Chapter 1: Economics and Economic Reasoning

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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

- ***Economic model*** – a set of simple behavioural assumptions to explain decision making.
- ***Economic principle*** – a commonly held insight stated as a law or general assumption.

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 rise when the quantity demanded is greater than the quantity supplied.

The Invisible Hand Theory

- 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

- To make clear the distinction between objective and subjective analysis, economics is divided into three categories:
  - Positive economics
  - Normative economics
  - Science of economics

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.

Objective Policy Analysis

- ***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