the basic categories of inputs used to produce goods and services.

They include the following.

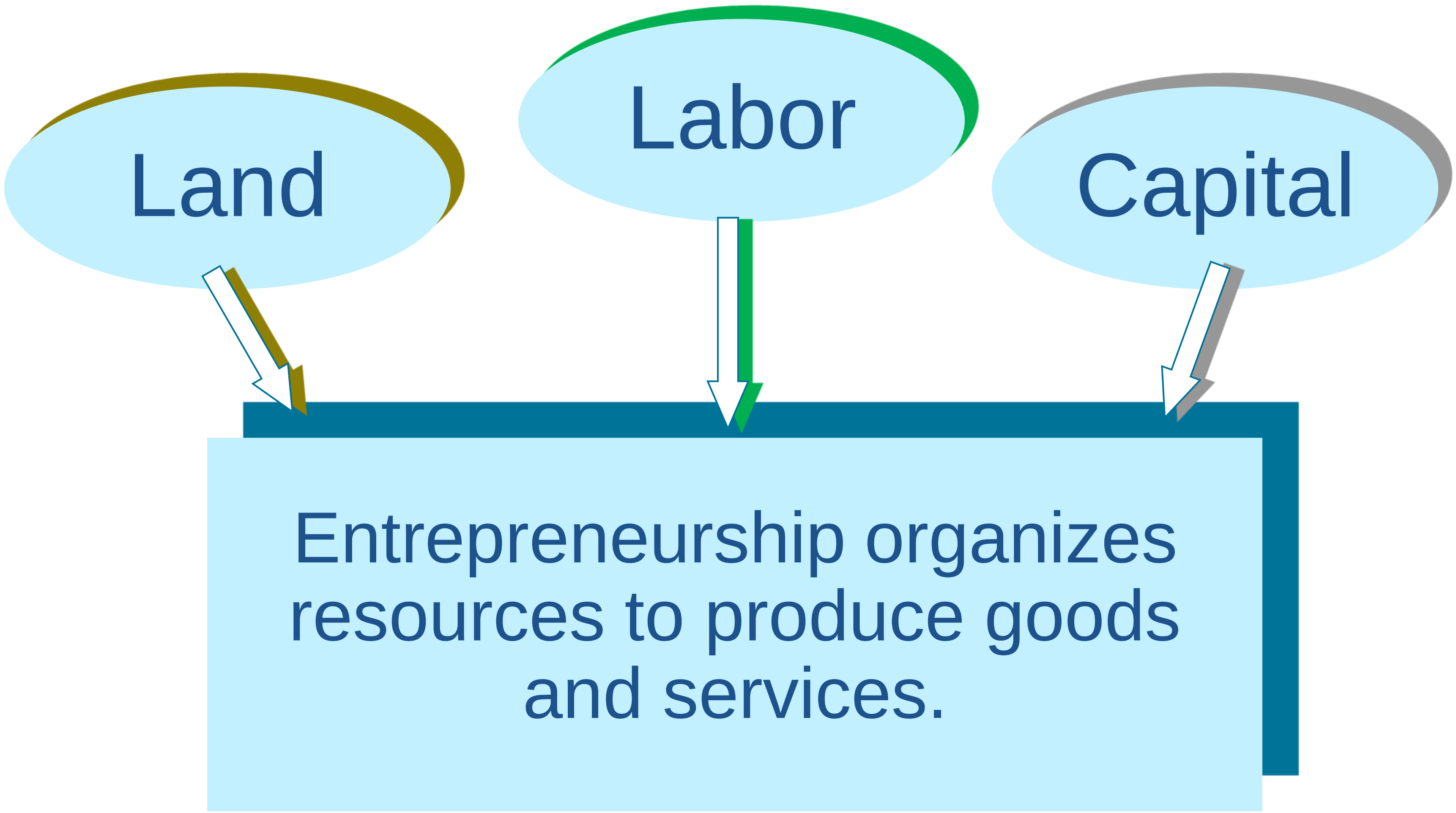
Land is a shorthand expression for any natural resource provided by nature.

Labor is the mental and physical capacity of workers to produce goods and services.

Capital includes the physical plants, machinery and equipment used to produce other goods. Capital does not directly satisfy human wants. Financial capital is the money used to purchase capital. Financial capital by itself is not productive … it is a paper claim on capital.

Entrepreneurship is the creative labor of individuals that enables them to seek profits by combining resources.

Graphic: The Resources Used to Produce Goods and Services



What is economics?
What is macroeconomics?
What is microeconomics?

Economics is the study of how society chooses to allocate its scarce resources in order to satisfy unlimited wants and needs.

Macroeconomics is the branch of economics that studies decision-making for the economy as a whole.

Microeconomics is the branch of economics that studies decision-making by a single individual, household, firm, industry or government.

What is an economic model?

An economic model is a simplified description of reality used to understand and predict the relationships between variables.

The purpose of an economic model is to *forecast* or *predict* the results of various changes in variables.

What are the two common pitfalls in understanding how the economy works?

The two common pitfalls in understanding how the economy works are (1) failing to understand the *ceteris paribus* assumption and (2) confusing *association* with *causation*.

What is *ceteris paribus*?

Ceteris paribus is a Latin phrase that means even when some variables change, “all other things remain the same.”

For example, if the price of new Ford cars decreases and everything else stays the same, consumers will buy more new Ford cars. If other variables change, we cannot make a prediction.

What is the difference between *association* and *causation*?

We cannot always assume that when one event follows another, the first caused the second.

Just because two things are associated – by timing or anything else – does not mean there is a causal relationship.

What is positive economics?

Positive economics is an analysis limited to statements that are verifiable (provable).

What is normative economics?

Normative economics is an analysis based on someone's value judgment.

Therefore it is not verifiable and not necessarily correct.

When opinions or points of view are not based on facts, they are scientifically untestable.

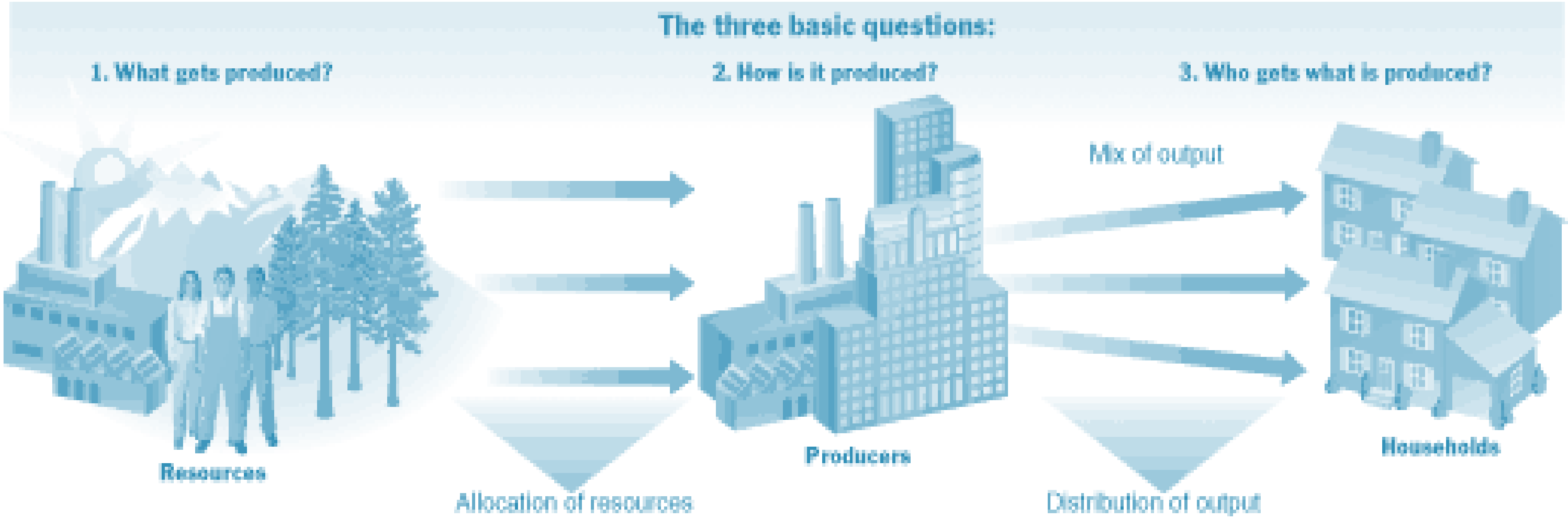
What are the three fundamental economic questions?

Three fundamental economic questions are:

What to produce?

How to produce?

For whom to produce?



What is opportunity cost?

Opportunity cost is the best alternative sacrificed for a chosen alternative.

If you spend your last $50 buying your economics textbook instead of paying your electricity bill, the opportunity cost of buying your textbook is an unpaid electricity bill. In economics the total cost of your textbook is $50 plus your unpaid electricity bill.

Opportunity cost is *not always money*. It can also be the most desired activity that you are giving up.

If you stay up all night so you can study for and pass your economics exam, your opportunity cost of passing the exam is a full night's sleep.

What is
marginal analysis?

Marginal analysis is an examination of the effects of an addition to or subtraction from a current situation … analyzing the margin.

Marginal changes are small, incremental adjustments to an existing plan of action. Marginal thinking requires decision-makers to evaluate whether *the benefit of one more unit of something is greater than its cost.*

In the situation below, thinking about the benefit and cost of whether to add each additional hour is marginal analysis.

Options	Benefit	Opportunity Cost
1st hour of extra study time	Grade of C on test	1 hour of sleep
2nd hour of extra study time	Grade of B on test	2 hours of sleep
3rd hour of extra study time	Grade of B+ on test	3 hours of sleep

What is a production possibilities curve?

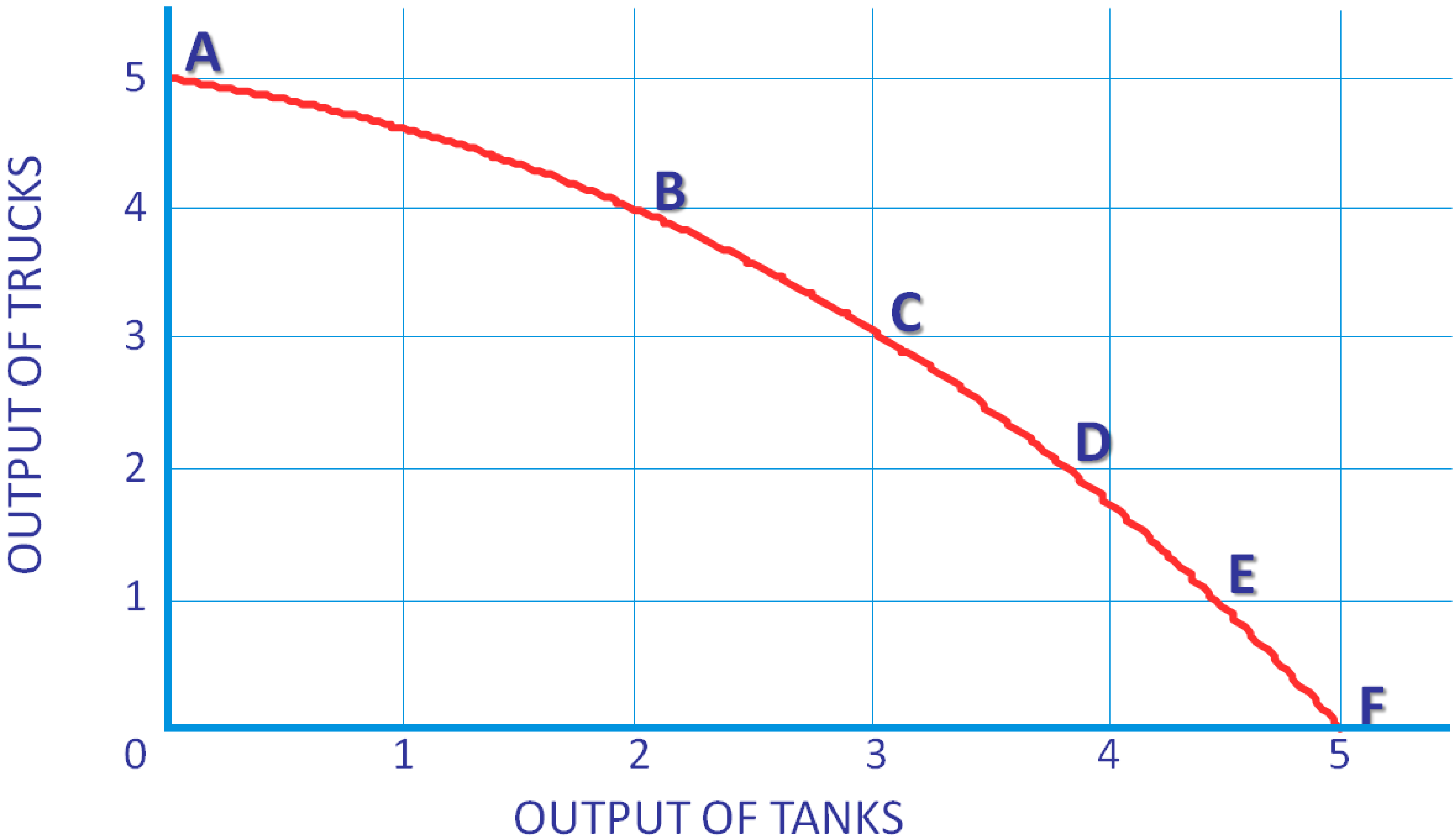
A production possibilities curve is a curve that shows the maximum combinations of two outputs that an economy can produce, given its available resources and technology.

Technology is the body of knowledge and skills applied to how goods are produced.

The productions possibilities curve assumes a situation in which *resources are fixed* and *fully-employed* and *technology is unchanged*.

Scarcity limits an economy to the points *on or below* its production possibilities curve.

Chart: The Production Possibilities Curve

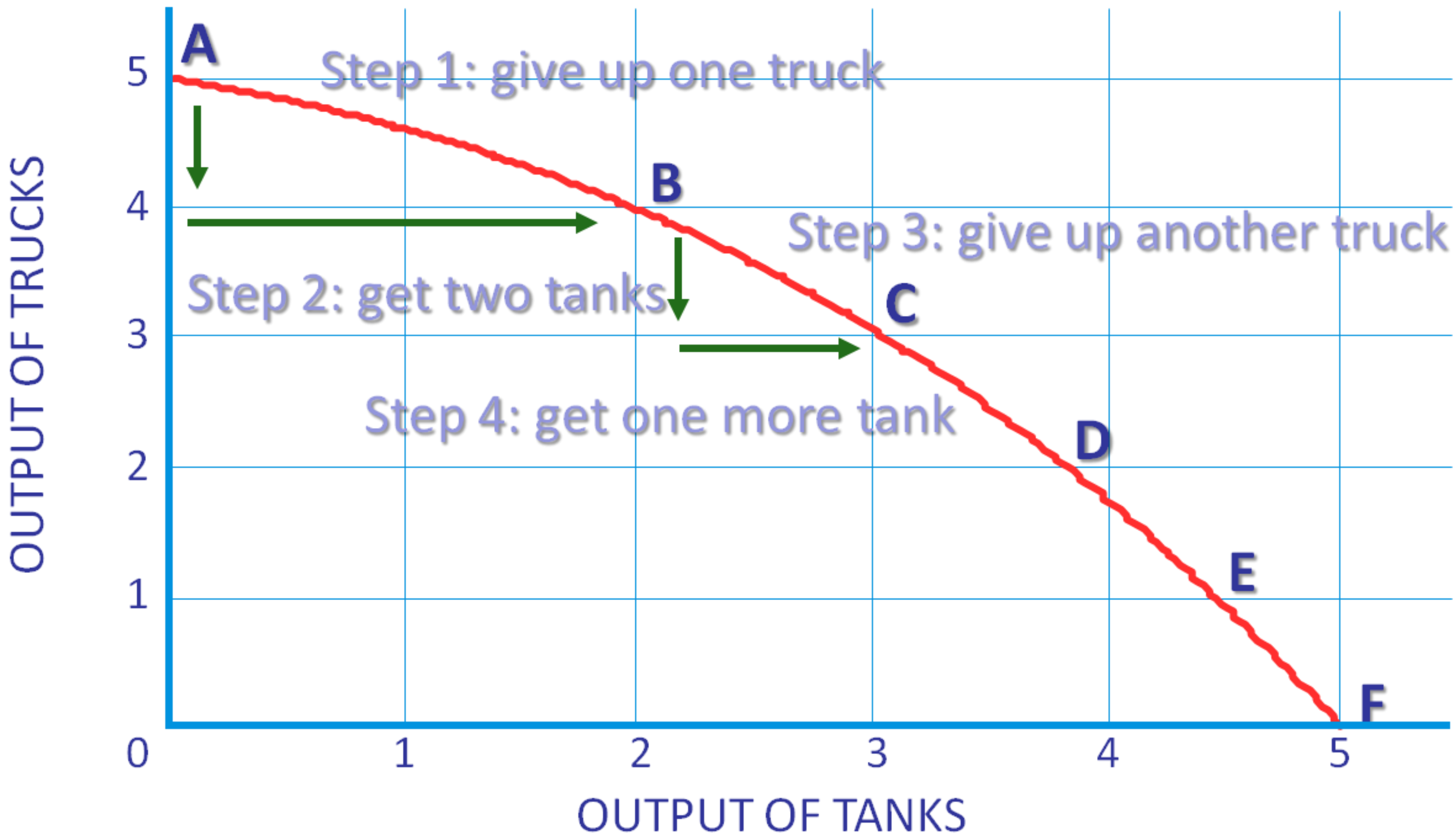


What are efficient points?

Because all the points along the production possibilities curve are maximum output levels with given resources and technology, they are called *efficient points*.

A movement between any two efficient points on the curve means that more of one product is produced only by producing less of the other.

Chart: The Production Possibilities Curve



What is the law of increasing opportunity costs?

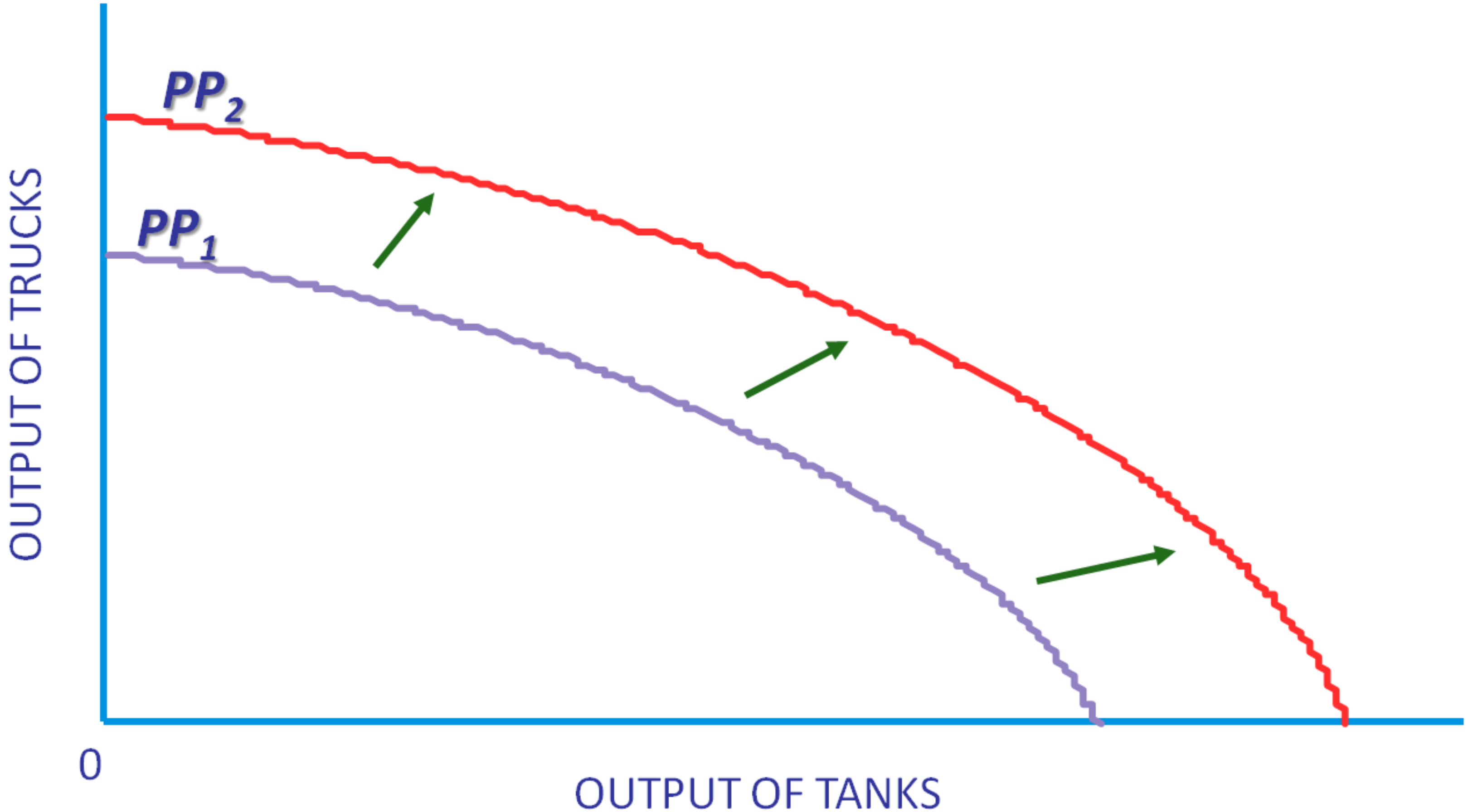
The law of increasing opportunity costs is the principle that the opportunity cost increases as production of one output expands. (See again the chart on slide 34.)

What is economic growth?

Economic growth is the ability of an economy to produce greater levels of output. It is an expansion of production possibilities and an outward shift of its production possibilities curve.

One of the variables that makes economic growth possible is research in and the development of new technologies. When an economy does not invest in new technology, everything else being equal, the economy will not grow.

Chart: Economic Growth



CONTINUED IN TEST YOURSELF: CORE CONCEPTS PART II