CHAPTER
1

Economics and Economic Reasoning

Chapter Goals

- Define economics and identify its components.
- Discuss various ways in which economists use economic reasoning.
- Explain real-world events in terms of economic forces, social forces, and political forces.
- Explain how economic insights are developed and used.
- Distinguish among 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 mechanisms, social customs, and political realities of the society.

The three central coordination problems any economy must solve are:

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.

Microeconomics and Macroeconomics

Economic theory is divided into two parts:

1. **Microeconomics** is the study of individual choice, and how that choice is influenced by economic forces.
2. **Macroeconomics** is the study of the economy as a whole.

Microeconomics and Macroeconomics

Microeconomics studies things such as:

- The pricing of firms
- Household decisions on what to buy
- How markets allocate resources among alternative ends

Macroeconomics studies such things as:

- Inflation
- Unemployment
- Economic growth

A Guide to Economic Reasoning

Economic reasoning or “thinking like an economist” involves things such as:

- Analyzing issues and comparing costs and benefits of a decision
- Abstracting from the unimportant elements of a question and focusing on the important ones

A Guide to Economic Reasoning

Steve Levitt's bestseller *Freakonomics* contains many examples of "thinking like an economist."

For example, 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 what has already derived.

Economic reasoning is based on the premise that everything has a cost.

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 that you might have gained from choosing the next-best alternative.

Opportunity cost should always be less than the benefit of what you have chosen.

Opportunity cost is the basis of cost/benefit economic reasoning.

Examples of Opportunity Cost

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.

Government Decisions

- The opportunity cost of money spent on the war on terrorism is less spending on health care or education.

Opportunity Cost: Types of Costs

Opportunity cost focuses on two aspects of the costs of a choice that may be forgotten:

- **Implicit costs** are costs associated with a decision that often are not included in normal accounting costs.
- **Illusionary sunk costs** are costs that show up in financial accounts that are already spent.
- Implicit costs should be included in opportunity costs but illusionary sunk costs should not be included.
- Costs relevant to decisions are often different from the measured costs.

Economic Knowledge in One Sentence

This one sentence embodies the concept of opportunity cost:

There ain’t no such thing as a free lunch.

Abbreviated as TANSTAAFL.

Economic and Market Forces

Economic forces: the necessary reactions to scarcity.

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.

Social and Political Forces

What happens in society can be seen as a reaction to, and interaction of:

- Economic forces
- Social forces
- Political forces

Social and political forces influence market forces.

Social and political forces often work together against the invisible hand.

Using 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.

Theories and Precepts

Theories, models, and principles are continually tested to see of the predictions of the model match the data.

Models lead to:

- **Theorems** (propositions that are logically true based on the assumptions of the model)…
- 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 Theorem

According to the invisible hand theorem, a market economy, through the price mechanism, will allocate resources efficiently.

- Price has a tendency to *fall* when quantity supplied is greater than quantity demanded.
- Price has a tendency to *rise* when the quantity demanded is greater than the quantity supplied.

Efficiency: achieving a goal as cheaply as possible.

Economic Institutions

Economic institutions are laws, common practices, and organizations in a society that affect the economy.

To apply economic theory to reality, you've got to have a sense of economic institutions.

Economic institutions differ significantly among nations.

They sometimes seem to operate differently than economic theory predicts.

Objective and Subjective Economic Policy

Economic policies are actions (or inaction) taken by the government to influence economic actions.

There are two types of policy analysis:

1. **Objective** policy analysis keeps value judgments separate from the analysis.
2. **Subjective** policy analysis reflects the analyst's views of how things should be.

Economic Policy Options

To distinguish between objective and subjective analysis, economics is divided into three categories:

1. **Positive economics** is the study of what is and how the economy works.
2. **Normative economics** is the study of what the goals of the economy should be.
3. **The art of economics** is using the knowledge of positive economics to achieve the goals determined in normative economics.

Examples of Categories of Economics

Examples of each of the three categories of economics:

1. **Positive economics** asks questions such as: How does the market for hog bellies work?
2. **Normative economics** asks questions such as: What should tax policy be designated to achieve?
3. **Art of economics** looks at questions such as: To achieve the goals that society wants to achieve, how would you go about it, given the way that the economy works?

Chapter Summary (1 of 3)

Three coordination problems are what to produce, how to produce it, and for whom to produce it.

Economics is divided into microeconomics and macroeconomics. 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.

Economic reasoning structures all questions in a cost/benefit framework.

Chapter Summary (2 of 3)

"There ain't no such thing as a free lunch" embodies the concept of opportunity cost.

Opportunity costs exist.

Unlike market forces, economic forces and the forces of scarcity are always at work.

Economic reality is controlled by economic, political, and social forces.

Chapter Summary (3 of 3)

Under certain conditions, the market, through its price mechanism, will allocate scarce resources efficiently.

Theorems are propositions that follow from the assumptions of a model.

Precepts are the guides for policies based on theorems, normative judgments, and empirical observations about how the real world differs from the model.

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