Chapter 1

REVIEW CONCEPTS

Allocative Efficiency: When the right mixture of goods and services is produced, taking account of the preferences and costs of all economic actors.

Bounded Rationality: The recognition that people have cognitive limits in formulating and processing information and recognizing opportunity costs in trying to solve complex problems.

Cost Disease: The rapid increase in labor costs that results when an organization cannot improve its productivity as fast as productivity increases in the economy at large.

Economics: The study of how decision makers (individuals, organizations, industries, sectors, countries, society) generate, accumulate, allocate, distribute, and consume resources and create value.

Economies of Scale: Reductions in the unit cost of a good or service as a result of expanding the scale of production (see Chapter 4).

Economies of Scope: Reductions in the unit cost of a good or service as a result of co-producing that good or service jointly with other goods or services (see Chapter 9).

Equity of Endowments: The degree to which people start at the same place in life.

Equity of Outcomes: The degree to which differential resources are provided to different groups so that they can achieve fair final outcomes.

Equity of Process: The degree to which the rules of the game are fair or the same for all participants.

Gifts: Unilateral transfers of economic value between economic actors, a donor and a recipient, for which there is no explicit quid pro quo.

Homo Economicus: A stereotype of economic actors as fully rational decision makers.

Horizontal Equity: The degree to which individuals or organizations in the same category (e.g., income class, age, family, or organization size) are treated the same.

Incentives: Economic rewards or penalties meant to influence the economic behavior of organizations or individuals.

Incremental Value: The additional value of consuming or producing one more unit of an economic good; synonymous with "marginal" value.

Macroeconomics: The study of how the economy works as a whole.

Market: A decentralized institution in which independent producers (sellers) and consumers (buyers) voluntarily exchange their resources, goods, and services for money.

Microeconomics: The study of economic processes at the level of individuals, organizations, industries and markets.

Normative Economics: The study of how economic actors should make decisions to achieve social efficiency and other social goals such as equity.

Positive Economics: The study of how economic actors and institutions actually make economic decisions and how the economy actually works.

Productive Efficiency: When goods or services of a given quality and quantity are produced at the least cost, or when the highest possible quality or quantity is attained for a given expenditure of valuable resources.

Rational: Economic decision making where people make logical and consistent choices and consider all relevant alternatives.

Satisfice: The use of simpler rules of thumb (or heuristics) to make decisions or solve problems, rather than search for the best possible (optimal) alternatives.

Social Business: A profitmaking business which seeks to maximize a combination of profits and social impact.
Social Efficiency: A feasible state of an economy in which there are no possible changes (in production methods, the quantity of each good or service, or the distribution of each good to each person) that can make at least one person better off without making someone else worse off. Synonymous with Pareto-optimality.

Trading Efficiency: When no pair of consumers wants to swap what they bought for what the other person bought.

Vertical Equity: The degree to which there is a fair distribution of rewards or burdens between ordered classes of individuals (such as classes of individuals categorized by income or wealth).

Warm Glow: Good feeling received in exchange for giving a gift.

Willingness to Pay: The amount of money a consumer is willing to pay in order to purchase an additional unit of a good or service.

EXERCISES

1. Can you think of three trade-offs that must be made in a nonprofit organization or a social enterprise for which you have worked or volunteered? Did that organization address these trade-offs in a systematic fashion? Do you think management decisions would have been different if ideas from economics were applied in these cases?

2. Critically analyze the following imaginary quote: “Because volunteers are not paid by the organizations that employ them, economics is irrelevant to the questions of volunteer recruitment and allocation.” (William Acrimony, The 3.5 Minute Nonprofit Manager)

3. Critically analyze the following imaginary quote: “If a donor has unsatisfied consumption needs, he is acting irrationally by disregarding his self-interest.” (Aynt Rand, The Bubblehead)

4. Imagine a world where the entire economy consists of two nonprofit fraternities – Alpha Alpha and Kappa Chino, each containing three “brothers.” There is only one good in this economy – beer, and needless to say, every brother likes more beer better than less beer. Beer is not produced, but magically appears under their pillows each night, brought by the beer fairy (who is a teetotaler and not part of the economy). The beer fairy places the same number of six-packs under each brother’s pillow within a fraternity but may give different amounts to each fraternity. An economy is a complete listing of the quantities of each good consumed by each individual. In this case, since there is only one good, a complete specification of the economy consists of the amount of beer consumed by each brother in Alpha Alpha and the corresponding amount consumed by each brother in Kappa Chino. Suppose that there are five alternative feasible economies, A through E. The beer allocations in each are:

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<thead>
<tr>
<th>Economy</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
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</thead>
<tbody>
<tr>
<td>Alpha Alpha</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Kappa Chino</td>
<td>2</td>
<td>3</td>
<td>5</td>
<td>3</td>
<td>1</td>
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</tbody>
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(a) Which economies (if any) are efficient?
(b) What can you say (if anything) about the fairness of economy C for each of the categories of equity discussed in the text?

5. Joe Fix-It, a social entrepreneur, decides to establish an automobile repair shop that employs high school drop-outs and provides them with on-the-job training in automotive maintenance. What are the different ways that this venture can create new economic value? What prices observed in the marketplace can help to measure this value? Where do market prices fall short of measuring some of this economic value? State the reasoning behind your answers.

6. Yummy, a social business owned by Sally and Tony Spudnik, buys knishes, latkes and other potato delicacies at fair-traded prices from little old ladies struggling to make a living in Siberia, and sells them in upscale ethnic communities in Europe and the U.S. Yummy donates most of its profit to Oy!, a U.S. charity dedicated to preserving the Yiddish language. In what ways does Yummy create new economic value? And in what ways might Yummy be addressing concerns about horizontal and vertical equity? How would you decide if Yummy is efficient in addressing its social goals of helping struggling little old ladies and preserving the Yiddish language? What trade-offs might Yummy be making between these goals?