Chapter 1: Economics and Economic Reasoning

Prepared by:
Kevin Richter, Douglas College
Charlene Richter, British Columbia Institute of Technology

What Economics Is

- **Economics** is the study of how individuals, firms, and governments make optimal choices from among a set of alternatives when facing scarce resources.
- Key words:
  - *choice*
  - *alternative*
  - *scarcity*

What Economics Is

- **Scarcity** exists because individuals want more than available resources can produce.
- Wants are unlimited, but resources are limited.

What Economics Is

- The degree of scarcity is constantly changing.
- The quantity of goods, services, and usable resources depends on technology and human action.

What Economics Is

- Any economic system must solve three central coordination problems:
  - What, and how much, to produce.
  - How to produce it.
  - For whom to produce it.

What Economics Is

- In this course you will learn:
  - Economic reasoning.
  - Economic terminology.
  - Economic insights economists have about issues, and theories that lead to those insights.
What Economics Is

To understand the economy, you need to learn:

- Information about economic institutions.
- Information about the economic policy options facing society today.

A Guide to Economic Reasoning

Economic reasoning is making decisions by comparing costs and benefits.

Marginal Costs and Marginal Benefits

- The relevant costs and benefits are the expected incremental, or additional, costs incurred and the expected incremental benefits of a decision.
- Economists use the term marginal when referring to additional or incremental.

Marginal Costs and Marginal Benefits

- Marginal cost – the additional cost to you over and above the costs you have already incurred.
- This means not counting sunk costs – costs that have already been incurred and cannot be recovered.

Marginal Costs and Marginal Benefits

- Marginal benefit – the additional benefit above and beyond what you’ve already accrued.

Marginal Costs and Marginal Benefits

- According to the economics decision rule:
  - If the relevant marginal benefits of doing something exceed the marginal relevant costs, do it.
  - If the relevant marginal costs of doing something exceed the relevant marginal benefits, don’t do it.
Economics and Passion

- Economic reasoning is based on the premise that everything has a cost.
- It leads to a better society for the majority of people.

Opportunity Cost

- The opportunity cost of the chosen activity is the value of the next-best alternative to the activity you have chosen.
- Opportunity cost is the basis of cost/benefit economic reasoning.
- In economic reasoning, opportunity cost must be less than the benefit of what you have chosen.

Economic and Market Forces

- The opportunity cost concept applies to all aspects of life.
- It is fundamental to understanding how society reacts to scarcity.
- “There is no free lunch.”

Economic and Market Forces

- When goods are scarce, they must be rationed.
- Rationing is the mechanism for determining who gets what.

Economic and Market Forces

- Economic reality is controlled by three forces:
  - Economic forces (the invisible hand).
  - Social and cultural forces.
  - Political and legal forces.

Economic and Market Forces

- Economic forces are 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.
Economic and Market Forces

- Market forces ration quantity by changing prices: when there is a shortage, the price goes up, when there is a surplus, the price goes down.

- The *invisible hand* is the price mechanism -- the rise and fall of prices -- that guides our actions in a market.

Economic and Market Forces

- Political and social forces often work together against the invisible hand.

- What happens in society can be seen as a reaction to, and interaction of, the invisible hand, political and legal forces, and social and cultural forces.

Theories, Models and Assumptions

- General insights into how economies work are often based on generalizations called *economic theories*.

- Economic theories are abstract.

- A theory is often embodied in an *economic model* or an *economic principle*.

Theories, Models and Assumptions

- Economists cannot (usually) test their models with controlled experiments.

- It is impossible to physically hold “other things constant,” as is done in laboratory experiments.

- This can be done with “natural experiments” and complex statistical analysis.

Theories, Models and Assumptions

- Theories, models, and principles must be combined with a knowledge of real-world economic institutions to arrive at a specific policy recommendation.

- In order to understand the theory you must understand the assumptions underlying the theory.
The Invisible Hand Theory

- Economist have observed:
  - Price tends to fall when the quantity supplied is greater than the quantity demanded.
  - Price tends to rise when the quantity demanded is greater than the quantity supplied.

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

*Efficiency* means achieving a goal as cheaply as possible.

---

Economic Theory and Stories

- Economic theory and its models are a shorthand means of telling a story.

- If you can’t translate a theory into a story, you don’t understand the theory.

---

Microeconomics and Macroeconomics

- Economics is divided into two parts: microeconomics and macroeconomics.

---

Microeconomics

- *Microeconomics* is the study of individual decision making.

- It considers household and business decisions, market allocations and pricing policies.

---

Macroeconomics

- *Macroeconomics* is the study of the economy as a whole.

- It considers the problems of inflation, unemployment, business cycles, and economic growth.
Economic Institutions

- In applying economic theory to reality, you must know about economic institutions.

- Economic institutions are the laws, common practices, and social, political, and religious organization, of a society.

Economic Institutions

- Economic institutions differ significantly among nations.

- They sometimes seem to operate in ways quite different than economic theory predicts.

Economic Policy Options

- Economic policies are actions taken by government to influence economic events.

Economic Policy Options

- To carry out economic policy effectively, one must understand how the economic policy might change institutions.

- Also, how might changes in institutions affect the economy.

Objective Policy Analysis

- Objective policy analysis keeps the value judgments separate from the analysis.

- Subjective policy analysis is that which reflects the analyst’s view of how things should be.
Objective Policy Analysis

- **Positive economics** – the study of what is, and how the economy works.
- **Normative economics** – the study of what the goals of the economy should be.

Science of economics – the application of the knowledge learned in positive economics to achieve the goals determined in normative economics.

Some argue that it is difficult (if not impossible) to maintain objectivity in the science of economics.

Policy and Social and Political Forces

- The choice of policy options depends on more than economic theory.
- Political and social forces must be taken into account when applying economic theory to policy.

Economics and Economic Reasoning

End of Chapter 1