

Thinking Like an Economist

Chapter 2

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Every field of study has its own terminology

Mathematics

integrals
axioms
vector spaces

Psychology

ego
id
cognitive
dissonance

Law

torts
Promissory
estoppel
venues

Every field of study has its own terminology

Economics

Supply

**Opportunity
cost**

Elasticity

**Comparative
advantage**

**Consumer
Surplus**

Demand

**Deadweight
loss**

Economics trains you to. . . .

- **Think in terms of alternatives.**
- **Evaluate the cost of individual and social choices.**
- **Examine and understand how certain events and issues are related.**

The Economist as a Scientist

The economic way of thinking . . .

- Involves thinking analytically and objectively.
- Makes use of the scientific method.

The Scientific Method

- **Uses abstract models to help explain how a complex, real world operates.**
- **Develops theories, collects, and analyzes data to prove the theories.**

Observation, Theory and More Observation!

The Role of Assumptions

- **Economists make assumptions in order to make the world easier to understand.**
- **The art in scientific thinking is deciding which assumptions to make.**
- **Economists use different assumptions to answer different questions.**

The Economic Way of Thinking

- Includes developing *abstract models* from theories and the analysis of the models.
- Uses two approaches:
 - *Descriptive* (reporting facts, etc.)
 - *Analytical* (abstract reasoning)

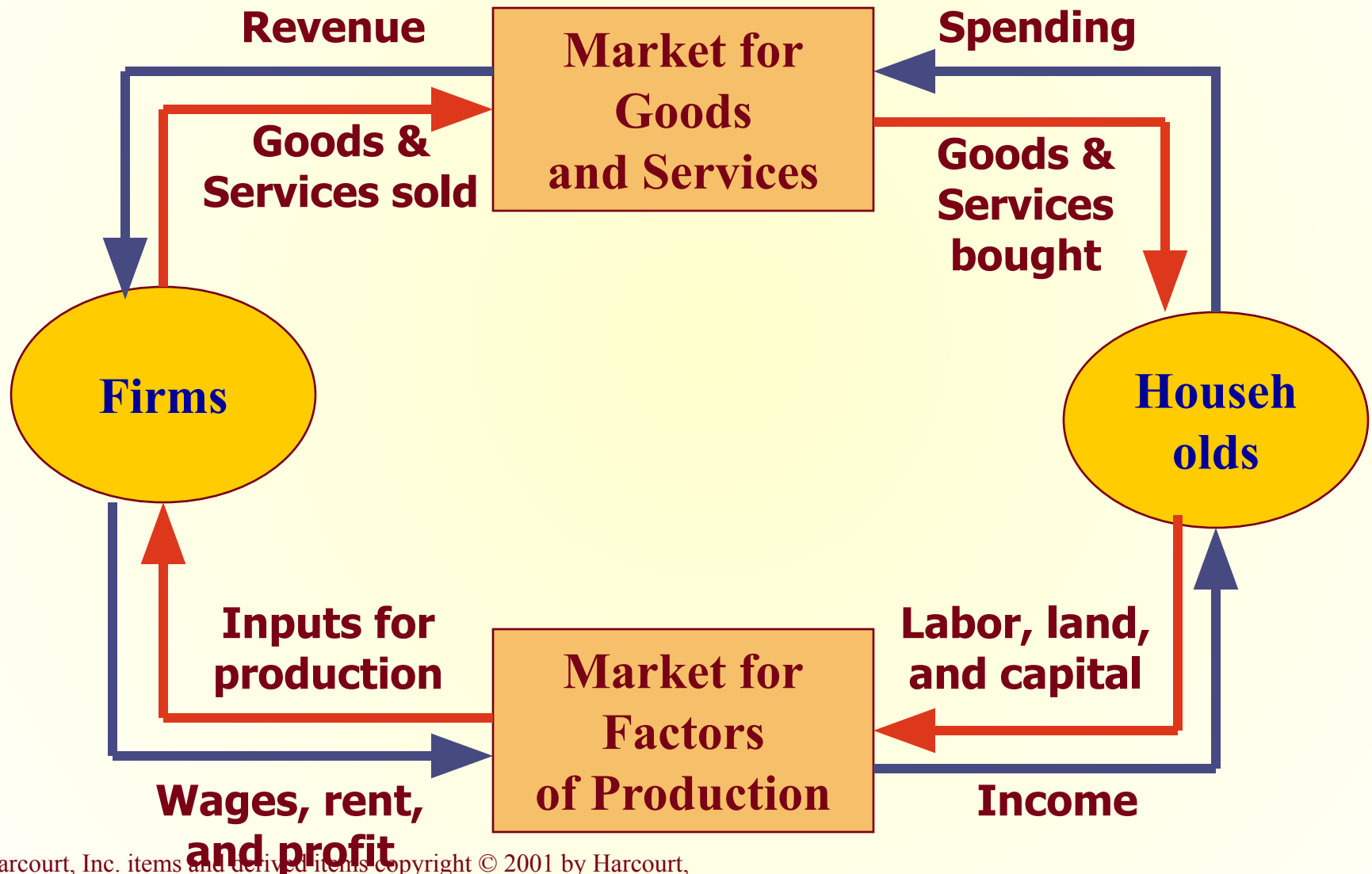
Economic Models

- Economists use models to simplify reality in order to improve our understanding of the world
- Two of the most basic economic models include:
 - *The Circular Flow Model*
 - *The Production Possibilities Frontier*

The Circular-Flow Model

The circular-flow model is a simple way to visually show the economic transactions that occur between households and firms in the economy.

The Circular-Flow Diagram



The Circular-Flow Diagram

Firms

- Produce and sell goods and services
- Hire and use factors of production

Households

- Buy and consume goods and services
- Own and sell factors of production

The Circular-Flow Diagram

Markets for Goods & Services

- **Firms sell**
- **Households buy**

Markets for Factors of Production

- **Households sell**
- **Firms buy**

The Circular-Flow Diagram

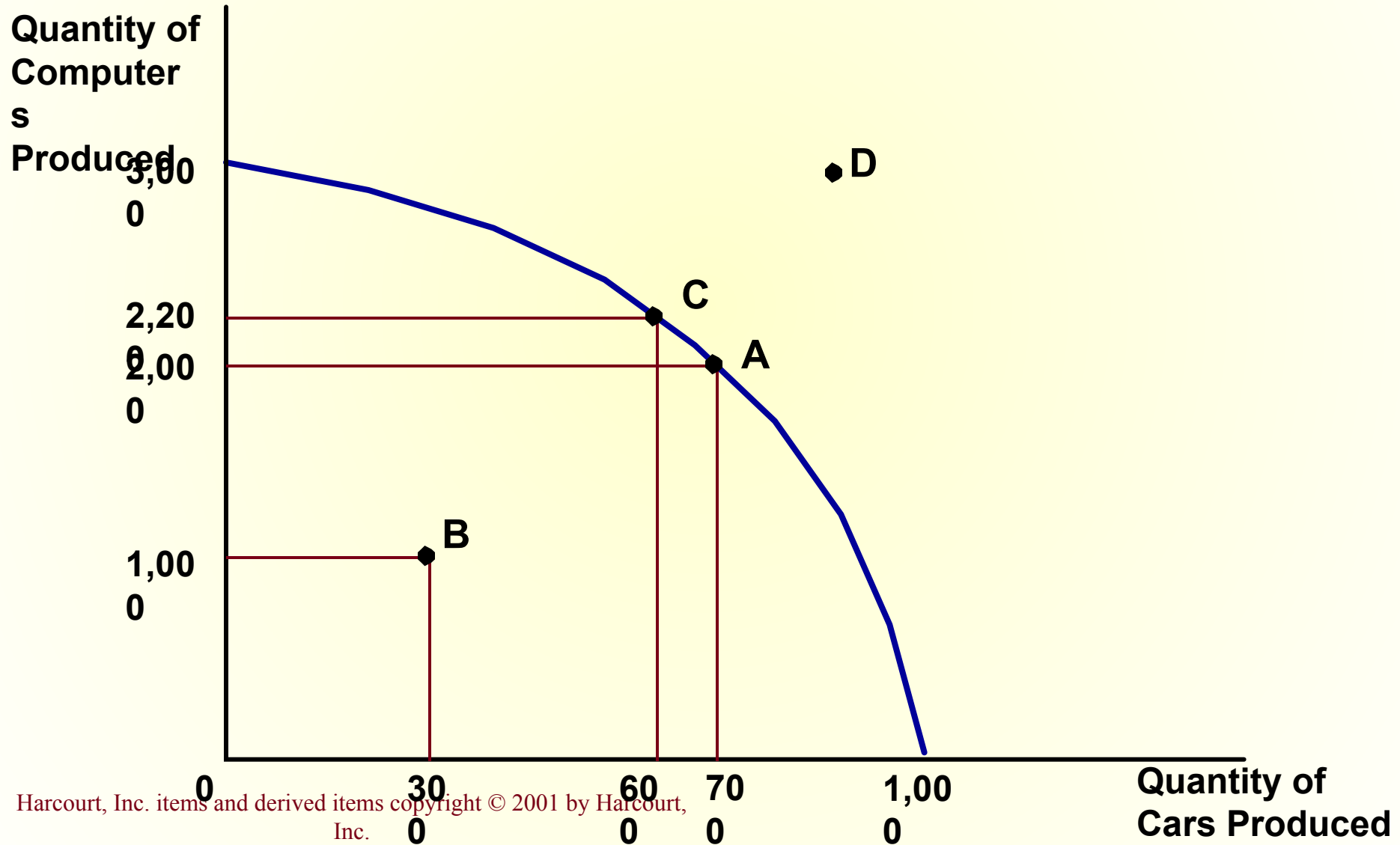
Factors of Production

- Inputs used to produce goods and services
- Land, labor, and capital

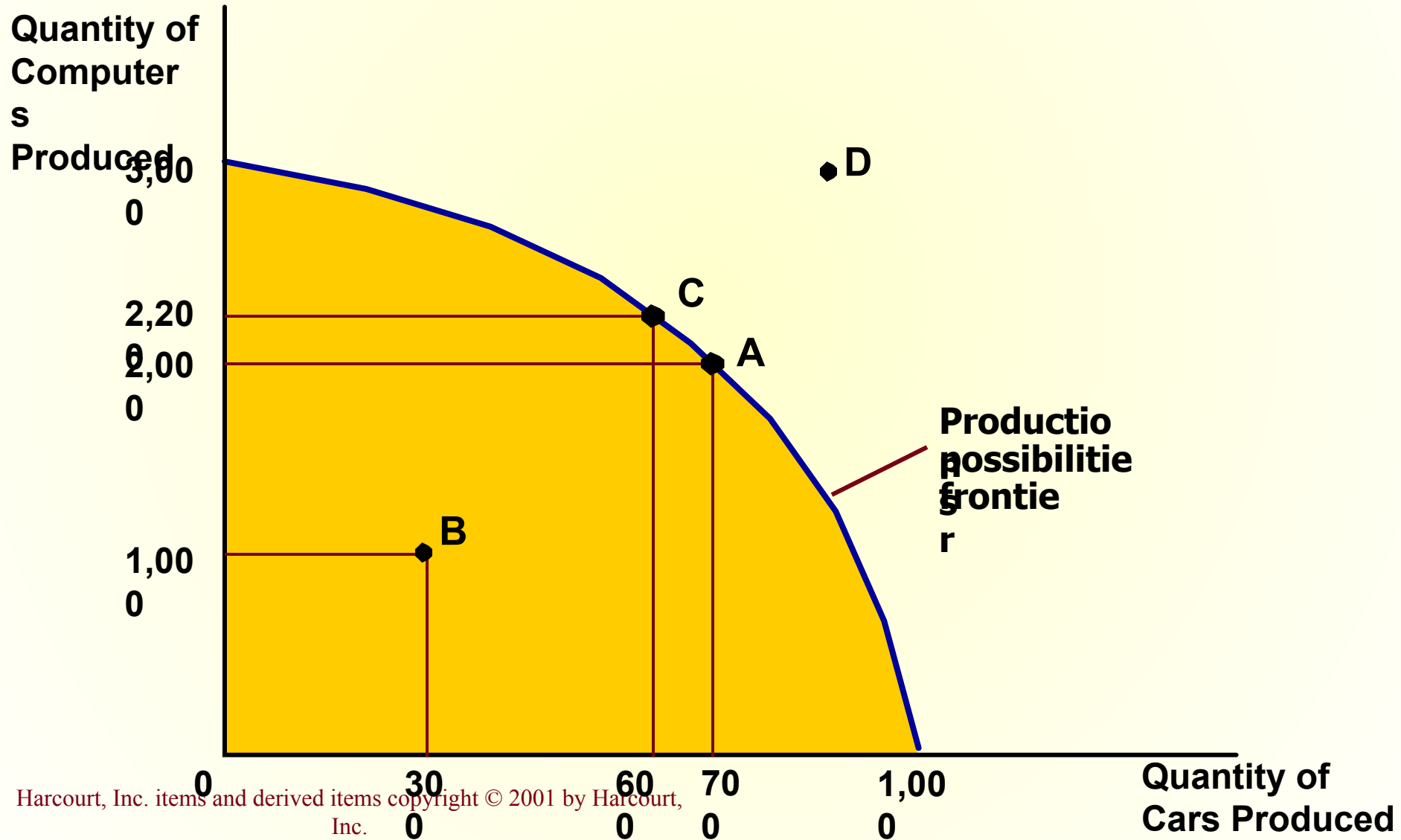
The Production Possibilities Frontier

The production possibilities frontier is a graph showing the various combinations of output that the economy can possibly produce given the available factors of production and technology.

The Production Possibilities Frontier



The Production Possibilities Frontier



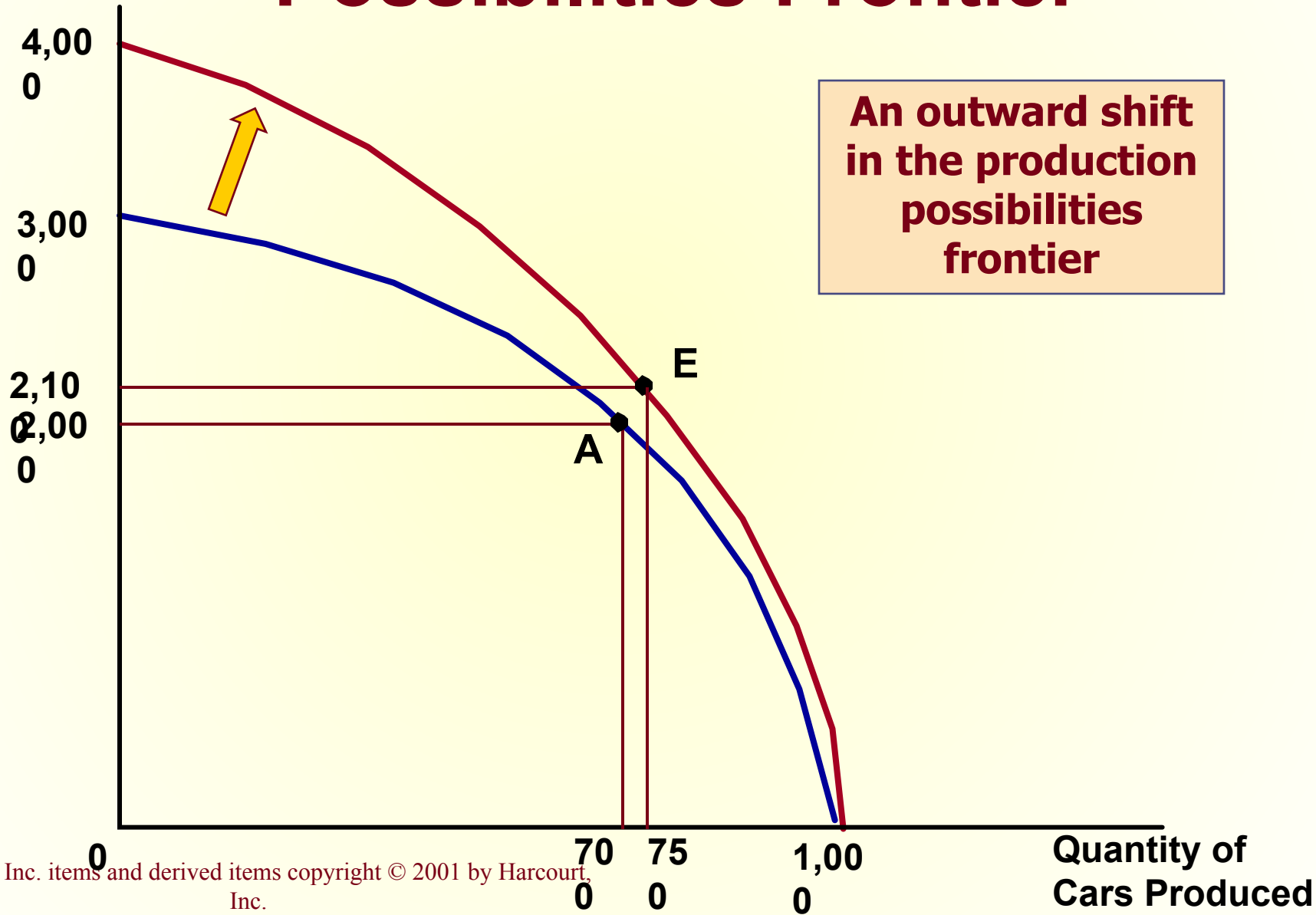
Concepts Illustrated by the Production Possibilities Frontier

- **Efficiency**
- **Tradeoffs**
- **Opportunity Cost**
- **Economic Growth**



The Production Possibilities Frontier

Quantity
of Computers
Produced



Microeconomics and Macroeconomics

- Microeconomics focuses on the individual parts of the economy.
 - How households and firms make decisions and how they interact in specific markets
- Macroeconomics looks at the economy as a whole.
 - How the markets, as a whole, interact at the national level.

Two Roles of Economists

- When they are trying to explain the world, they are *scientists*.
- When they are trying to change the world, they are *policymakers*.

Positive versus Normative Analysis

- **Positive statements** are statements that describe the world as it is.
 - Called *descriptive* analysis
- **Normative statements** are statements about how the world should be.
 - Called *prescriptive* analysis

Positive or Normative Statements?



**An increase in the minimum wage
will cause a decrease in employment
among the least-skilled.**



Positive or Normative Statements?



Higher federal budget deficits will
cause interest rates to increase.



Positive or Normative Statements?

**The income gains from a higher
minimum wage are worth more than
any slight reductions in employment.**



Positive or Normative Statements?

?

State governments should be allowed to collect from tobacco companies the costs of treating smoking-related illnesses among the poor.

?

Economists in Washington . . .

. . . serve as advisers in the policymaking process of the three branches of government:

- **Legislative**
- **Executive**
- **Judicial**

Why Economists Disagree

- They may disagree on theories about how the world works.
- They may hold different values and, thus, different normative views.

Examples of What Most Economists Agree On

- A ceiling on rents reduces the quantity and quality of housing available.
- Tariffs and import quotas usually reduce general economic welfare.

Summary

- In order to address subjects with objectivity, economics makes use of the scientific method.
- The field of economics is divided into two subfields: microeconomics and macroeconomics.

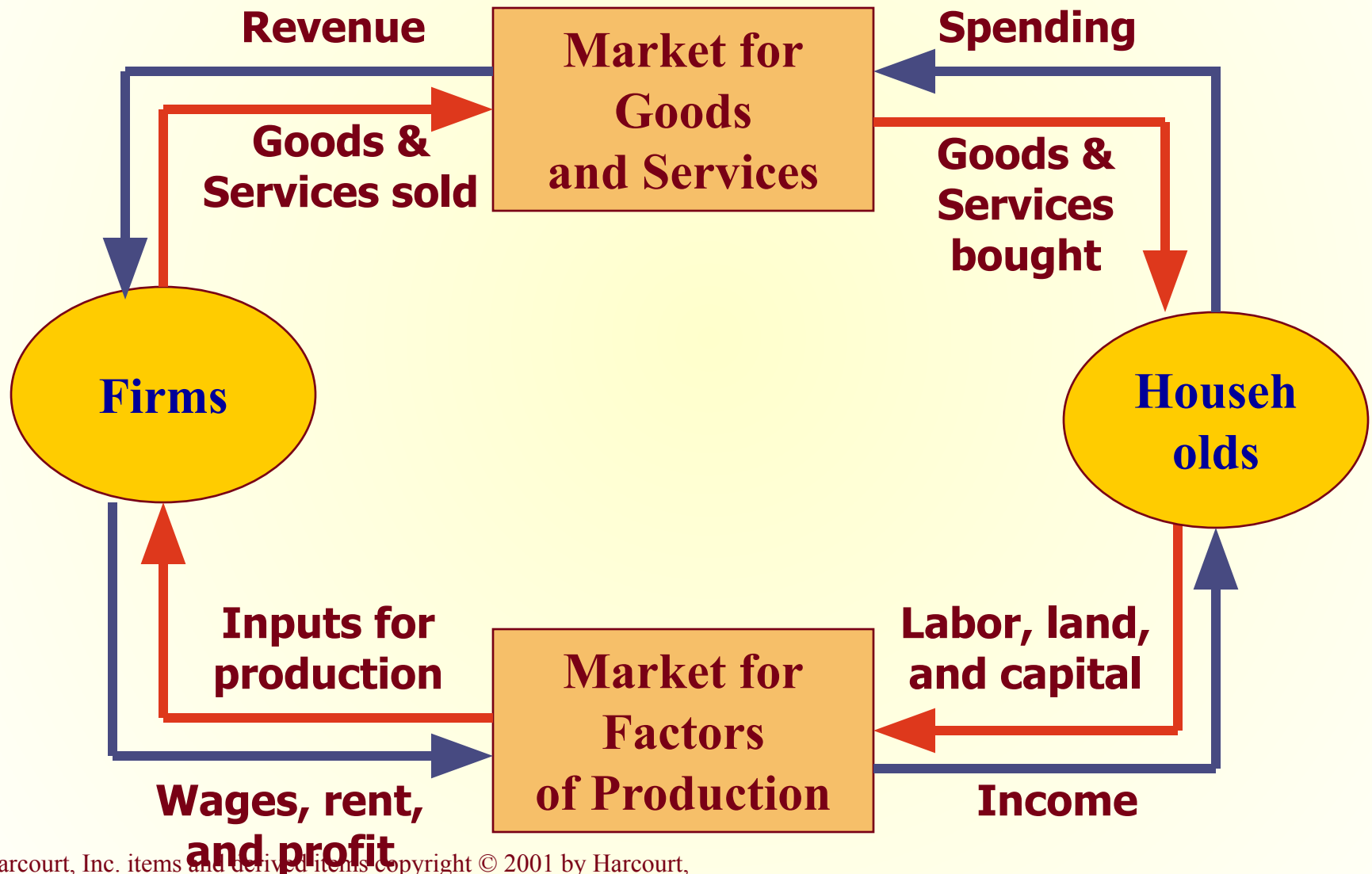
Summary

- **Economics relies on both positive and normative analysis. Positive statements assert how the world “is” while normative statements assert how the world “should be.”**
- **Economists may offer conflicting advice due to differences in scientific judgments or to differences in values.**

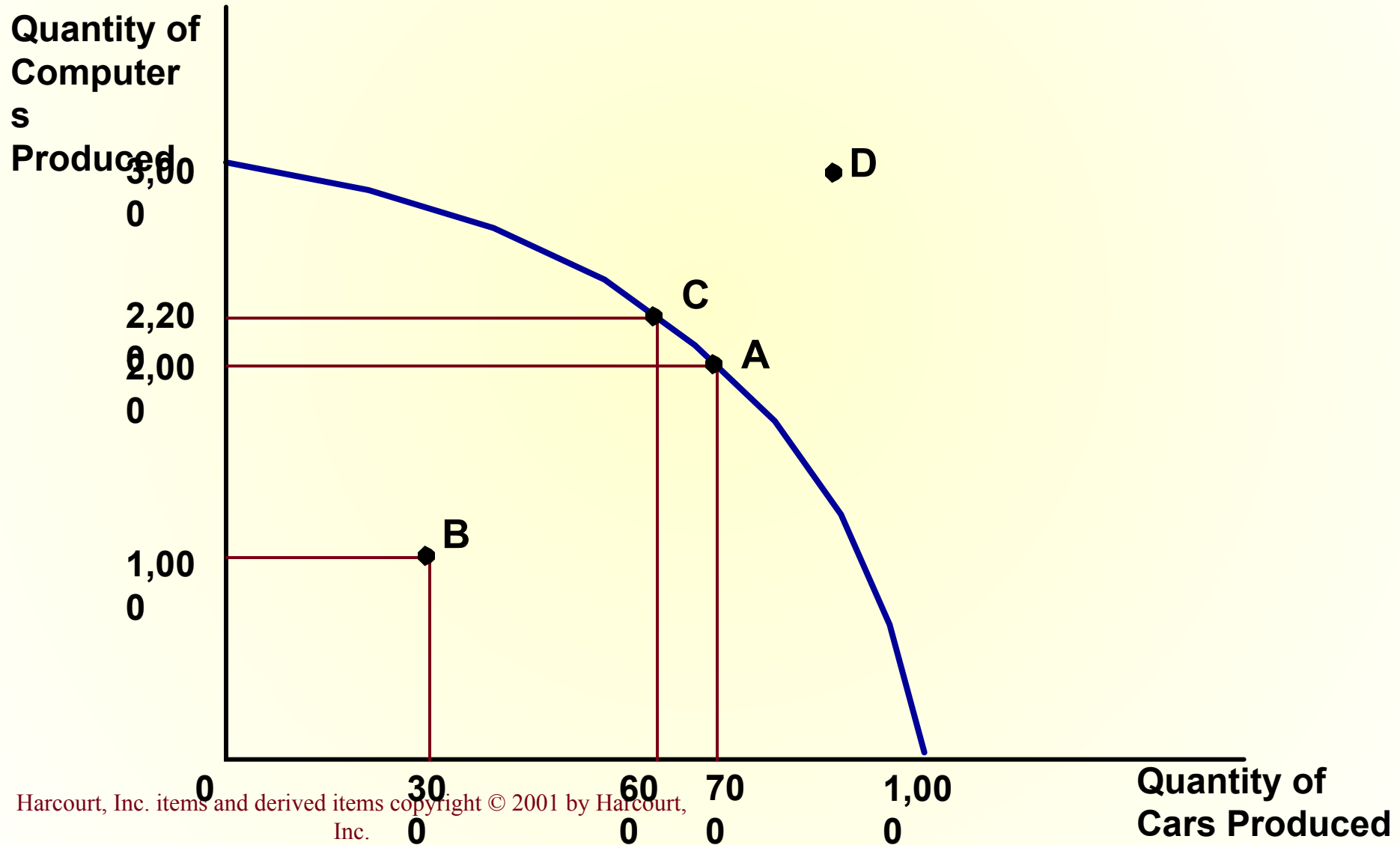


Graphical Review

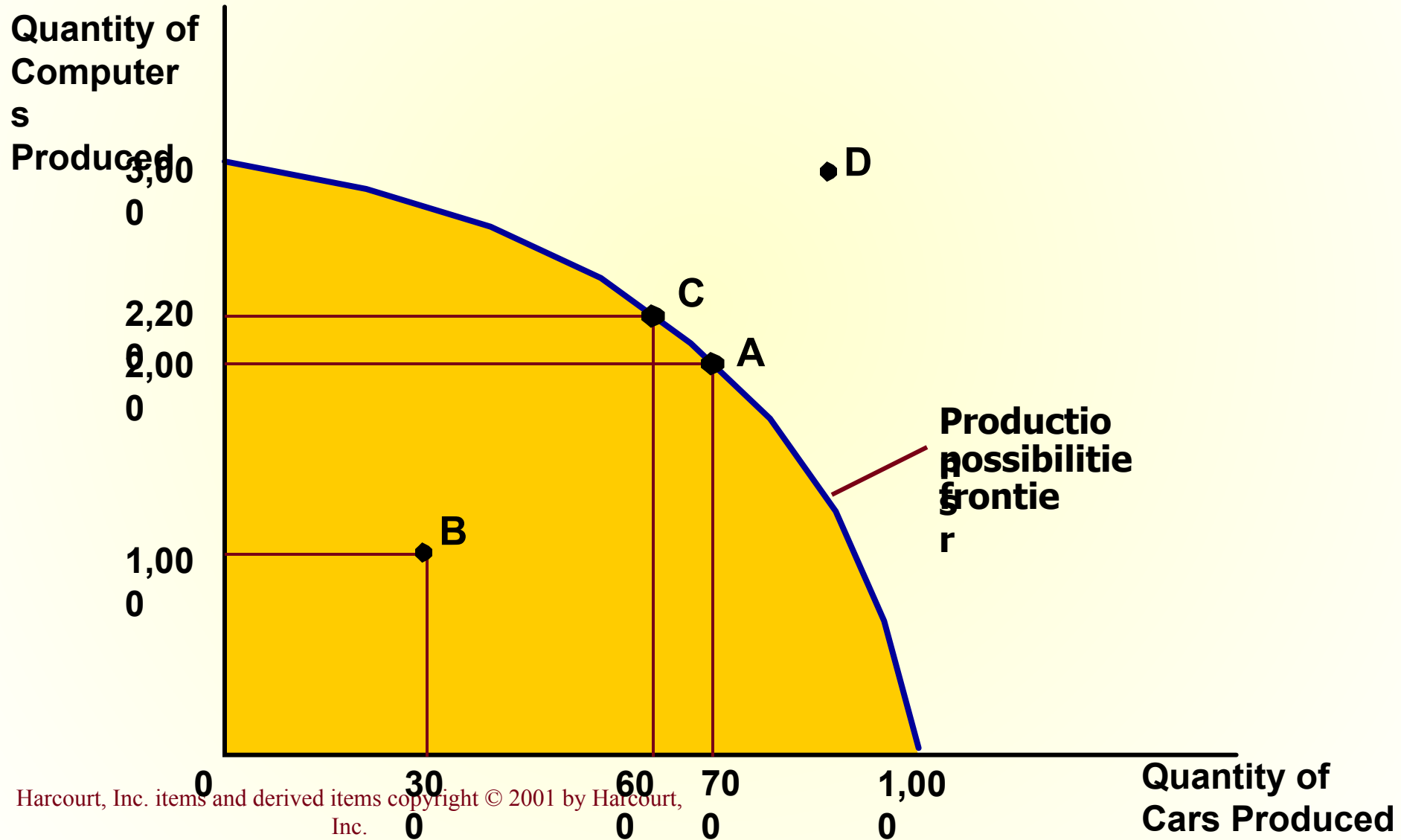
The Circular-Flow Diagram



The Production Possibilities Frontier



The Production Possibilities Frontier



The Production Possibilities Frontier

Quantity
of Computers
Produced

