

Thinking Like an Economist

Thinking Like an Economist

- Every field of study has its own terminology
 - Mathematics
 - Psychology
 - Law
 - Economics

Thinking Like an Economist

- 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: Observation, Theory, and More Observation

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

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.

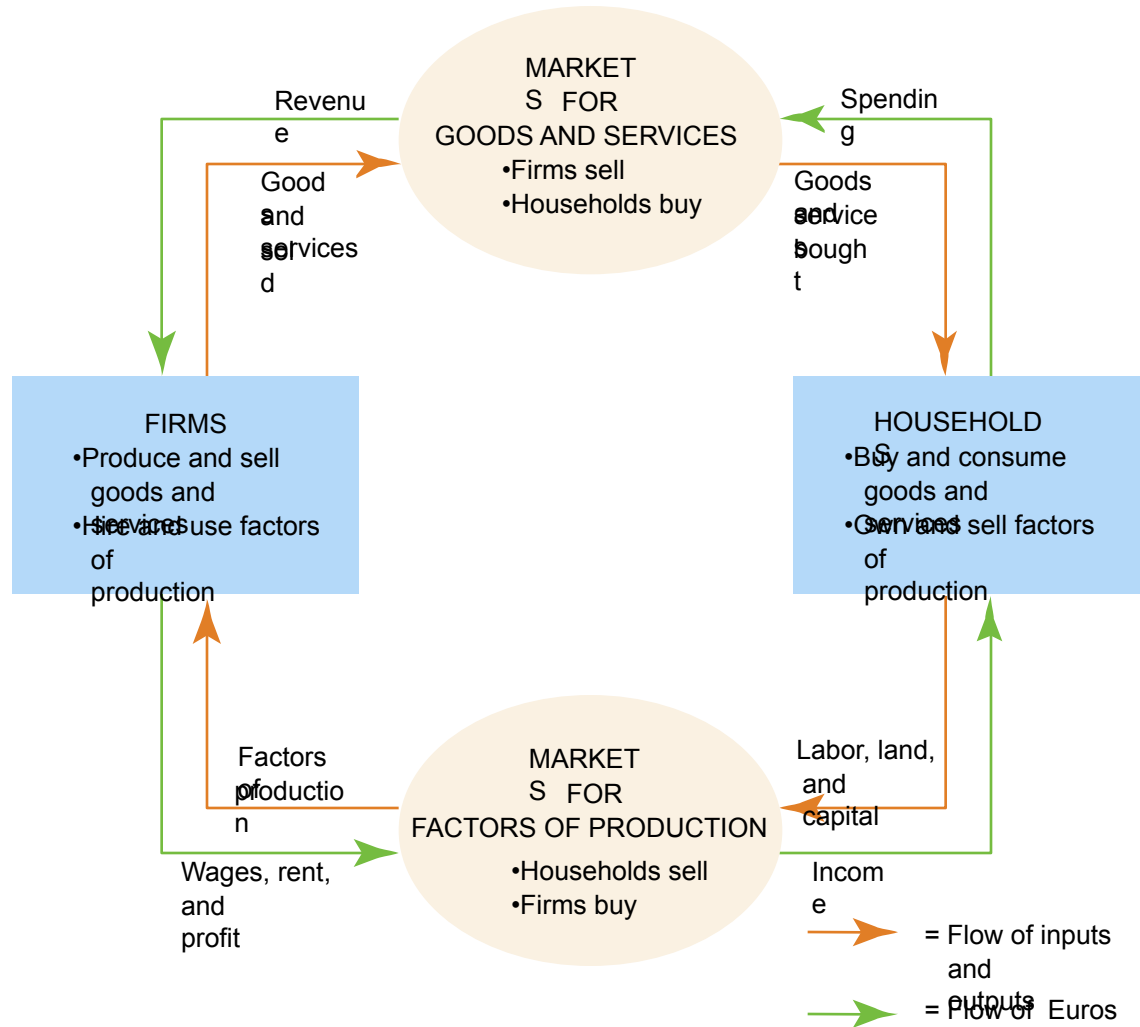
Economic Models

- 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 Diagram
 - The Production Possibilities Frontier

Our First Model: The Circular-Flow Diagram

- The circular-flow diagram is a visual model of the economy that shows how dollars flow through markets among households and firms.

The Circular Flow



Our First Model: 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

Our First Model: The Circular-Flow Diagram

- Markets for Goods and Services
 - Firms sell
 - Households buy
- Markets for Factors of Production
 - Households sell
 - Firms buy

Our First Model: The Circular-Flow Diagram

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

Our Second Model: The Production Possibilities Frontier

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

The Production Possibilities Frontier

Quantity of
Computers
Produced

3,000

2,200

2,000

1,000

0

300

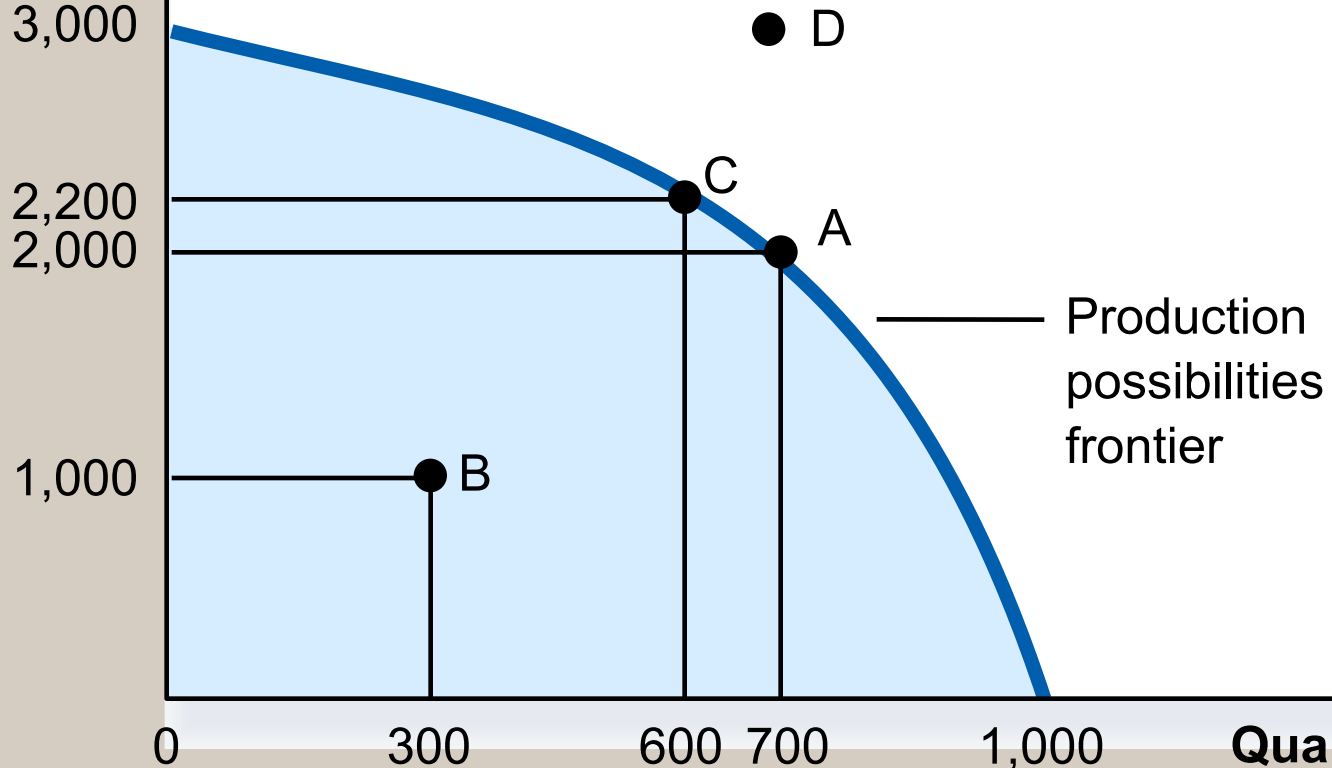
600

700

1,000

Quantity of

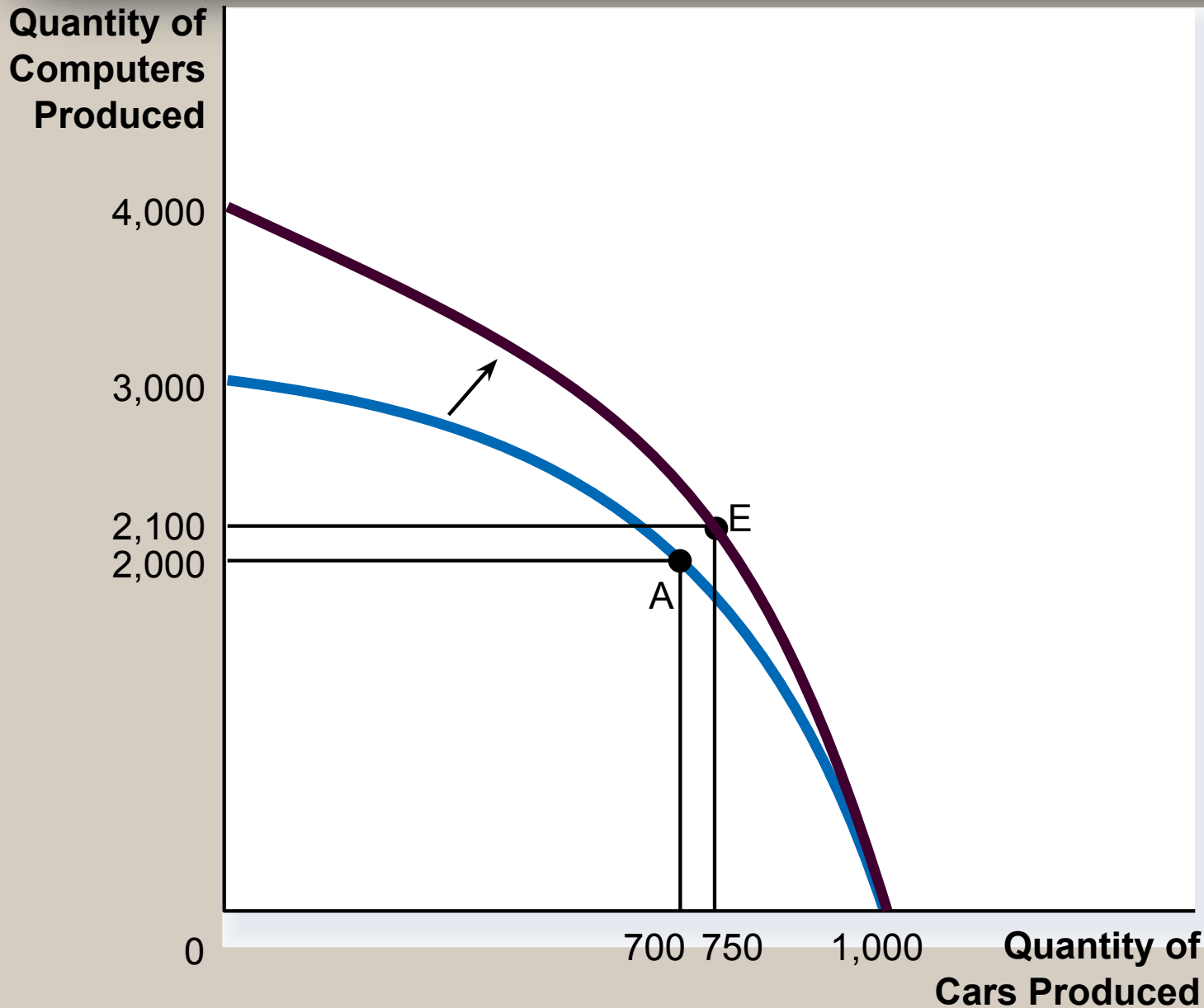
Cars Produced



Our Second Model: The Production Possibilities Frontier

- Concepts Illustrated by the Production Possibilities Frontier
 - Efficiency
 - Tradeoffs
 - Opportunity Cost
 - Economic Growth

A Shift in the Production Possibilities Frontier



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.
 - Economy-wide phenomena, including inflation, unemployment, and economic growth

The economist as policy advisor

- When economists are trying to explain the world, they are scientists.
- When economists are trying to change the world, they are policy advisor.

Positive versus normative analysis

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

Positive versus normative analysis

- Positive or Normative Statements?
 - An increase in the minimum wage will cause a decrease in employment among the least-skilled.
 - POSITIVE

 - Higher federal budget deficits will cause interest rates to increase.
 - POSITIVE

Positive versus normative analysis

- Positive or Normative Statements?
 - The income gains from a higher minimum wage are worth more than any slight reductions in employment.

NORMATIVE

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

NORMATIVE

Economists in Washington and Helsinki...

- . . . serve as advisers in the policymaking process of the three branches of government:
 - Legislative
 - Executive
 - Judicial

WHY ECONOMISTS DISAGREE

- They may disagree about the validity of alternative positive theories about how the world works.
- They may have different values and, therefore, different normative views about what policy should try to accomplish.

Ten Propositions about Which Most Economists Agree

Proposition (and percentage of economists who agree)

1. A ceiling on rents reduces the quantity and quality of housing available. (93%)
2. Tariffs and import quotas usually reduce general economic welfare. (93%)
3. Flexible and floating exchange rates offer an effective international monetary arrangement. (90%)
4. Fiscal policy (e.g., tax cut and/or government expenditure increase) has a significant stimulative impact on a less than fully employed economy. (90%)
5. If the federal budget is to be balanced, it should be done over the business cycle rather than yearly. (85%)
6. Cash payments increase the welfare of recipients to a greater degree than do transfers-in-kind of equal cash value. (84%)
7. A large federal budget deficit has an adverse effect on the economy. (83%)
8. A minimum wage increases unemployment among young and unskilled workers. (79%)
9. The government should restructure the welfare system along the lines of a "negative income tax." (79%)
10. Effluent taxes and marketable pollution permits represent a better approach to pollution control than imposition of pollution ceilings. (78%)

Summary

- Economists try to address their subjects with a scientist's objectivity.
 - They make appropriate assumptions and build simplified models in order to understand the world around them.
 - Two simple economic models are the circular-flow diagram and the production possibilities frontier.

Summary

- Economics is divided into two subfields:
 - Microeconomists study decision-making by households and firms in the marketplace.
 - Macroeconomists study the forces and trends that affect the economy as a whole

Summary

- A positive statement is an assertion about how the world is.
- A normative statement is an assertion about how the world ought to be.
- When economists make normative statements, they are acting more as policy advisors than scientists.

Summary

- Economists who advise policymakers offer conflicting advice either because of differences in scientific judgments or because of differences in values.
- At other times, economists are united in the advice they offer, but policymakers may choose to ignore it.