

# Thinking Like an Economist

## Chapter 2

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# Every field of study has its own terminology

## Mathematics

axioms  
integrals  
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)



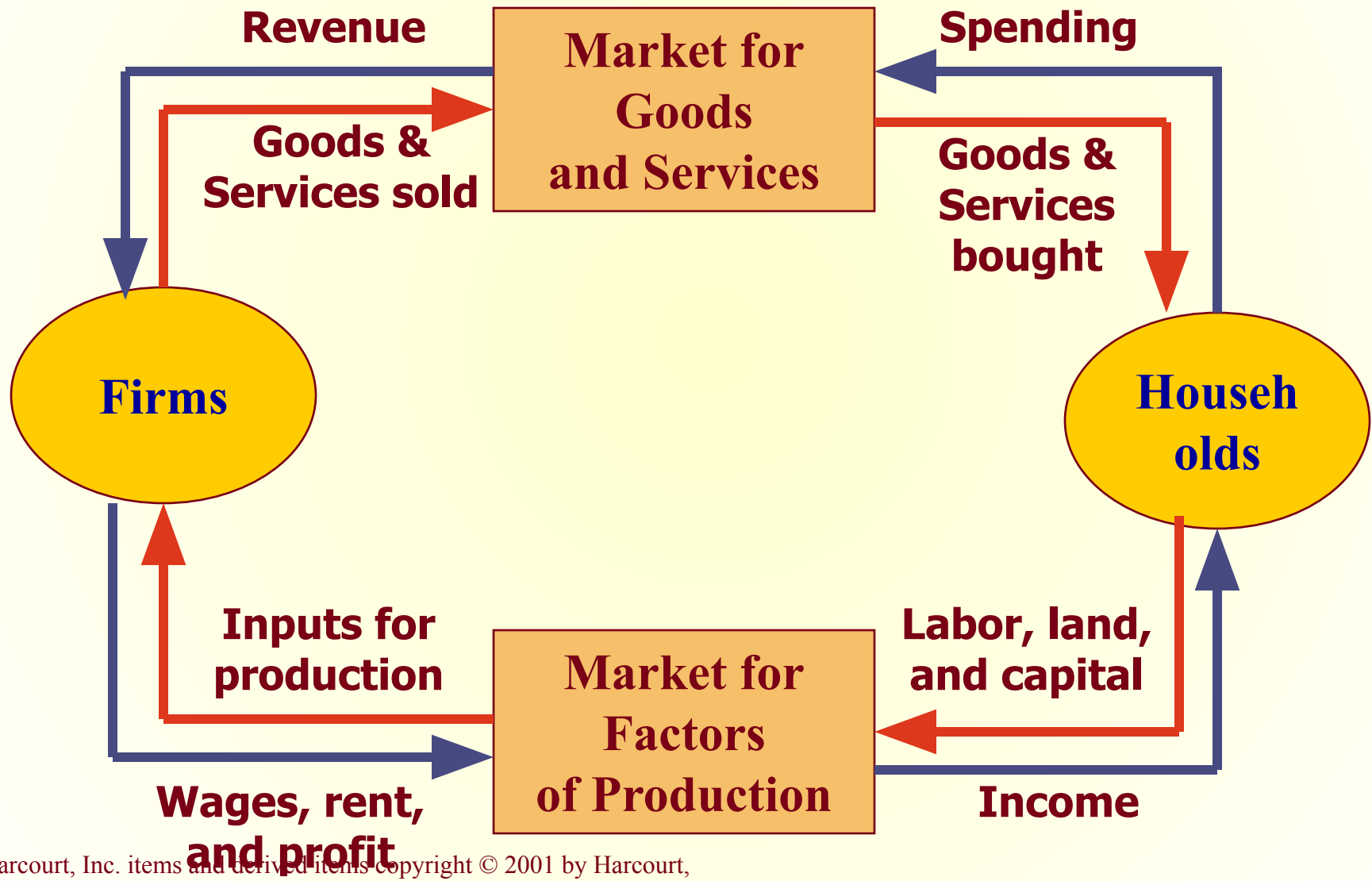
# Economic Models

- 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

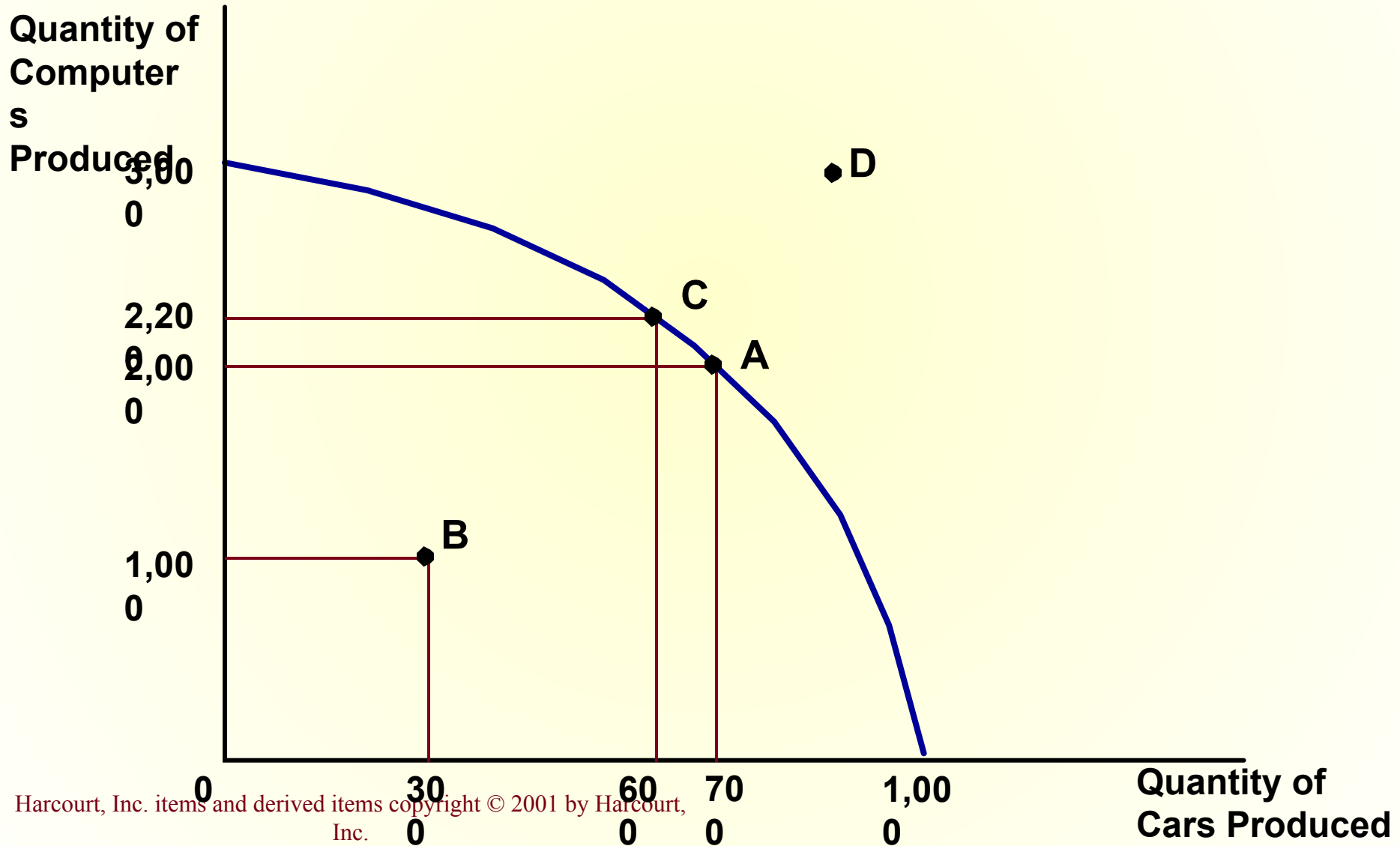
## Factors of Production

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

# The Production Possibilities Frontier

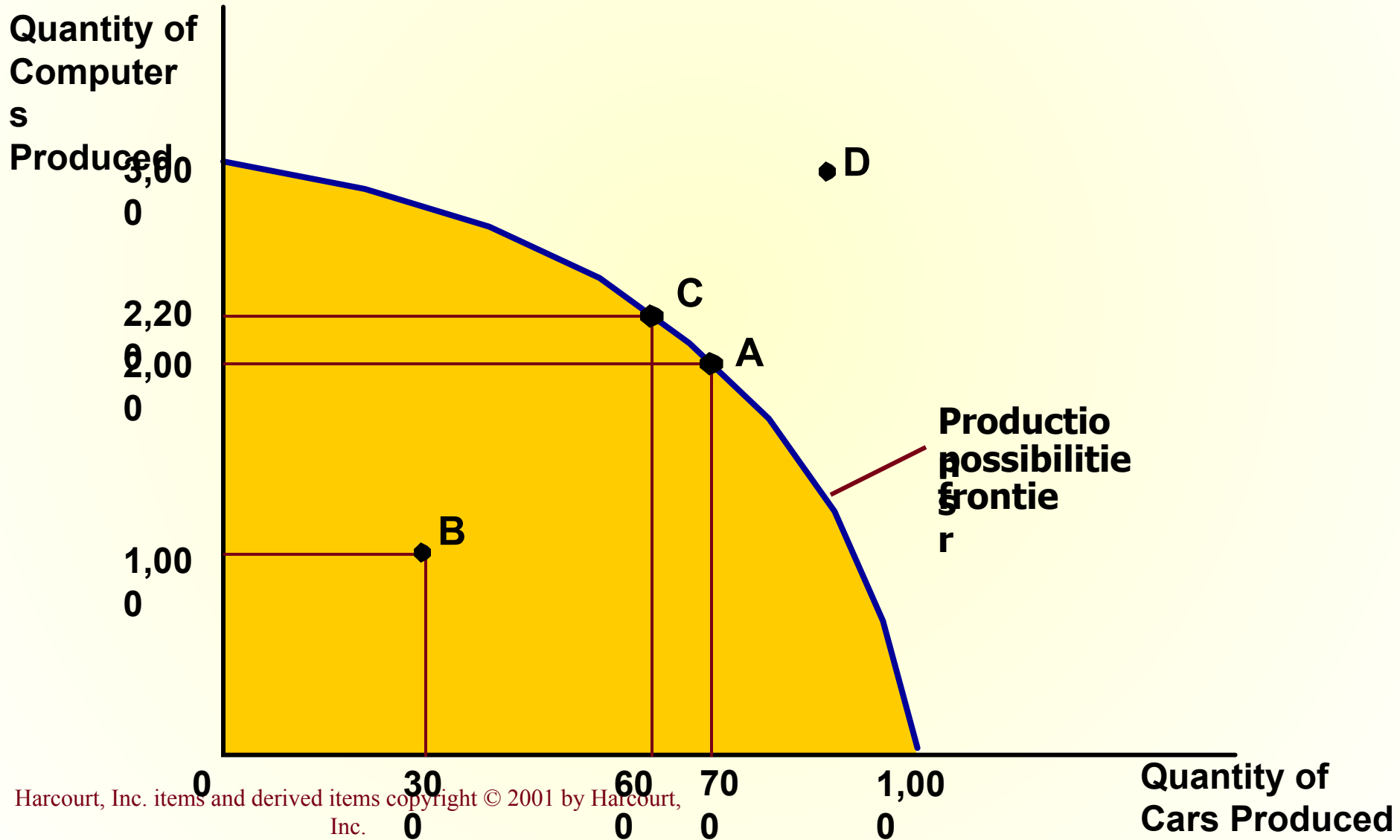
The production possibilities frontier is a graph showing the various combinations of output that the economy can possibly produce given the available factors of production and technology.

# The Production Possibilities Frontier





# The Production Possibilities Frontier



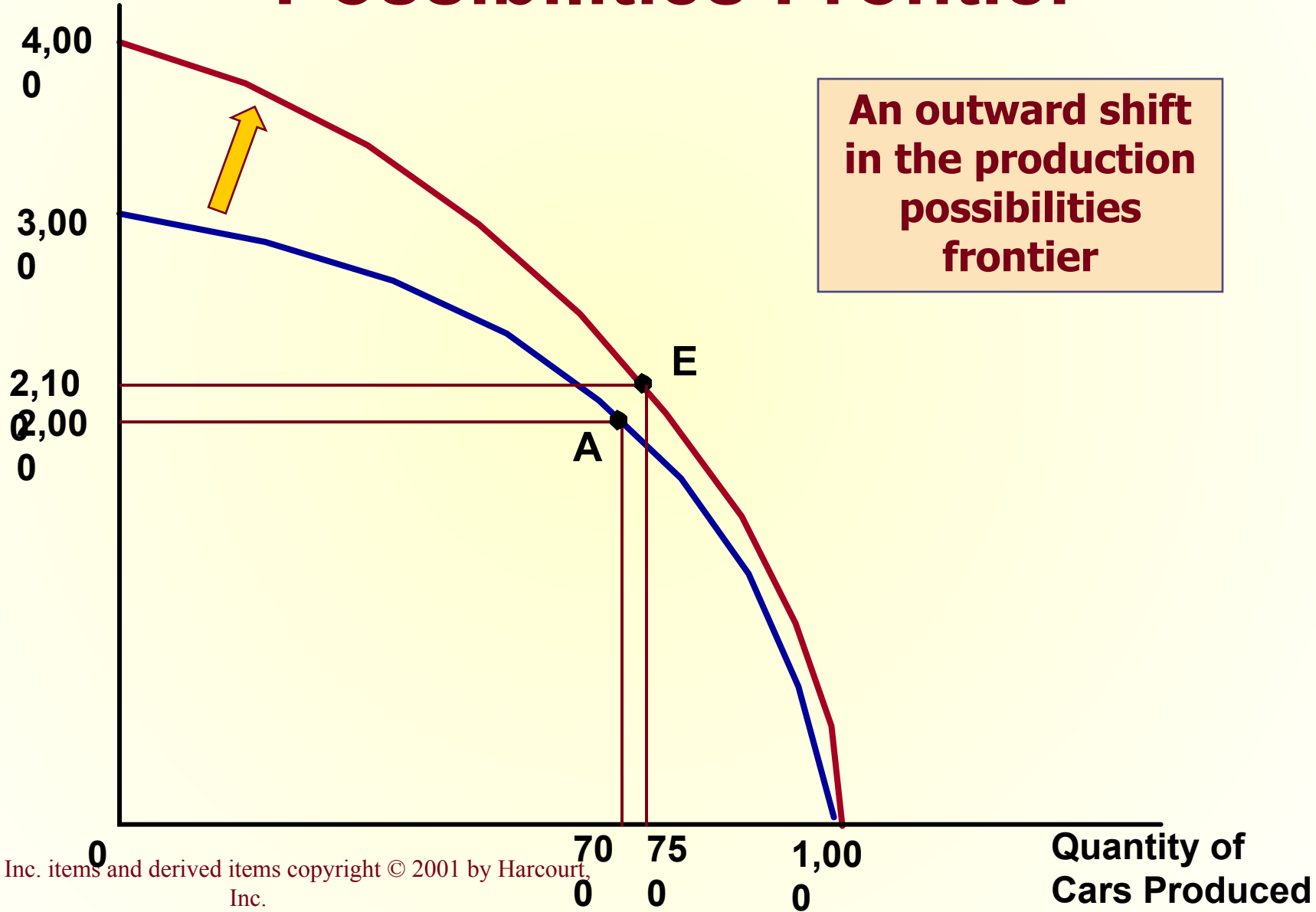
# Concepts Illustrated by the Production Possibilities Frontier

- **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

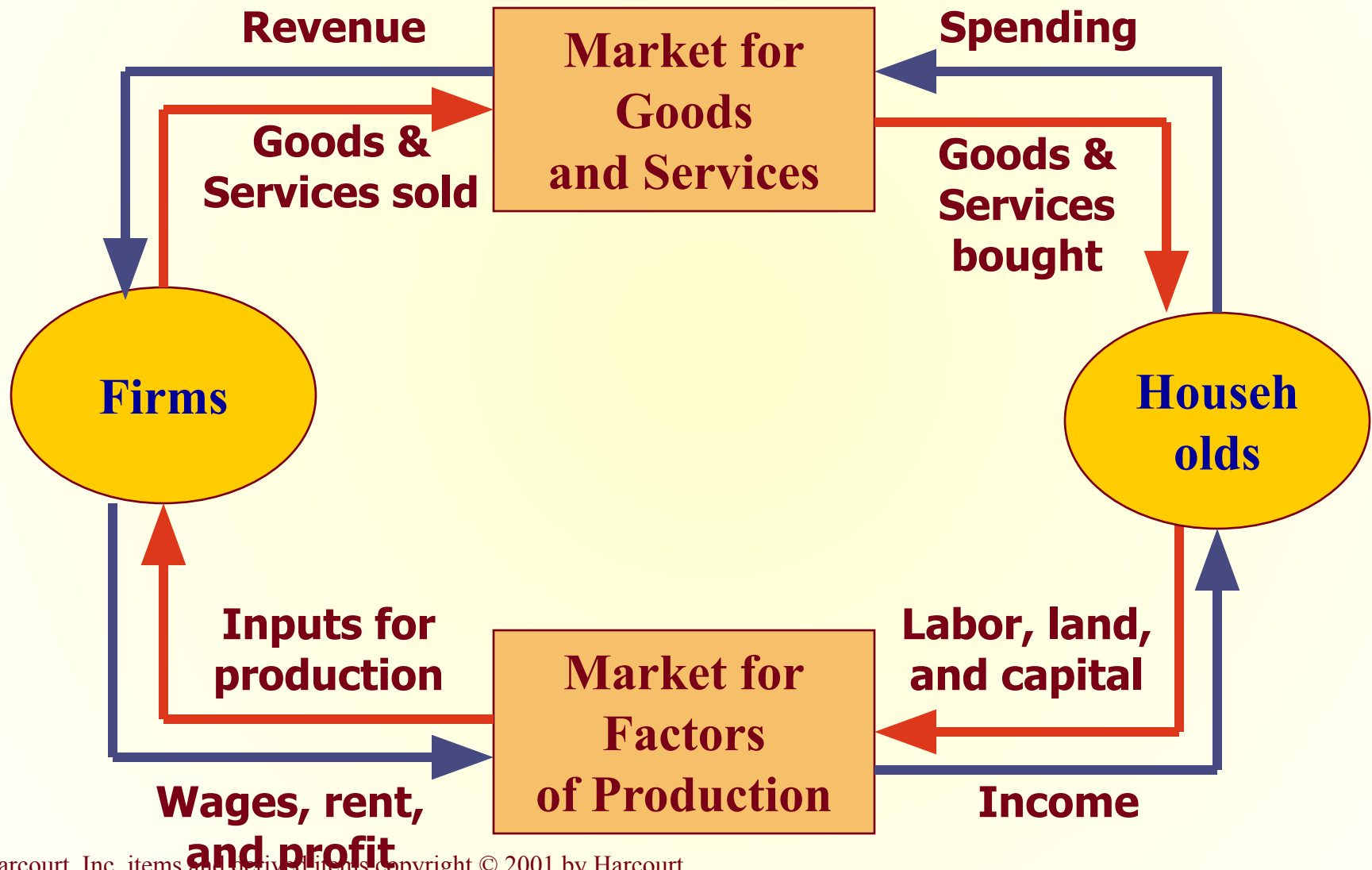
- **Economics relies on both positive and normative analysis. Positive statements assert how the world “is” while normative statements assert how the world “should be.”**
- **Economists may offer conflicting advice due to differences in scientific judgments or to differences in values.**



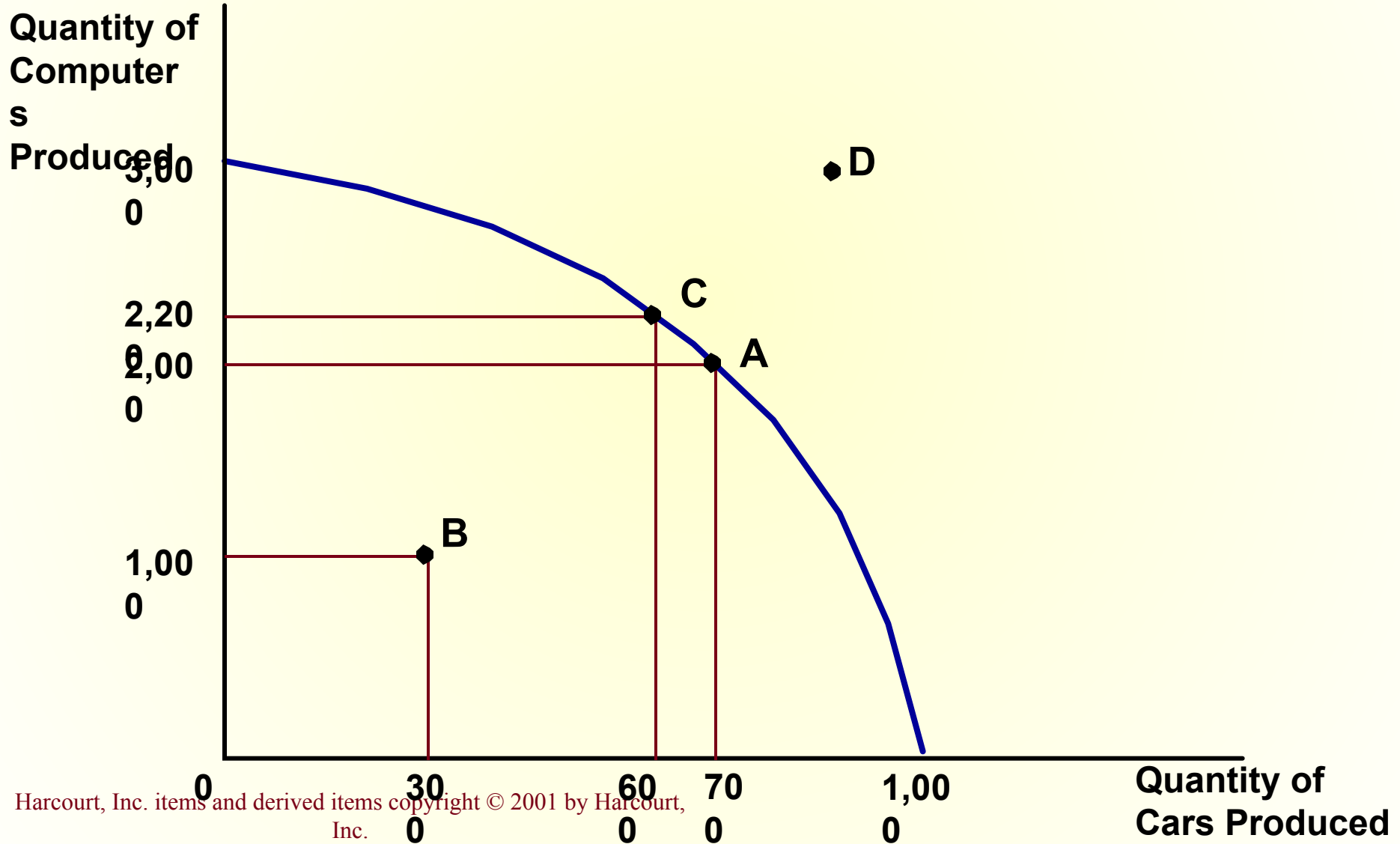
# Graphical Review



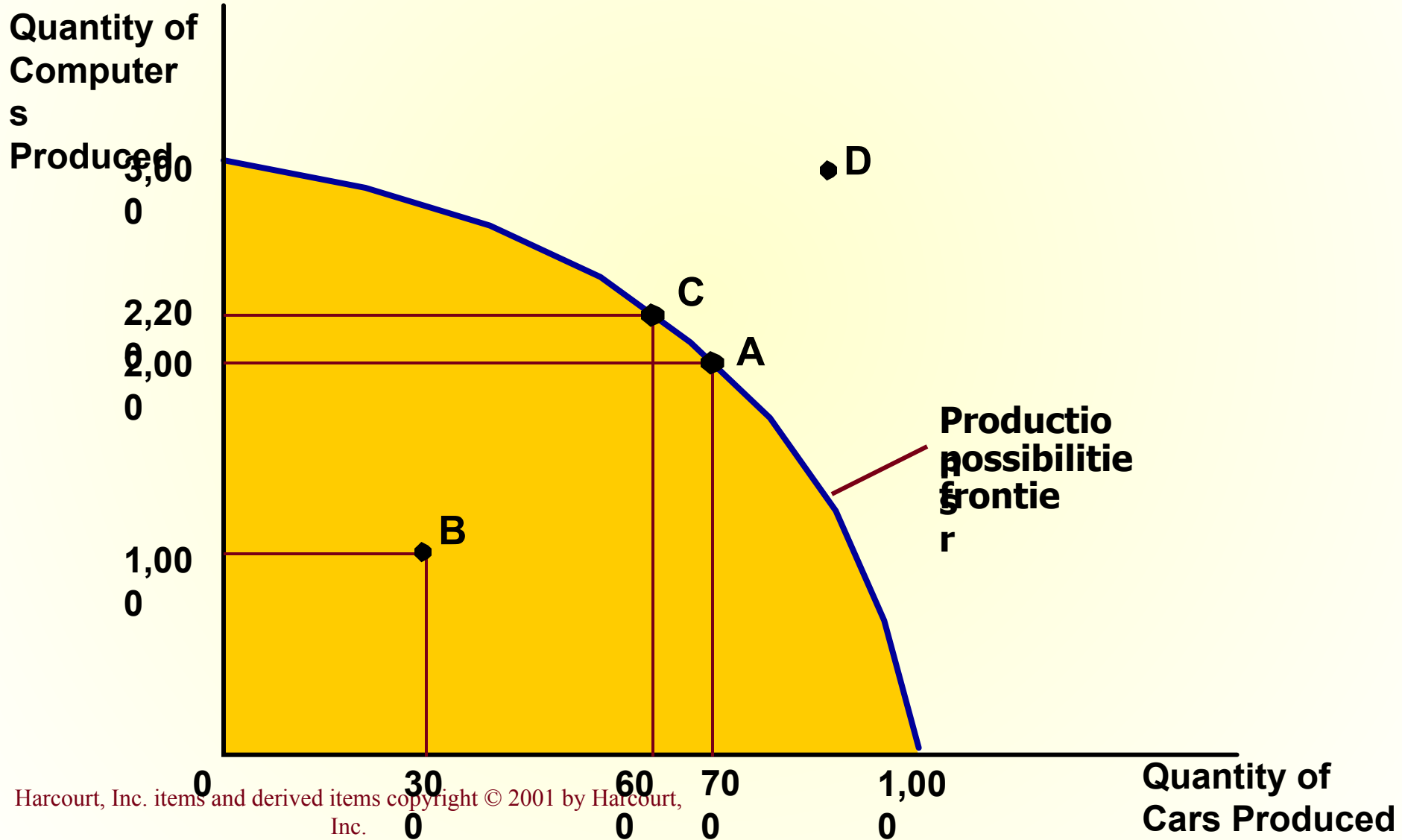
# The Circular-Flow Diagram



# The Production Possibilities Frontier



# The Production Possibilities Frontier



# The Production Possibilities Frontier

Quantity of Computers Produced

