CHAPTER 1

Economics and Economic Reasoning

Learning Objectives

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

Coordination in economics means how the three central coordination problems any economy must solve are:

1. What 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 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.
- **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, which underlie production. Individuals' imagination, innovativeness, and willingness to do what needs to be done can greatly increase available goods and resources.

Scarcity

So How the Economy deals with the Scarcity?

- The answer is the 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 help solve society's problems.

- 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 are not wild about doing (such as studying) and not to do things they are wild about doing (such as eating all the lobster they like), so that the things some people want to do are consistent with the things other people want to do.

Microeconomics and Macroeconomics 1

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.It considers the problems of inflation, unemployment, business cycle, and growth.

Microeconomics and Macroeconomics 2

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 1

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 2

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.