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What Economics is
Economics is the study of how human beings coordinate their wants and desires, given the decision-making mechanism, social customs, and political realities of the society

- The three central coordination problems any economy must solve:
  1. What, and how much, to produce
  2. How to produce it
  3. For whom to produce it

Scarcity
- Scarcity exists because individuals want more than can be produced
  - Scarcity means the goods available are too few to satisfy individuals’ desires
- The degree of scarcity is constantly changing
- The quantity of goods, services and usable resources depends on technology and human action

Modern Economics
- Economics, like any field of study, evolves and changes
- Modern economics is based both on deduction and induction
  - Deduction is a method of reasoning in which one deduces a theory based on a set of almost self-evident principles
  - Induction is a method of reasoning in which one develops general principles by looking for patterns in the data
  - Abduction is the combination of deduction and induction
A Guide to Economic Reasoning

An example of the economic decision rule:

- Steve Levitt's bestseller, *Freakonomics*, contains many examples of "thinking like an economist"
  - Levitt uses economic reasoning to explain why people become drug dealers
  - The potential financial benefit of selling drugs is much higher than the cost of giving up a minimum wage job

Marginal costs and marginal benefits

- Using economic reasoning, decisions are often made by comparing marginal costs and marginal benefits
  - **Marginal cost** is the additional cost over and above costs already incurred
  - **Marginal benefit** is the additional benefit above and beyond what has already accrued

Marginal costs and marginal benefits

The economic decision rule:

- If the marginal benefits of doing something exceed the marginal costs, do it.
  - **MB > MC** → Do it!
- If the marginal costs of doing something exceed the marginal benefits, don't do it.
  - **MC > MB** → Don't do it!
Opportunity Cost

- **Opportunity cost** is the benefit forgone of the next-best alternative to the activity you have chosen.
- Opportunity cost should always be less than the benefit of what you have chosen.
- Opportunity cost is the basis of cost/benefit economic reasoning.

Opportunity Cost

**Examples of opportunity cost:**

1. Individual decisions
   - The opportunity cost of college includes:
     - Items you could have purchased with the money spent for tuition and books.
     - Loss of the income from a full-time job.
2. Government decisions
   - The opportunity cost of money spent on the war against terrorism is less spending on health care or education.

Economic and Market Forces

- **Economic forces** are mechanisms that ration scarce goods.
- A market force is an economic force that is given relatively free rein by society to work through the market.
- The invisible hand is the price mechanism that guides our actions in a market. The invisible hand is an example of a market force.
  - If there is a shortage, prices rise.
  - If there is a surplus, prices fall.
Economic and Market Forces

- What happens in society can be seen as a reaction to, and interaction of:
  - Economic forces
  - Social forces
  - Historical forces
- Social, cultural, and political forces influence market forces
- Political and social forces often work together against the invisible hand

Economic Terminology

- Goal of this class is to describe how economics works in the real world
- You will be introduced to many terms that occur in business and in discussions of the economy
  - For example:
    - Opportunity cost
    - Marginal benefit and marginal cost
    - The invisible hand
    - Market and economic forces
    - ... and many more

Economic Insights

- Theories tie together economists' terminology and knowledge about economic institutions
- Theories are too abstract to apply in specific cases and are often embodied in economic models and principles
  - An economic model is a framework that places the generalized insights of the theory in a more specific contextual setting
  - An economic principle is a commonly held insight stated as a law or general assumption
Economist Do It With Models

\[ Y = C + I + G + (X-I) \]
This is the economic model for GDP!

Economic Insights
- Theories, models, and principles are continually tested to see if the predictions of the model match the data.
- Models lead to:
  - theorems (propositions that are logically true based on the assumptions of the model).
  - to arrive at policy precepts (policy rules that conclude that a particular course of action is preferable).
- These theorems must be combined with knowledge of real-world economic institutions and value judgments to determine economic goals for society.

The Invisible Hand Theory
- According to the invisible hand theory, a market economy, through the price mechanism, will allocate resources efficiently.
  - Prices fall when quantity supplied is greater than quantity demanded.
  - Prices rise when the quantity demanded is greater than the quantity supplied.
- Efficiency means achieving a goal as cheaply as possible.
Microeconomics and Macroeconomics

- Economic theory is divided into two parts;
  - **Microeconomics** is the study of individual choice, and how that choice is influenced by economic forces
  - **Macroeconomics** is the study of the economy as a whole

Microeconomics and Macroeconomics

- **Microeconomics** studies such things as:
  - The pricing policy of firms
  - Household’s decisions on what to buy
  - How markets allocate resources among alternative ends

- **Macroeconomics** studies such things as:
  - Inflation
  - Unemployment
  - Economic growth

Economic Institutions

- To apply economic theory to reality, you’ve got to have a sense of economic institutions
- **Economic institutions** are laws, common practices, and organizations in a society that affect the economy
- Economic institutions differ significantly among nations
- They sometimes seem to operate differently than economic theory predicts
Economic Policy Options

- **Economic policies** are actions (or inactions) taken by the government to influence economic actions.
- **Objective** policy analysis keeps value judgments separate from the analysis.
- **Subjective** policy analysis reflects the analyst’s views of how things should be.

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Economic Policy Options

**Objective Policy Analysis**

- To distinguish between objective and subjective analysis, economics is divided into three categories:
  1. **Positive economics** is the study of what is.
  2. **Normative economics** is the study of what should be.
  3. **Art of economics** is using the knowledge of positive economics to achieve the goals determined in normative economics.

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Chapter Summary

- Three coordination problems are what to produce, how to produce it, and for whom to produce it.
- Scarcity exists.
- Modern economists use abduction.
- Economic reasoning structures all questions in a cost/benefit framework.
- Opportunity costs exist.
Chapter Summary

- Economic, political, and social forces are always at work.
- Under certain conditions, the market, through the price mechanism, will allocate scarce resources efficiently.
- Economics is divided into micro and macroeconomics.
- Precepts are the guides for policies based on theories.
- Economics can be subdivided into positive economics, normative economics, and the art of economics.