

About Understanding Economics

BASIC ECONOMIC CONCEPTS

- **Needs and Wants:** Needs are items that are required to survive. In economics, this is a short list. Water, food, clothing, shelter, and medical care are basic needs. Anything else is a want, not a need. Items that make life easier or more pleasant—automobiles, cell phones—are classified as wants. Wants are items that people enjoy having but do not need to survive. For example, clothing is a need, but fashionable clothing is a want. Economists consider needs and wants to be unlimited—in other words, people will never have all their needs and wants met.
- **Consumers and Producers:** Consumers buy goods and services to meet their needs and wants. Producers make and sell goods or provide services. When people make purchases, they are consumers. Producers become consumers when they purchase resources to make goods or provide services—e.g., a bakery buys flour to use to make bread.
- **Goods and Services:** Goods and services are the two categories of things that are produced and consumed. Goods are physical or tangible items that can be possessed, bought, and sold; services are tasks that people carry out for others. Goods and services are differentiated based on four qualities: (1) tangibility—goods are tangible, services are not; (2) perishability—goods continue to exist for a time after purchase, while services perish as soon as they are carried out; (3) separability—goods can be stored for later use, while services are used at the time of purchase; and (4) standardization—the quality of a particular good is fairly standard, while the quality of a service can vary each time it is delivered.
- **Resources:** Resources are supplies of things used to create goods and services. Unlike wants and needs, all resources are limited. There are several different kinds of resources:
 - Natural resources come from nature and include lumber, raw materials, fish, soil, minerals, and energy resources. Natural resources can be renewable or nonrenewable. Renewable resources, such as trees, can be replenished. Nonrenewable resources, such as oil and coal, cannot.
 - Capital resources are items that are required to produce goods or services. These include factory machinery, office buildings and equipment, vehicles and fuel, and tools. Money is often also considered a capital resource.
 - Human resources (sometimes called labor) include the people who produce goods and services and their skills, abilities, and knowledge.
- **Supply and Demand:** The supply of a commodity is the total amount that producers are willing and able to offer to consumers at one time. The demand is how much consumers would buy. Supply and demand help establish the price of goods and services. The laws of supply and demand state that if supply exceeds demand, prices fall, and if demand exceeds supply, prices rise. When

prices rise, supply rises because producers see a greater possibility for profit. However, as prices rise, consumers buy less. This dynamic guides buyers and sellers toward an equilibrium price—a price at which the quantity supplied and the quantity demanded are the same.

- **Scarcity:** Scarcity is the economic fact that there are limited resources to fill unlimited wants and needs. Scarcity is often called the “basic problem of economics.” Because of scarcity, every economic decision involves a trade-off.
- **Opportunity Cost:** When we make an economic choice, we leave behind other options. Presumably, we choose the option that appears to provide the greatest benefits. The options we do not choose also offer benefits, which we miss out on. Opportunity cost is the value or benefits of the alternative we did not choose.

The Three Economic Questions

All economic systems must answer three basic questions:

- What to produce—What needs and wants will be addressed? What goods and services will address them? On what basis will producers make those decisions? How much will be produced? For instance, will they choose to supply candy, bread, or sports cars, and in what amounts?
- How to produce it—Who will produce goods and services, where will they produce them, and what methods will they use? Will the government tell people which jobs to take and what to make, or will businesses be privately owned and free to make their own decisions?
- For whom to produce it—How will products be distributed among consumers? For instance, will goods be given freely to everyone, given only to selected people, or sold to the highest bidder?

Different economic systems answer these questions in different ways. For example, in a command economic system, a central authority—usually the government—controls most resources and decides how they will be used. In a market economic system, private businesses and individuals own resources and decide how to use them; to a large extent, the questions are answered through the operation of the laws of supply and demand. Mixed systems combine elements of both command and market systems to various degrees. Most economic systems in the world today are mixed systems.

Economic Choices

Because of scarcity, we cannot have everything we want or need. We must make trade-offs and choices about what we buy and what we do. A *trade-off* means sacrificing something to obtain something else: you can spend your bus fare on a coffee, but then you will have to walk to work. When we choose to buy one item rather than another, we are placing a greater value on the item we buy. What we give up is what economists call *opportunity cost*. If you choose to ride the bus rather than buy the coffee, the coffee is your opportunity cost.

Often, our economic choices are based on the amount of money we have in hand. A budget can help us make responsible economic choices. A *budget* is a plan for how to best use our money and time to meet our needs and wants. Cost is a key factor in budgeting, but so are needs and wants. For example, cereal might cost less than eggs, but you might enjoy eggs more. Will you have eggs, or will you have cereal and a bit of extra cash you can use for something else? Your choice will reflect how much you value eggs as opposed to cereal and savings. Similarly, organic food products often cost more than nonorganic products, but a person who values the benefits to health and the environment that they associate with organic products will choose to pay that additional cost.

METHODS OF EXCHANGE

Barter

Barter is the oldest form of exchange, dating back thousands of years. It involves the trading of goods or services between two or more parties without the use of money or credit. Ancient Mesopotamians were bartering nearly eight thousand years ago. Barter was later adopted by Phoenicians, who in turn spread the practice throughout the Mediterranean and beyond. In the Middle Ages, European traders used barter to obtain silk, perfume, and spices from Asia and Oceania in exchange for furs and crafted goods. Indigenous peoples of the Americas bartered with each other and later with European colonists.

One major advantage of barter is that it does not involve cash. People without money, or with different kinds of money, can still get what they want and need. Barter can also create close relationships between the individuals and/or groups involved in the exchange. However, in order to get what you need through barter, you must first find someone who is willing and able to provide the goods or services you need and who needs the goods or services you can offer. It can also be difficult to assign value to goods that are bartered. For example, how much butter or pet-sitting would you trade for a haircut? And unlike money, some goods are not easily divisible.

Money

Money is an object that has a value placed on it, which allows it to be exchanged for goods and services. Money was first invented about five thousand years ago in Mesopotamia. Before then, people satisfied their wants and needs through barter. Using objects with set values, such as coins, made it easier for different groups to compare the values of goods and trade for goods and services.

In addition to making it easier to compare values, money is simple and convenient to use. Money is widely accepted as a means of exchange. Transactions can be carried out quickly and efficiently with money. However, money also has some disadvantages. For example, it can be very difficult to use money outside of the country that issued it. Money can easily be lost or stolen. If the government prints too much money, it can lose its value, causing inflation; if it prints too little money, businesses can find it hard to borrow and invest, resulting in a recession and unemployment. It can be difficult to use bills and coins to pay for items that are very expensive. It is also hard for people to obtain what they want and need without money.

Credit

Credit is a type of loan. It allows people to borrow money to make purchases. Lending and credit are thousands of years old. The first loans can be traced back nearly four thousand years to ancient Mesopotamia. Farmers would borrow seed with the promise of repayment later. Over time, different types of credit emerged, but all have the same basic premise: customers borrow money and promise to repay it later with interest.

Credit allows people to get what they need without having the money in hand to pay for it. This is especially useful for expensive items; few people have enough cash on hand to buy a car or a home outright, and saving for these items can take years. The obvious disadvantage of credit is that it can be overused. It is easy to pile up a large amount of debt that cannot be repaid. Another disadvantage of credit is that in most cases, the amount borrowed must be paid back with interest. When interest is added to the purchase price, buying on credit results in consumers paying more for an item than it originally cost. Note that with credit cards, if the full balance is paid each month, no interest accumulates. Because of its convenience, credit can also tempt people into buying things they do not really need.

THE MARKETPLACE

A market is a place where people buy, sell, and trade goods. The term *market* can refer to a physical space such as a grocery store or restaurant, a virtual market where there is no physical contact, or a specific portion of the economy such as the housing market. It can also refer to the stock market, where people buy and sell securities.

In all cases, markets provide a way for buyers and sellers to interact, agree on the prices of goods and services, and make exchanges, or transactions. In a market, the main influences on prices are supply and demand. Supply and demand change continually based on consumer preferences and the availability of resources. Therefore, markets are always in flux to some degree. Different products, services, and buyers continually enter and leave the market.

Markets are also highly influenced by consumers' standard of living. *Standard of living* is a measure of the quality of life enjoyed by a given population. It is related to the quantity and quality of goods and services available to a given population. Other factors that help determine standard of living include income, health, life expectancy, housing, access to health care and education, and political and social freedom. Generally, if the standard of living for a given population is fairly low, the market will reflect that by offering more basic goods and services that satisfy needs and fewer nonessential goods and services that satisfy only wants.

Government Influence

The government can influence the market and standard of living in many different ways. For example, government investment in infrastructure lowers production costs and makes more resources more easily available to producers, contributing to lower consumer prices and more variety in available goods. Government agencies such as the Federal Reserve, FDIC, and SEC protect financial markets from unfair practices and from actions that could hurt the economy. Government-issued and government-guaranteed business loans increase the number of sellers and therefore the quantity and variety of goods and services available to consumers. Government-sponsored education increases the value and productive capacity of the country's human resources. Laws restricting the sale of items that are unsafe or unhealthy improve standard of living, as do workplace safety and environmental regulations that limit producers' choices about where and how they will produce goods and services and how they will handle waste. Government-mandated minimum wages, Social Security, Medicare, and worker's compensation programs help ensure that workers have at least some income to spend in the marketplace to meet their needs and wants. Government assistance programs such as Medicaid, SNAP (Supplemental Nutrition Assistance Program, formerly known as food stamps), and TANF (Temporary Assistance for Needy Families) help people meet their needs when they cannot work.

The Influence of Climate Change

Climate change is already impacting the marketplace and is projected to continue to influence the economy going forward. Temperature increases, rising sea levels, and more extreme weather have already damaged property and infrastructure (roads, highways, bridges, power systems, etc.), disrupting supply chains and natural systems around the world. Rising prices and shortages of consumer goods have already been felt in the marketplace. The demand for energy will likely increase as stress on utility systems will make them less reliable. In February 2021, for example, unexpectedly cold weather rendered the Texas electric grid unable to supply people in that state with sufficient power.

Temperature extremes will also likely begin to take a toll on people's health. It has been estimated that by 2090, more than two billion labor hours may be lost due to health issues caused by climate change, resulting in \$160 billion of lost wages. This will reduce both the ability of consumers to make purchases and the ability of producers to keep up with demand. A drop in supply will inevitably lead to higher prices.

Climate change also affects natural resources. Increased temperatures and risk of drought will impact agricultural output in many places. Rising sea levels threaten coastal communities and the consumers and producers who live and work in them. But it is not just coastal communities that are in danger. Climate change threatens forests, rivers, and oceans and the resources that are found there. A loss of already limited resources will force consumers and producers to make hard choices about how best to answer the three basic economic questions.

But we are not helpless in the face of these challenges. Governments, businesses, and communities around the globe are taking action to slow or stop these changes and minimize their impact, including but not limited to clean energy initiatives, resource management, and infrastructure updates.

EXAMPLES OF ECONOMICS IN AMERICAN HISTORY

Economics has always played a part in American history, from its earliest Indigenous civilizations until today. Note that the examples provided in the Student Reader are meant to illustrate different economic systems and changes over time. They are not meant to be a comprehensive explanation of the development of the U.S. economy.

Native American Economies

Indigenous groups traded with each other for thousands of years before the arrival of Europeans in the Americas. Native peoples relied on the land and its flora and fauna to supply their wants and needs, adapting to the environment as necessary. People in the Northeast and Southeast took advantage of abundant fishing and fertile land to create permanent villages. People of the Great Plains, lacking these resources, relied more on hunting and were largely nomadic. All groups used materials at hand to make clothing and tools and build shelter, which varied widely from place to place.

Virtually all Indigenous groups engaged in trade. Skins and furs, meat and other foodstuffs, feathers, salt, shells, and pottery were commonly traded goods, as were various minerals and precious metals such as copper, obsidian, turquoise, and malachite. Trade networks could extend for hundreds of miles. Great Lakes groups traded with peoples in the coastal Southeast. Southwestern groups ventured into Mesoamerica. Northwestern groups traded the highly coveted eulachon fish all along the Pacific coast. Perhaps the most important trading hub in precolonial North America was the Mississippian city

of Cahokia, located near present-day St. Louis. Trade served not only an economic function among Indigenous peoples but also a diplomatic function. Groups that traded regularly with one another attempted to maintain peaceful relations with each other.

European Exploration and Colonization

During the Middle Ages, Europe developed a growing interest in and trade relationships with Asia. By the 1300s CE, several Italian city-states had become strong and powerful as a result of this trade. Other nations, such as Spain, Portugal, France, the Netherlands, and England, also wanted to use trade to expand their reach and to gain economic power. The Italians dominated the land trade through the Middle East to Asia. By the 1400s CE, advances in technology (e.g., compass, astrolabe, better maps) allowed Spanish and Portuguese explorers to venture farther from shore and eventually to seek oceanic trade routes to Asia.

Christopher Columbus's arrival in the Americas in 1492 began a wave of colonization in the Americas. Spain gained the early upper hand, creating a vast empire called New Spain that spread across the Caribbean, Central America, Mexico, and the southwestern United States. Portugal also created its own large empire, in modern-day Brazil. An exchange of plant and animal species, goods, and ideas between the Americas and the rest of the world, known as the Columbian Exchange, was the result. The Columbian Exchange fueled further interest among other European powers—particularly France, England, and the Netherlands—in establishing colonies in the Americas in order to gain access to this new source of raw materials and wealth. European warfare against Native Americans and the introduction of diseases to which they had little immunity led to massive numbers of Indigenous people dying.

Europe's trading nations based their policies on the economic theory of *mercantilism*. Mercantilists argued that nations became powerful by building their supply of gold and silver, which were generally obtained through trade. The path to that goal, they believed, was to export more goods than were imported. In this thinking, national and business interests aligned, and governments were heavily involved in the economy, supporting businesses that produced goods for export. Colonies were an important part of the mercantilist system because they provided the home country with not only gold, silver, and raw materials but also a market for the manufactured goods made with those raw materials.

The Spanish Mission System

Spain's exploitation of people and resources in the Americas brought it great wealth. The Spanish almost immediately began establishing a system of missions throughout New Spain. One purpose of the missions was to convert Indigenous people to Christianity. Another purpose was to "civilize" Native peoples, integrating them into Spanish political, economic, and cultural systems (though certainly not as social equals). The presence of missions throughout the Americas also helped establish Spanish claims to the region, discouraging other European nations from colonizing the same places.

Each mission was a small compound that included a church, a small town, and fields to grow crops. Native peoples lived and worked in the missions (often in overcrowded conditions), growing crops, raising livestock, and learning various trades in addition to receiving religious training. They also learned Spanish. Life within the missions was highly structured: prayer, work, training, and meals. Though some missionaries treated Native people kindly, Indigenous people were often forced to work on the missions. Those who refused to convert to Christianity were frequently beaten or even killed.

British Colonial Policy and the American Revolution

British colonial policy was largely driven by mercantilist principles. Passed in the 1660s, the Navigation Acts prevented colonists from trading with any other nation but Great Britain. The British government dictated to colonists how to use resources and for what purposes. Because of trade restrictions, colonists were also wholly dependent on Britain for manufactured goods.

Because Britain was almost continually at war during the 1600s and 1700s, it had a great need for money to pay war debts. Particularly after the French and Indian War, which ended in 1763, Britain imposed a series of laws and taxes on the colonies to help raise money to pay the cost of the war and to maintain its military presence in North America. The British saw these efforts as beneficial to the colonists; the colonists had different views, and British economic policy created tension between them and the British government.

Colonists objected not only to being forced to pay taxes without having representation in British government but also to the mercantilist policies that restricted commerce and stopped colonial farmers, entrepreneurs, merchants, and tradespeople from maximizing their profits from their own labor. These restrictive economic laws and policies led to several small colonial uprisings and ultimately to the American Revolution. Upon achieving independence, much of the United States implemented free-market economic practices, but it also maintained a system that relied on unpaid, enslaved labor.

Industrialization

Industrialization drastically changed the U.S. economy, transforming the country from an agricultural society to an increasingly industrial one. During the late 1700s and 1800s, innovations in farm machinery allowed more land to be worked with fewer people, putting millions out of work. In search of factory jobs, they moved to urban areas, where they competed with large numbers of immigrants from Asia and Europe.

The federal government passed laws to encourage industrial growth. Large corporations became an important part of the economy. To maintain profits, however, many businesses took advantage of the labor surplus and paid employees low wages while demanding long hours in unsafe working conditions. Women and children entered the workforce—and were paid even less than men. This exploitation, and the failure of government to protect workers, ultimately led to the rise of labor unions, which attempted to improve the lives of working people.

Though there was a wide income and cultural gap between wealthy industrialists and working people, the 1800s also saw the rise of a middle class of professionals such as office workers, teachers, and lawyers. Those who could afford to do so began moving out of the crowded cities and into suburbs. More efficient production of manufactured goods increased their supply, thus increasing the standard of living for many Americans. Leisure activities acquired mass audiences. Educational opportunities grew as well.

Globalization

The unequal distribution of resources around the world stimulates trade among countries. World trade involves the import and export of goods and services internationally, and trade supports specialization. The principle of comparative advantage states that countries should specialize in types of production in

which they have the lowest opportunity cost. These factors result in greater economic interdependence among nations and globalization.

Globalization involves more than just economics. Globalization involves the increasing interconnection of economic, political, and cultural factors. Events in one part of the world impact people in other parts of the world as never before. Improvements in communications and transportation over the past several decades have increased the speed of globalization. Ideas and culture, as well as goods and services, spread around the world quickly.

Positive effects of globalization include decreased manufacturing costs and a wider variety of consumer goods. Negative aspects of globalization include environmental damage from the increasing production and consumption of goods. The transition to a fully global economy also causes disruption of traditional societies and economic displacement as industries move among countries. Globalization also encourages a kind of cultural homogenization, particularly as Western ideas and institutions spread to countries around the world.