Chapter 1

The Economic Approach

# OUTLINE

I. What Is Economics About?

A. Scarcity means having to make choices.

1. Scarcity and choice are the two essential ingredients of an economic topic.

2. Scarcity is present whenever there is less of a good or resource freely available than people would like.

a. Scarce goods are called economic goods.

b. Resources are the inputs that people use to produce goods and services and may include human, physical, and natural resources.

3. Scarcity forces us to choose among available alternatives.

B. Scarcity and poverty are not the same.

1. Scarcity is a factual concept in which limited resources cause our desires for goods and services to be lacking.

2. Poverty is more subjective in nature; different people have different ideas of what it means to be “poor.”

3. We may someday eliminate poverty, but scarcity will always be with us.

C. Scarcity necessitates rationing.

1. Every society must have a method to ration the scarce resources among competing uses.

a. Various factors can be used to ration (first-come, first-served).

b. In a market setting, price is used to ration goods and resources.

c. When price is used, the good or resource is allocated to those willing to give up “other things” in order to obtain ownership rights.

D. The method of rationing influences the nature of competition.

1. Competition is a natural outgrowth of the need to ration scarce goods.

2. Changing the rationing method used will change the form of competition, but it will not eliminate competitive tactics.

II. The Economic Way of Thinking

A. Eight guideposts to economic thinking

1. The use of scarce resources is costly, so decision-makers must make trade-offs.

a. Someone must give up something if we are to have more scarce goods.

(1) The highest-valued alternative that must be sacrificed is the opportunity cost of the choice.

2. Individuals choose purposefully—they try to get the most from their limited resources.

a. Economizing: gaining a specific benefit at the least possible cost.

3. Incentives matter—changes in incentives influence human choices in a predictable way. Both monetary and nonmonetary incentives matter.

a. As personal benefits (costs) from choosing an option increase, other things constant, a person will be more (less) likely to choose that option.

4. Individuals make decisions at the margin.

a. Decisions will be based on marginal costs and marginal benefits (utility).

5. Although information can help us make better choices, its acquisition is costly..

6. Beware of the secondary effects: Economic actions often generate indirect as well as direct effects.

7. The value of a good or service is subjective.

8. The test of a theory is its ability to predict.

III. Positive and Normative Economics

A. Positive economics is the scientific study of “what is” among economic relationships.

1. Positive economic statements can be proved either true or false.

a. Ex: The inflation rate rises when the money supply is increased.

B. Normative economics are judgments about “what ought to be” in economic matters.

1. Normative statements cannot be proved true or false.

a. Ex: The inflation rate should be lower.

IV. Pitfalls to Avoid in Economic Thinking

A. Violation of the *ceteris paribus* condition can lead one to draw the wrong conclusion.

1. *Ceteris paribus* is a Latin term meaning “other things constant.”

2. Used when the effect of one change is being described, recognizing that if other things changed, they also could affect the result.

B. Good intentions do not guarantee desirable outcomes.

1. Policies formed with good intentions may have unintended adverse secondary effects.

C. Association is not causation.

1. Statistical association alone cannot establish causation.

D. The fallacy of composition: What’s true for one might not be true for all.

1. The fallacy of composition is the erroneous view that what is true for the individual (or the part) will also be true for the group (or the whole).

2. Microeconomics focuses on narrowly defined units, while macroeconomics focuses on highly aggregated units.

a. One must beware of the fallacy of composition when shifting from micro to macro units.

# FOCUS QUESTIONS

As you read this chapter, look for answers to the following questions:

* What is scarcity? Why does scarcity necessitate rationing and cause competition?
* What is the economic way of thinking? What is the basic postulate of economics, and why is it so important?
* What is the difference between positive and normative economics?

# CONTEXT

The purpose of this chapter is to introduce the student to the economic way of thinking. Unless students understand the concept of scarcity, the importance of personal incentives, and subject their thinking to the scientific method, they will do poorly in economics.

Generally, teachers overestimate their students. While many of your students will easily grasp the basics of the economic way of thinking, others will need additional examples and illustrations before they understand the essentials. The concepts of scarcity, economizing behavior, and incentives are so important, they are worth an entire lecture. Use several illustrations to highlight the impact on human behavior of changes in personal benefits or costs.

Introductory students tend to associate economics with business decision making. We must illustrate to them that the basic principles of economics and personal incentives influence all of human decision making, including choices in the political and social spheres. You may also want to contrast the methodology of economics with that of other social sciences and the physical sciences. Discuss both the similarities and differences.

# IMPORTANT POINTS AND TEACHING SUGGESTIONS

1. Be sure to distinguish clearly between scarcity and poverty (and shortages, once supply and demand have been covered). Anything that we would like to have more of at no cost is scarce. Thus, almost everything from clean air to leisure time to the ingenuity necessary to make other resources useful is scarce. Poverty is defined as failure to attain some minimum level of income. Poverty can conceivably be eliminated, whereas scarcity persists since goods are scarce for both the rich and the poor. A shortage is present when purchasers would like to buy more than is available *at the current price.*

2. Introducing the subject of incentives, one can readily emphasize the importance and generality of this basic principle of economics. When an activity is made more costly, people will be less likely to choose it. Similarly, when the benefits derived from an event increase, people will be more likely to undertake it. Numerous examples can illustrate this concept. How does hot weather influence one’s decision to do without air-conditioning (or a swimming pool)? How does rewarding class attendance with higher grades influence one’s decision to go to class? How does the grading policy of the instructor influence a student’s incentive to study?

3. Discuss the meaning of “the margin” with students. Use non-economic examples to help clarify the idea. For example, ask students how an additional outstanding running back will influence the quality of a football team. (This is a marginal change.) If the running back position was previously a team weakness, the new player may make a substantial difference. On the other hand, if the team was already strong at this position, the new player may exert little influence on the overall performance of the team. Indicate clearly the difference between (a) the overall performance of the team (a total concept) and (b) the change that results from the addition of the new player (a marginal concept).

4. A good way of illustrating the search for information is to ask students how long they would search for a $50 bill. If your time had an opportunity cost of $10, you would look as long as you thought the probability of finding the bill in the next hour was at least 1/5. (The answer is not five hours in this case, because time already spent searching is then a sunk cost. A person could look well more or less than five hours.)

5. Give examples of actions that have secondary effects. What are the secondary effects of overeating? Lack of adequate sleep? Restricting trade with Japan? Fixing the price of wheat at $6 per bushel?

6. Emphasize both the theory and empirical parts of economics. Many professional economists are engaged in the continual testing of various aspects of economic theory. Discuss how economic theory is tested. Indicate real-world events that have convinced economists to modify their theories. Two examples of the latter are:

a. the impact of the Great Depression on the theory that wage and price flexibility quickly restores full employment.

b. the economic events of the 1970s on the theory that moderate inflation enables us to permanently attain low levels of unemployment.

7. Discuss the distinctions between positive and normative economics. Point out that positive economic statements are testable, whereas normative statements are not. Give several illustrations of both positive and normative economic statements. The following are examples of positive economic statements:

a. “If the price of wheat rose, buyers would purchase less of it.”

b. “Nations that import substantial amounts of crude oil will experience inflation when crude oil prices rise.” (Although this may or may not be true, it is nonetheless a positive statement.)

c. “An increase in government borrowing will cause interest rates to rise.”

The following are examples of normative statements:

a. “The price of wheat is too high.”

b. “The United States should impose price controls on domestic oil producers if the price of foreign oil rises.”

c. “It is wrong for lenders to charge higher interest rates to poor people than they charge the low-credit-risk customers.”

8. It is important to emphasize that association is not the same thing as causation. Discuss the following points with regard to this point.

a. Skirt lengths tend to rise during prosperous times (1920s and 1960s, for example) and fall during bad times (1930s). Therefore, prosperity is caused by short skirts, whereas hard times result from low hemlines.

b. High crude oil prices caused the inflation experienced by the United States during the 1970s.

c. The post-World War II baby boom caused the prosperity of the period from 1946 to 1965.

d. War causes inflation.

9. Provide examples that illustrate the fallacy of composition, such as the following statements:

a. “Total output remains virtually unchanged whether I work or not; thus output is largely unaffected by whether or not people work.”

b. “I am no more likely to have an accident by driving ten miles over the speed limit than by obeying the limit. Thus, even if everyone drove 10 miles over the speed limit, the number of automobile accidents would not change.”

c. “Aliyah, a Kansas wheat farmer, doubled her income this year when she doubled her production of wheat. If all wheat farmers doubled their production of wheat, they could double their annual income.”

10. The Critical Analysis questions at the end of each chapter are very useful in getting students to think more clearly about issues and events in the real world. Frequently, they can be used to also stimulate classroom discussion. Our experience suggests that only by *using* the economic way of thinking can most students really learn it.

11. A bird-watching analogy can help students see the usefulness of the economic way of thinking. Just as training and experience direct birdwatchers “where to look” to spot various birds, the economic way of thinking directs students to look at decision makers’ incentives to “see” the predictable consequences of actions and policies. This is why those trained in economics can often find predictable policy consequences that others are unable to grasp very easily.

12. Another analogy that can help students see the power of the economic way of thinking is the framing of a building. Just as buildings will not be structurally sound if the framing is not done correctly, economic analyses will be faulty unless it is built on the framework of the set of incentives faced by the relevant decision makers. This is why economists spend so much effort trying to properly specify the incentives facing the actors involved, because predictions that are inconsistent with actors’ incentives are likely to be incorrect.

13. In talking about choices and costs, one helpful illustration is to show that sometimes it is cheaper to make some mistakes than to be right all of the time. This is true whenever the costs associated with being wrong a certain fraction of the time are expected to be low compared to the costs of avoiding such mistakes (although these expectations themselves may prove incorrect). Examples run the gamut from dating (“you’ve got to kiss a lot of frogs before you find your prince”), to exams (you don’t generally want to incur the costs to get every problem on an exam correct because you can miss some and still get an A), to buying “off brands” when shopping (where you trade off lower prices for greater risks of unsatisfactory product performance).

# HINTS FOR ANSWERING CRITICAL ANALYSIS QUESTIONS

2. Production of scarce goods always involves a cost; there are no free lunches. When the government provides goods without charge to consumers, other citizens (taxpayers) will bear the cost of their provision. Thus, provision by the government affects how the costs will be covered, not whether they are incurred.

6. Self-interest implies neither selfishness nor greed. Neither does it imply that people are *only* interested in their own welfare. Self-interest and selfishness do not have the same meaning. Webster defines self-interest as “concern for one’s own well-being.” There is no implication that a self-interested person is either desirous of the possessions of others or seeking to gain at the expense of others. In contrast, Webster defines selfishness and greed as “pursuit of one’s own welfare *without regard for the welfare of others.*” A selfish person willingly pursues gain at the expense of others.

11. Statements (a) and (c) are normative and statements (b) and (d) are positive.