

# Chapter 1

## ECONOMICS AND ECONOMIC REASONING



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1-2

### Today's lecture will:

- Define economics.
- Examine three coordination problems all economies must solve.
- Compare marginal costs and marginal benefits to make decisions.
- Define and explain opportunity costs.

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### Today's lecture will:

- Explain how economic, social, and political forces influence real-world events.
- Distinguish between:
  - microeconomics and macroeconomics.
  - positive economics, normative economics, and the art of economics.

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## 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.

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## Coordination in Economics

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

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## The Economic Problem

- **Scarcity** exists because individuals want more than can be produced.
  - **Scarcity** – 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.

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## 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.

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## Economic Reasoning

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

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## The Economic Decision Rule

- If the **marginal benefits** of doing something exceed the **marginal costs**, do it.
- If the **marginal costs** of doing something exceed the **marginal benefits**, don’t do it.

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## Opportunity Cost

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

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## Examples of Opportunity Costs

- **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.

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## Economics 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 a market force that rations goods by changing prices.
  - If there is a shortage, prices rise.
  - If there is a surplus, prices fall.

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## Economics and Market Forces

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

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## Economic Insights

- **Economic theories** are generalizations that are insights into how economies work.
- Theories may be embodied in economic models or economic principles.
- **Economic model** – a framework that places the generalized insights of the theory in a more specific contextual setting.
- **Economic principle** – a commonly held insight stated as a law or general assumption.

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## The Invisible Hand Theory

- According to the **invisible hand theory**, a market economy, through the price mechanism, will allocate resources efficiently.
  - Price has a tendency to fall when the quantity supplied is greater than the quantity demanded.
  - Price has a tendency to rise when the quantity demanded is greater than the quantity supplied.
- **Efficiency** means achieving a goal as cheaply as possible.

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## Microeconomics and Macroeconomics

- Economic theory is divided into two parts: microeconomic theory and macroeconomic theory.
- **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.

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## Microeconomics and Macroeconomics

- **Microeconomics** studies such things as:
  - the pricing policy of firms.
  - Households' decisions on what to buy.
  - how markets allocate resources among alternative ends.
- **Macroeconomics** deals with:
  - inflation.
  - unemployment.
  - economic growth.

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## Economic Institutions

- **Economic institutions** – laws, common practices, and organizations in a society that affect the economy.
- They sometimes seem to operate differently than economic theory predicts.
- Economic institutions differ significantly among nations.

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## Economic Policies

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

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## Policy Analysis

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

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## Economics and Economic Reasoning Summary

- In solving the economic problem of scarcity, any economy must answer the questions
  - what should be produced?
  - how should it be produced?
  - who should get it?
- Economic reasoning compares marginal benefits with marginal costs. Do something if its marginal benefits > its marginal costs.
- The opportunity cost of an activity is the benefit you would have gained from the next best alternative.

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## Economics and Economic Reasoning Summary

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- The market, which rations scarce resources by changing prices, is efficient under certain conditions.
- Economics can be divided into
  - Microeconomics – the study of individual choice
  - Macroeconomics – the study of the economy as a whole
- Economics can be subdivided into
  - Positive economics – the study of what is
  - Normative economics – the study of what should be
  - The art of economics – relating positive to normative economics

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### Review Exercise 1-1

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Suppose that you are considering going to a concert. Tickets cost \$60. If you go to the concert, you will have to miss 4 hours of work, where you are making \$10 an hour. What is your total opportunity cost of going to the concert measured in dollars given up?

The total opportunity cost of going to the concert is \$100, \$60 for the ticket and \$40 lost income from missing work.

### Review Exercise 1-2

Suppose that after studying 7 hours for an economics test, you are confident that you know enough to make a B. However, if you study one more hour instead of watching your favorite TV show, you will probably improve your grade to an A. Identify the marginal costs and benefits in this situation.

The marginal benefit is the improvement in your grade from a B to an A. The marginal cost is the hour of lost entertainment.

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