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Thinking Like an Economist



Thinking Like an Economist

Every field of study has its own terminology

- Mathematics

- integrals ❖ axioms ❖ vector spaces

- Psychology

- ego ❖ id ❖ cognitive dissonance

- Law

- promissory ❖ estoppel ❖ torts ❖ venues

- Economics

- supply ❖ opportunity cost ❖ elasticity ❖ consumer surplus ❖ demand ❖ comparative advantage ❖ deadweight loss



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

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.

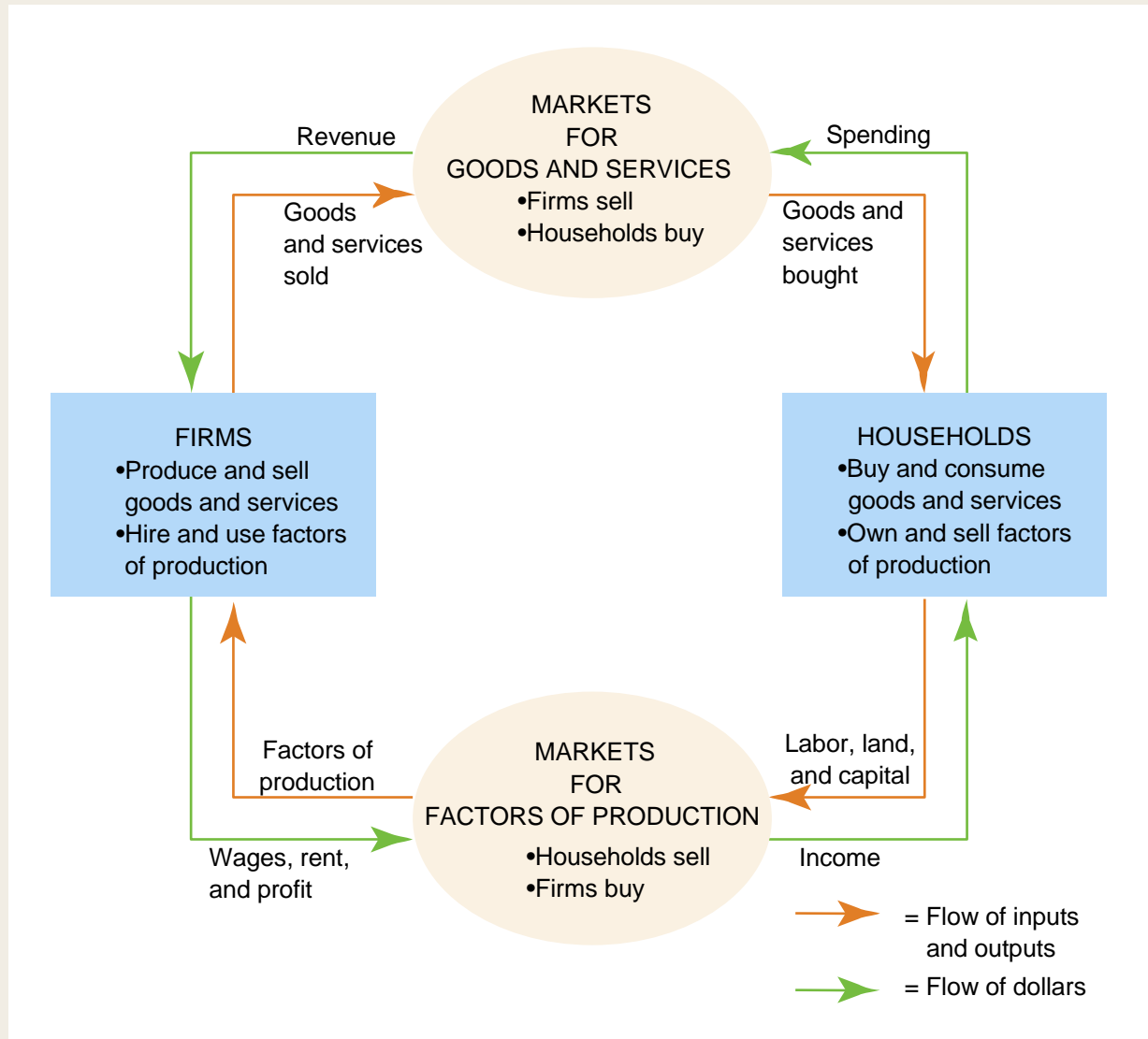
Economic Models

- Economists use models to simplify reality in order to improve our understanding of the world.
- Two of the most basic economic models are:
 - 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.

Figure 1 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

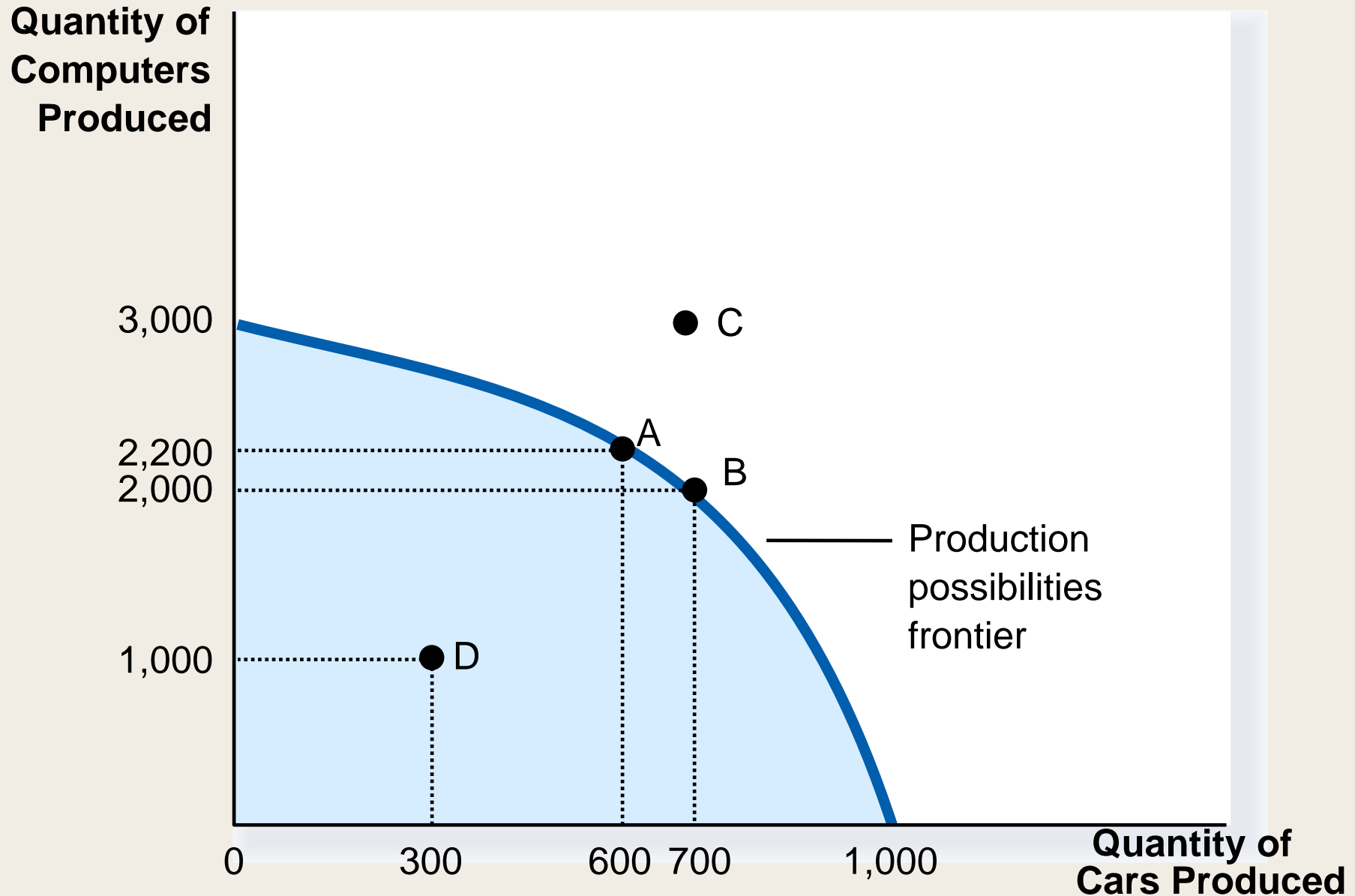
Our First Model: The Circular-Flow Diagram

- 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.

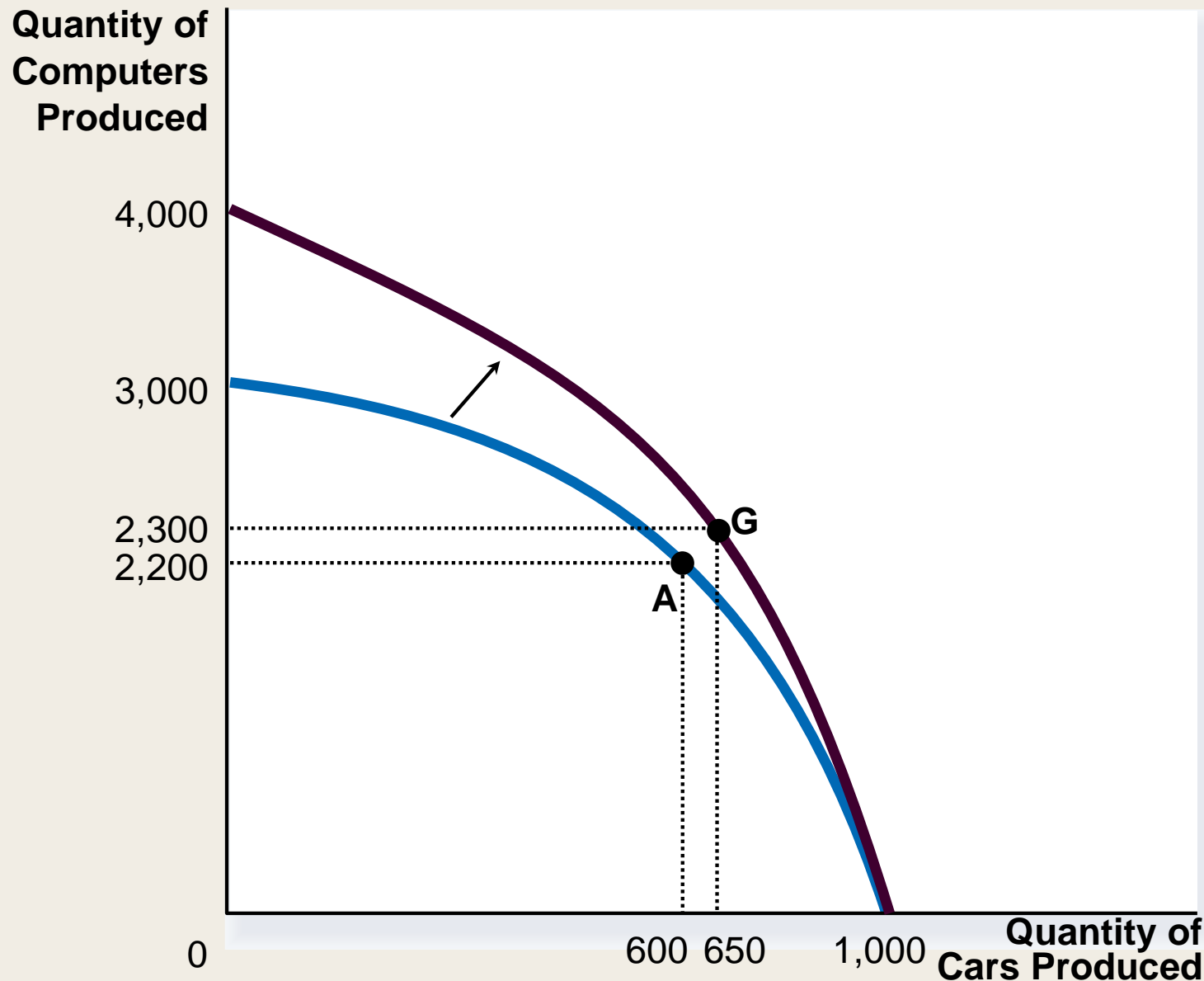
Figure 2 The Production Possibilities Frontier



Our Second Model: The Production Possibilities Frontier

- Concepts illustrated by the production possibilities frontier
 - Efficiency
 - Trade-offs
 - Opportunity cost
 - Economic growth

Figure 3 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 advisors.

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

• Are the following 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

- Are the following 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

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

Economists in Washington

- Some government agencies that collect economic data and make economic policy include:
 - Department of Commerce
 - <http://www.commerce.gov>
 - Bureau of Labor Statistics
 - <http://www.bls.gov>
 - Congressional Budget Office
 - <http://www.cbo.gov>
 - Federal Reserve Board
 - <http://www.federalreserve.gov>



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.

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T A B L E

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%)

Source: Richard M. Alston, J. R. Kearl, and Michael B. Vaughn, "Is There Consensus among Economists in the 1990s?" *American Economic Review* (May 1992): 203–209. Reprinted by permission.

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:
 - Microeconomics is the study of decision-making by households and firms in the marketplace.
 - Macroeconomics is the study of 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.