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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

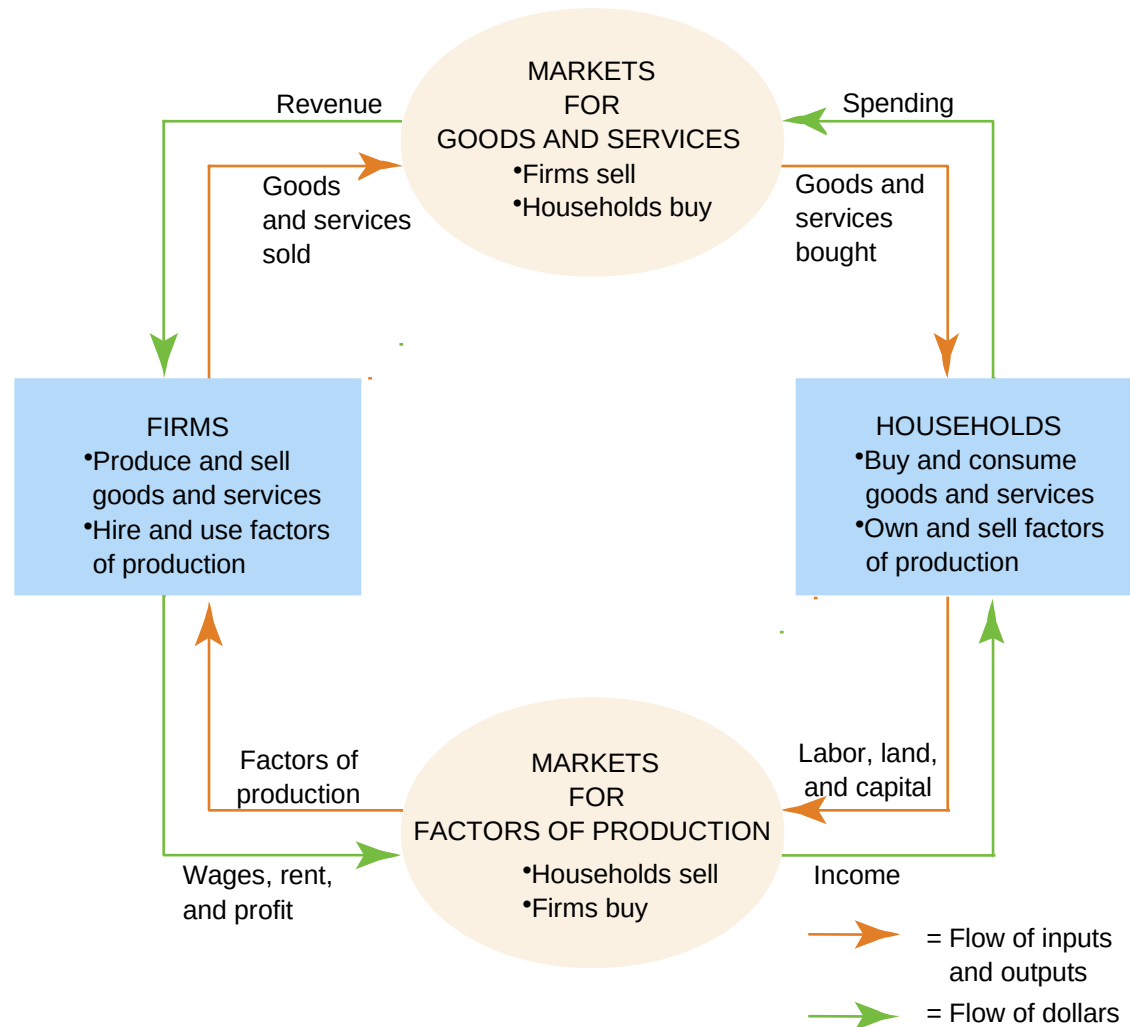
- Economists use models to simplify reality in order to improve our understanding of the world.
- Two of the most basic economic models are:
  - The Circular Flow Diagram
  - The Production Possibilities Frontier

# 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

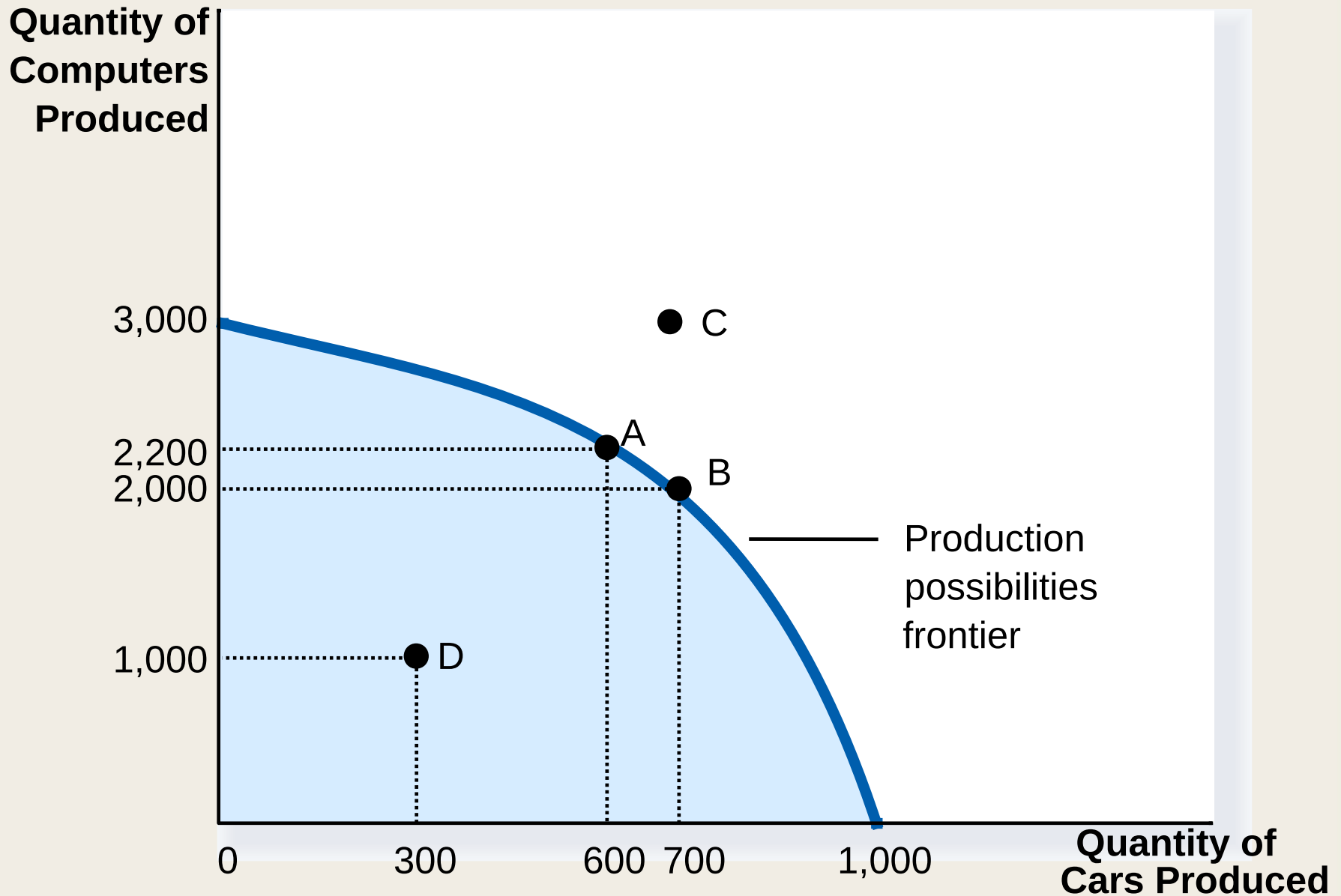
# Our First Model: The Circular-Flow Diagram

- 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.

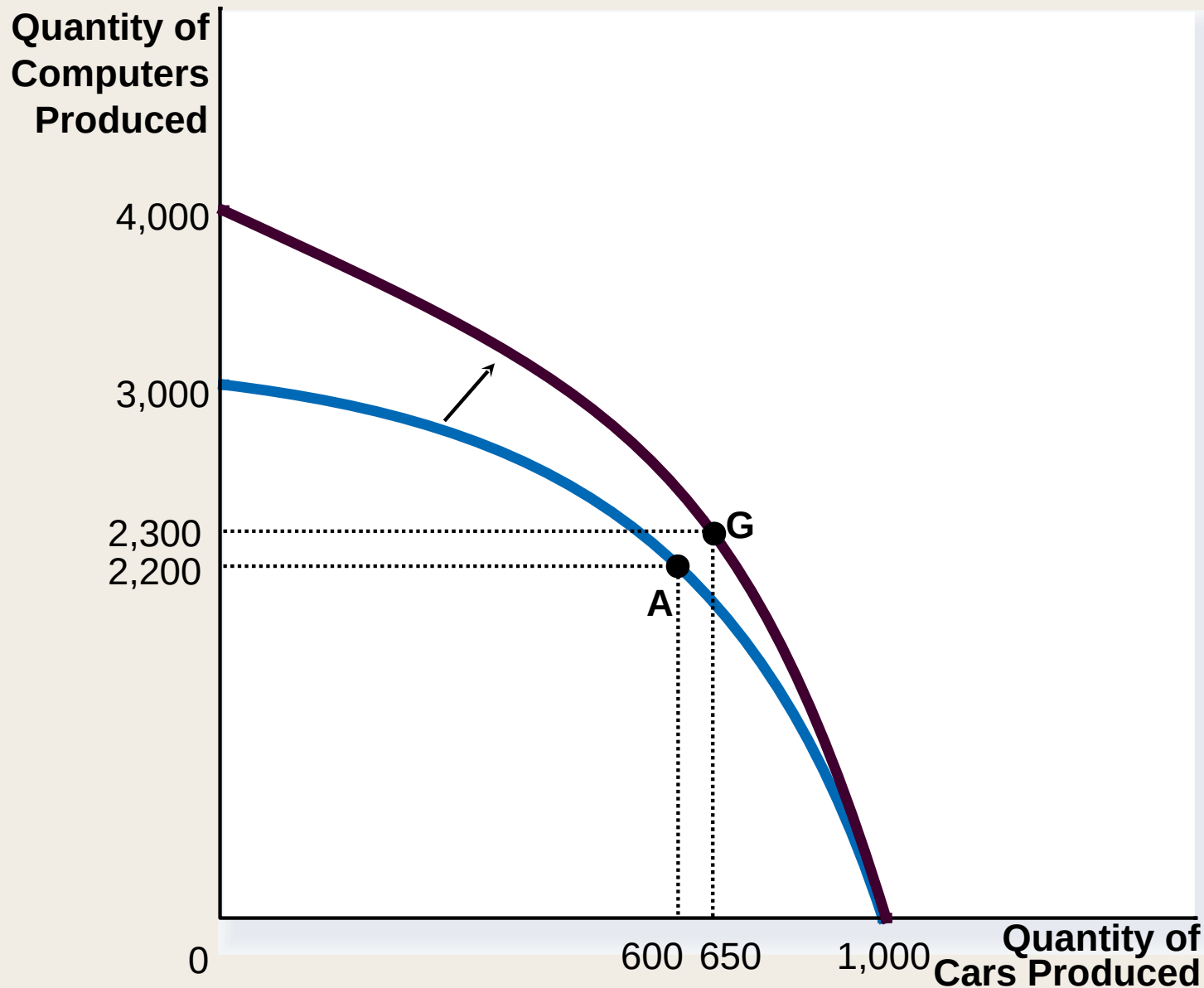
## Figure 2 The Production Possibilities Frontier



# 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

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- 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

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- 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

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- 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

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- 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.