

# CHAPTER 1

After reading this chapter,  
you should be able to:

- LO1-1** Define *economics* and identify its components.
- LO1-2** Discuss various ways in which economists use economic reasoning.
- LO1-3** Explain real-world events in terms of economic forces, social forces, and political forces.
- LO1-4** Explain how economic insights are developed and used.
- LO1-5** Distinguish among positive economics, normative economics, and the art of economics.

## 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



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When an artist looks at the world, he sees color. When a musician looks at the world, she hears music. When an economist looks at the world, she sees a symphony of costs and benefits. The economist's world might not be as colorful or as melodic as the others' worlds, but it's more practical. If you want to understand what's going on in the world that's really out there, you need to know economics.

I hardly have to convince you of this fact if you keep up with the news. You will be bombarded with stories of unemployment, interest rates, how commodity prices are changing, and how businesses are doing. The list is endless. So let's say you grant me that economics is important. That still doesn't mean that it's worth studying. The real question then is: How much will you learn? Most of what you learn depends on you, but part depends on the teacher and another part depends on the textbook. On both these counts,

you're in luck; since your teacher chose this book for your course, you must have a super teacher.<sup>1</sup>

## 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. One of the key words in the definition of the term *economics* is *coordination*. Coordination can mean many things. In the study of economics, coordination refers to how the three central problems facing any economy are solved. These central problems are:

1. What, and how much, to produce.
2. How to produce it.
3. For whom to produce it.

Three central coordination problems any economy must solve are what to produce, how to produce it, and for whom to produce it.

How hard is it to make the three decisions? Imagine for a moment the problem of living in a family: the fights, arguments, and questions that come up. “Do I have to do the dishes?” “Why can’t I have piano lessons?” “Bobby got a new sweater. How come I didn’t?” “Mom likes you best.” Now multiply the size of the family by millions. The same fights, the same arguments, the same questions—only for society the questions are millions of times more complicated. In answering these questions, economies find that inevitably individuals want more than is available, given how much they’re willing to work. That means that in our economy there is a problem of **scarcity**—the goods available are too few to satisfy individuals’ desires.

The coordination questions faced by society are complicated.

## Scarcity

Scarcity has two elements: our wants and our means of fulfilling those wants. These can be interrelated since wants are changeable and partially determined by society. The way we fulfill wants can affect those wants. For example, if you work on Wall Street, you will probably want upscale and trendy clothes. In Vermont I am quite happy wearing Levi’s and flannel; in Florida I am quite happy in shorts.

The degree of scarcity is constantly changing. The quantity of goods, services, and usable resources depends on technology and human action, which underlie production. Individuals’ imagination, innovativeness, and willingness to do what needs to be done can greatly increase available goods and resources. Who knows what technologies are in our future—nanites or micromachines that change atoms into whatever we want could conceivably eliminate scarcity of goods we currently consume. But they would not eliminate scarcity entirely since new wants are constantly developing.

The quantity of goods, services, and usable resources depends on technology and human action.

So, how does an economy deal with scarcity? The answer is coercion. In all known economies, coordination has involved some type of coercion—limiting people’s wants and increasing the amount of work individuals are willing to do to fulfill those wants. The reality is that many people would rather play than help solve society’s problems. So the basic economic problem involves inspiring people to do things that other people want them to do, and not to do things that other people don’t want them to do. Thus, an alternative definition of economics is: the study of how to get people to do things they’re not wild about doing (such as studying) and not to do things they are wild

<sup>1</sup>This book is written by a person, not a machine. That means that I have my quirks, my odd sense of humor, and my biases. All textbook writers do. Most textbooks have the quirks and eccentricities edited out so that all the books read and sound alike—professional but dull. I choose to sound like me—sometimes professional, sometimes playful, and sometimes stubborn. In my view, that makes the book more human and less dull. So forgive me my quirks—don’t always take me too seriously—and I’ll try to keep you awake when you’re reading this book at 3 a.m. the day of the exam. If you think it’s a killer to read a book this long, you ought to try writing one.

about doing (such as eating all the ice cream they like), so that the things some people want to do are consistent with the things other people want to do.

## Microeconomics and Macroeconomics

Economic theory is divided into two parts: microeconomic theory and macroeconomic theory. Microeconomic theory considers economic reasoning from the viewpoint of individuals and firms and builds up to an analysis of the whole economy. **Microeconomics** is *the study of individual choice, and how that choice is influenced by economic forces*. Microeconomics studies such things as the pricing policies of firms, households' decisions on what to buy, and how markets allocate resources among alternative ends.

As we build up from microeconomic analysis to an analysis of the entire economy, everything gets rather complicated. Many economists try to uncomplicate matters by taking a different approach—a macroeconomic approach—first looking at the aggregate, or whole, and then breaking it down into components. **Macroeconomics** is *the study of the economy as a whole*. It considers the problems of inflation, unemployment, business cycles, and growth. Macroeconomics focuses on aggregate relationships such as how household consumption is related to income and how government policies can affect growth.

Consider an analogy to the human body. A micro approach analyzes a person by looking first at each individual cell and then builds up. A macro approach starts with the person and then goes on to his or her components—arms, legs, fingernails, feelings, and so on. Put simply, microeconomics analyzes from the parts to the whole; macroeconomics analyzes from the whole to the parts.

Microeconomics and macroeconomics are very much interrelated. What happens in the economy as a whole is based on individual decisions, but individual decisions are made within an economy and can be understood only within its macro context. For example, whether a firm decides to expand production capacity will depend on what the owners expect will happen to the demand for their products. Those expectations are determined by macroeconomic conditions. Because microeconomics focuses on individuals and macroeconomics focuses on the whole economy, traditionally microeconomics and macroeconomics are taught separately, even though they are interrelated.

Microeconomics is the study of how individual choice is influenced by economic forces.

Macroeconomics is the study of the economy as a whole. It considers the problems of inflation, unemployment, business cycles, and growth.

**Q-1** Classify the following topics as primarily macroeconomic or microeconomic:

1. The impact of a tax increase on aggregate output.
2. The relationship between two competing firms' pricing behavior.
3. A farmer's decision to plant soy or wheat.
4. The effect of trade on economic growth.