CHAPTER 1

Economics and Economic Reasoning

In my vacations, I visited the poorest quarters of several cities and walked through one street after another, looking at the faces of the poorest people. Next I resolved to make as thorough a study as I could of Political Economy.

— Alfred Marshall

McGraw-Hill/Irwin

Chapter Goals

- Define economics
- Examine the three coordination problems all economies must solve
- Explain how to make decisions by comparing marginal costs and marginal benefits
- Define opportunity costs and explain its relationship to economic reasoning

Chapter Goals

- Explain real-world events in terms of:
  - Economic forces
  - Social forces
  - Political forces
- Distinguish between:
  - Microeconomics and macroeconomics
  - Positive economics, normative economics, and the art of economics

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 on 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

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

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 economic**s 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

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 theorem
- Economics can be subdivided into positive economics, normative economics, and the art of economics

Preview of Chapter 2:

The Production Possibility Model, Trade, and Globalization

- Demonstrate opportunity cost with a production possibility curve
- Discuss the increasing marginal opportunity cost
- Relate the concept of comparative advantage to the production possibility curve
- Show how through comparative advantage and trade, a country can consume beyond their production possibility
- Explain how globalization and outsourcing are part of a global process guided by the law of one price