Lecture 2.
Economic Thinking (cont’d)
What is Economics?

Clicker Question
Announcements

- Please read announcements on the course website every Monday, Wednesday and Friday.
  
  http://sites.bu.edu/manove-ec101/

- Check your problem-set assignments on Friday evenings on the course website under Classes > Problem-Set Assignments.

- We use Blackboard only to register clickers and display exam scores.

- Discussion sections start next week, Tue, Dec 12.

- Purchase your clickers when you are sure you will stay in the course.

Thinking Like an Economist (Continued)

- So far, we’ve covered three useful principles of economic thinking.
  
  1. Think about the goods (not the money).
  2. Everything has a cost.
  3. People respond to incentives—sometimes in unexpected ways.

- Now we will add three more principles.
4. Prices that reflect ALL opportunity costs provide the best incentives.

- Should drivers have to pay tolls for using highways?

- Should universities be free?
  - We will discuss the cost of attending university later in the course.

**Clicker Question**
Example: Highway Tolls

- Are highway tolls necessary for good highway management? Why?
  - Taxes can be used for funding highway maintenance and law enforcement.
  - But tolls are the best way to reduce highway congestion.
  - Does highway congestion have a cost?
  - Highway tolls (the prices) should cover the cost of congestion.
  - Who is willing to pay high tolls? Who isn’t?

5. Statistical findings are often misleading.

Example: What should you conclude from the following statement?
Clicker Question

What is Economics?
My Own Definition of Economics

Economics is the *scientific study of human behavior* associated with the *production and distribution* of the *“necessities and conveniences of life.”*

I’ll explain each of the *italicized* terms in reverse order in the next few slides.

“*necessities and conveniences of life.*”

- refers to the goods and services that people need or want (for example: *bread, clothes, music*).

- The phrase was contained in the first sentence of *Adam Smith’s* 1776 book, *An Inquiry into the Nature and Causes of the Wealth of Nations*
Production

What is production?

It is the *transformation* of some goods and services (inputs) to other goods and services (outputs).

Example: Pizza Production

Distribution

In primitive economies, people produce for themselves and consume most of their own production.

In more complex economies, efficient *specialist producers* use *large quantities of inputs* to produce *large quantities of outputs*.

Outputs must be distributed to consumers.

Inputs must be distributed to producers.
**Human Behavior**

- Economics is *not* about production technology—that’s engineering.
- It’s *not* a study of the things people buy.
- It *is* about *how people organize themselves* for the production and distribution of goods and services.
- It *is* about *what people do* in order to create necessities and conveniences.
- It *is* about an aspect of human behavior.

**Scientific Study**

- Economics is *not* about how to run a business—that’s Management.
- It’s *not* about how to make money.
- It *is* an observational science like astronomy and meteorology (the science of weather).
- Experiments are less common in economics than in biology, physics and chemistry.
- But like other sciences, economics uses **models** as a basic tool.
Scientific Models:
- Models are similar to real-world objects in details that are important to the intended analysis...
- but simpler in details unimportant to the analysis.
  - model airplanes vs. real airplanes
  - mice vs. human beings
- *Economists prefer mathematical models:* $Q = f(p)$, etc.
Economic Agents

- The word “agent” is economic jargon for a person or group that plays an active role in the economy.

- We describe three important types of agents.
Households
- individuals living alone, or
- small groups living together (often related) and making joint economic decisions.

Firms
- individuals producing alone, or
- groups of people producing together.

Governments
- Groups of people who jointly regulate households and firms.
- Governments may be viewed as specialized firms with regulatory functions.
- Governments also provide public goods, [to be discussed later].

Households, firms and governments are
- composed of many of the same people,…
- playing different roles.
Wealth

- Wealth refers to the *capacity* to create valued goods and services.

- Wealth takes many forms: some physical, some intangible.
  - **Physical capital**: buildings, roads, machines, ships, cars, stores and warehouses filled with goods;
  - **Human capital**: education and training, which makes people more productive;
  - **Social capital**: productive social networks or relationships. *Trust in other people* and *good government* are important types of social capital.

- Think of wealth as the *tools* that make societies more productive.

- Where does wealth come from?

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Capital Formation: the Creation of Tools

- Capital formation is an economic process that occurs over time.

- The nature of capital formation is
  1. sacrifice now,
  2. have more later.

- Capital formation is the most important way that poor countries become rich countries.
**Capital Formation Example: The Rabbit Hunter**

- There was a cave woman who hunted rabbits for a living.

- When she saw a rabbit she would dive and try to grab it.

- Usually the rabbit escaped, and the hunter ended up with scrapes and bruises.

- But when she caught the rabbit, she would dash its brains out on the rocks,…

- …skin it, and tear off and eat the raw meat.

- On the average, she caught only one rabbit a week—so she was always hungry.

- She decided she could do better, …

- and she engaged in the process of capital formation.
The cave woman decided to make a **sling** *(physical capital)*…

and become a **sling expert** *(human capital)* in order to hurl stones at the rabbits.

While she was *making the sling* and *learning to use it* *(investing)*, she couldn’t hunt much, …

…so she had to *sacrifice* some of her already low consumption *(saving)*.

But when the sling was completed, she could use it *to kill one rabbit every day*,…

… so she had a lot more to eat *(returns to capital)*.

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**Clicker Question**
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