Economics

**I An Introduction to Economics and the Economy**

**1. The Nature and Method of Economics**

**A. The Economic Perspective**

\* Economists view the world through the lens of *scarcity*. As human and property resources are scarce or limited (finite), goods and services must also be limited. Scarcity limits our options and necessitates that we make *choices*.

\* At the core of economics is the idea that there is no free lunch. There is always a cost involved to someone – ultimately to society. What about something that is free? While free products may or may not be free to individuals, they are never free to society because these resources could have been used in other production activities. Such sacrifices are known as *opportunity costs*. The cost of what you get is the value of that which is sacrificed to obtain it.

\* Economics assumes that human behavior reflects “rational self-interest.” Individuals look for and pursue opportunities to increase their *utility* – pleasure, happiness, or satisfaction. Individuals allocate time, energy and money to maximize their well-being. Because they weight the costs and benefits, their decisions are *rational* or *purposeful*, not *random*.

\* Rational behavior means that the same person may make different choices under different circumstances, such as purchasing coke in bulk or individually depending on the circumstance. Rational behavior also means that choices will vary greatly among individuals given their varied preferences.

\* Rational decisions may change as costs and benefits change. Rational self-interest is not the same as selfishness. A rational decision may involve personal sacrifice, such as helping one’s family, whereas self-interest behavior simply enables a person to achieve personal satisfaction, however it is derived.

\* The Economic perspective focuses largely on *Marginal analysis* – comparisons of *marginal benefits* and *marginal costs*.

\* Used this way, marginal means additional, extra, or a change in. Most choices involve changes in the status quo: Should government increase or decrease its education funding? Should a business expand or reduce its output? Each option involves marginal benefits and, because of scarce resources, marginal costs. To make a rational decision involves comparing the benefits against the costs.

\* You are shopping for a truck. Should you buy the Ram 2500 with the Cummings Diesel or the Ram 1500 V8? The marginal cost of the diesel is the added expense beyond the cost of the small 1500. The marginal benefit is the greater pleasure of having the larger, more powerful truck. If the marginal benefit exceeds the marginal cost, you should by the diesel, but if the marginal cost is more than the marginal benefit, go with the 1500. In a world of scarcity, this means the extra money that goes to the diesel comes at the expense of something else.

\* There can, however, be too much of a good thing. It is possible to obtain too much of a desirable object (education, insurance…) when we obtain them even though their marginal costs exceed their marginal benefits. Then we are substituting alternative goods or services that are more valuable *at the margin* – the place where we consider the last units of each.

**B. Why Study Economics?**

\* Most of the ideologies of the modern world have been shaped by prominent economists such as – Adam Smith, John Stuart Mill, Karl Marx and John Maynard Keynes. It was Keynes who once pronounced FDR as “magnificently correct” in attempting to stimulate inflation by devaluing the dollar at a time (during the great depression) when prices were so low.

\* The President of the United States benefits from the recommendations of his Council of Economic Advisers in producing the Economic Report of the President, which addresses such issues as unemployment, inflation, economic growth, taxation, poverty, international trade, health care, pollution, education and others. The Federal Reserve Board also relies heavily on economic analysis in shaping its monetary policies.

**C. Economics for Citizenship**

\* A basic understanding of economics (history, geography, political science, and philosophy) is essential for well-informed citizenship. Most of today’s political problems have important economic aspects:

\* How can we ensure that corporate executives act in the long-run interest of their shareholders and not just themselves?

\* What level of taxes should we have?

\* How can we increase the rate of economic growth?

\* How can we reduce poverty?

\* As voters, we can influence the decisions of our elected officials in responding to these kinds of questions. Intelligence at the polls, however, requires a basic working knowledge of economics.

\* Studying economics invariably leads students to improve their analytical skills, something highly desired in the workplace. The study of economics also helps people make sense of everyday activity they observe around them. “How is it that so many different people, in so many different places, doing so many different things, produce the goods and the services we want to buy? Economics explains this.

\* An understanding of basic economic decision making also enables business managers to increase their profit. The manager/executive who understands when to use a new technology, when to merge with another firm, when to expand employment and so on, will outperform the executive who is less deft at such decision making.

\* The manager who understands the causes and consequences of recessions (economic downturns) or inflation (rising prices) can make intelligent business decisions during those periods.

\* A knowledge of economics helps consumers and workers make better buying and employment decisions. How can one spend his limited money income to maximize his satisfaction? Is it more economical to buy or lease a car? Which occupations pay well; which are most immune to unemployment?

\* Regardless, economics is mainly an academic, not a vocational subject. Unlike accounting or advertising, economics is not primarily a how-to-make-money area of study. While knowledge of economics will help you increase your earning potential, it ultimately examines problems and decisions from the social, rather than personal, point of view. The production, exchange and consumption of goods is examined from the view of society’s best interest, not strictly from the standpoint of one’s own wallet.

**D. Economic Methodology**

**i Economics relies on the scientific method, consisting of:**

\* The observation of facts (real world data);

\* Based on those facts, the formulation of a possible explanation of cause and effect (hypothesis);

\* The testing of the explanation by comparing the outcomes of specific events to the outcome predicted by the hypothesis;

\* The acceptance, rejection, or modification of the hypothesis, based on these comparisons;

\* The continued testing of the hypothesis against the facts. As favorable results accumulate, the hypothesis evolves into a *theory*. A very well tested and widely accepted theory is referred to a *law* or *principle*. Combinations of such laws or principles are incorporated into *models* – simplified representations of how something works, such as a market or segment of the economy.

\* Laws and models enable an economist to understand and explain reality and to predict the various outcomes of particular actions.

**ii Theoretical Economics**

\* Economists develop modes of the behavior of individuals and institutions engaged in the production, exchange, and consumption of goods and services.

\* They gather facts about economic activities and economic outcomes.

\* Economists then determine which facts are relevant to the problem under consideration, before drawing on the facts to establish cause-effect hypotheses about economic behavior.

\* Economists try to discover hypotheses that rising to the level of theories and principles or laws – well tested and widely accepted generalizations about how individuals and institutions behave. The process of deriving such theories and principles is called theoretical economics.

\* The role of economic theorizing is to systematically arrange facts, interpret them, and generalize from them. Theories and principles bring order and meaning to facts by arranging them in a cause-effect format.

\* Economic theories and principles are statements about economic behavior or the economy that enable predictions of the probable effects of certain actions.

\* Good theories are supported by facts, but facts may change in time, so economists must continually check theories against the shifting economic environment.

\* Theories, laws and principles are the ingredients of analytical economics – the ascertaining of cause and effect, of action and outcome, within the economic system.

**iii Generalizations**

\* Economic theories, principles, and laws are generalizations relating to economic behavior or to the economy itself. They are imprecise because economic facts are usually diverse – no two individuals or institutions act the same.

\* Economic principles are expressed as the tendencies of typical or average consumers, workers, or business firms.

\* i.e., Some economists say that consumers will buy more when the price of a particular good falls, but while some consumers may increase their purchases by a small amount, others will increase by a large amount, and some will not increase at all. Finding the typical average is the rub.

**iv Other-Things-Equal Assumption**

\* Economists use an other-things-equal assumption to construct their generalizations.

\* They assume that all other variables except those under immediate consideration are held constant for a particular analysis.

\* Economists then test their theories using real world data, which is generated by the actual operation of the economy. Because other things do change, however, economic principles are less certain and more open to debate than many scientific theories.

**v Abstractions**

\* Economic principles, or theories, are abstractions – simplifications that omit irrelevant facts and circumstances. The very process of sorting out and analyzing facts involves simplification and removal of clutter.

\* Economists simplify – that is, develop theories and build models – to give meaning to an otherwise overwhelming and confusing maze of facts.

**vi Policy Economics**

\* Policy economics recognizes that theories and data can be used to formulate *policies* – courses of action based on economic principles, and intended to resolve a specific economic problem or further an economic goal.

\* Economic policy is normally reactive, being applied to problems after they arise. If economic analysis can predict some undesirable even such as unemployment, inflation, or an increase in poverty, then it may be possible to avoid or moderate that event through economic policy.

\* For example, the Federal Reserve has reduced interest rates to increase private spending and prevent recession at a time with trends showed prices falling.

**vii Economic Policy**

\* State the Goal – Make a clear statement of the economic goal. The goal must be specific;

\* Determine the policy options – Formulate alternative policies. This requires a detailed assessment of the economic impact, benefits, costs, and political feasibility of the alternative policies.

\* Implement and evaluate the policy that was selected – After implementing the policy, we need to evaluate how well it worked. Did a specific change in taxes or the money supply alter the level of employment to the extent predicted? How might the policy be altered to make it work better?

**viii Economic Goals**

\* The following economic goals are widely accepted in the United States and elsewhere:

a. **Economic Growth** – Produce more and better goods and services, more simply, develop a higher standard of living.

b. **Full Employment** – Provide suitable jobs for all citizens who are willing and able to work;

c. **Economic Efficiency** – Achieve the maximum fulfillment of wants using the available resources;

d. **Price-level stability**- Avoid large upswings and downturns in the general price level; that is, avoid inflation and deflation;

e. **Economic freedom** – Guarantee that consumers, businesses…have a high degree of freedom in their economic activities;

f. **Economic Security** – Provide for those who cannot provide for themselves; the chronically ill, aged, laid off, or otherwise unable to earn minimum levels of income.

g. **Balance of trade** – Seek a reasonable overall balance of trade with the rest of the world, avoiding unfavorable trade balances.

h. **Equitable distribution of income**:

Ensure that no group of citizens faces poverty while most others enjoy abundance. How realistic is this goal? Has it been met? Bill Gates’ personal income is equal to that of the bottom 40% of the United States. You decide.

\* Economic goals may conflict or even be mutually exclusive. They may entail tradeoffs, meaning that to achieve one goal we must sacrifice another.

\* Taxing high income people heavily and transferring the tax revenues to low-income people is one way to equalize the distribution of income. But then the incentives to high-income individuals may diminish because higher taxes reduce their rewards for working. Similarly, low-income individuals may be less motivated to work when government stands ready to subsidize them.

\* Society, as with individuals, must establish ways to prioritize the objectives it seeks.

**E. Macroeconomics and Microeconomics**

1. Macroeconomics – It examines either the economy as a whole or its basic subdivisions or aggregates, such as the government, household, and business sectors. An **aggregate** is a collection of specific economic units treated as if they were one.

\* In using aggregates, macroeconomics seeks to obtain an overview, or general outline, of the structure of the economy and the relationships of its major aggregates.

\* Macroeconomics speaks of such economic measures as *total output*, *total employment*, *total income*, *aggregate* expenditures, and the general level of prices in analyzing various economic problems.

2. Microeconomics looks at specific economic units.

\* In Microeconomics we talk of an individual industry, firm or household. We measure the price of a specific product, the number of workers employed by a single firm, the revenue or income of a particular firm, or the expenditures of a specific household or firm.

**F. Positive and Normative Economics**

1. *Positive economics* focus on facts and cause-and-effect relationships. It includes description, theory development, and theory testing (theoretical economics).

2. Policy economics on the other hand, involves *normative economics*, which incorporates value judgments about what the economy should be like or what particular policy actions should be recommended to achieve a desirable goal.

G. Pitfalls to sound reasoning.

1. Bias – Most of us bring a ton of biases and preconceptions to the field of economics. Biases, however, cloud thinking and interfere with objective analysis. Newspapers and broadcasters will even *load economic terminology* to use our biases against us. All of us must be willing to shed biases and preconceptions that are not supported by facts.

H. Fallacy of Composition

\* Another pitfall in economic thinking is the assumption that what is true for one individual or part of a whole is necessarily true for a group of individuals or the whole. This is a logical fallacy called the fallacy of composition; the assumption is *not correct*. Here is an example: If you stand at a football game after a great play, you as an individual have an improved view. This is a valid statement; does that make it accurate for everyone at the game? What about the person sitting behind you?

\* The fallacy of composition reminds us that generalizations valid at one level of analysis may or may not be valid at the other.