Learning Objectives

After you have read this chapter, you should be able to

1. define economics;
2. distinguish between microeconomics and macroeconomics;
3. be able to list the three fundamental economic questions and discuss two economic systems that offer opposing answers;
4. recognize the rationality assumption;
5. recognize elements of an economic model, or theory;
6. recognize that economics is ultimately concerned with human behavior;
7. define behavioral economics and explain the bounded rationality hypothesis;
8. define resource; and
9. distinguish between positive economics and normative economics, and be able to classify specific statements under each category.

Outline

1. Economics is a social science involving the study of how people make choices to satisfy their wants.
   a. Wants are all the things that people would consume if they had unlimited income.
   b. Because wants are unlimited and people cannot satisfy all their wants, individuals are forced to make choices about how to spend their income and how to allocate their time.
2. Economics is broadly divided into microeconomics and macroeconomics.
   a. Microeconomics studies decision making by individuals (or households) and by firms.
   b. Macroeconomics studies the behavior of the economy taken as a whole. It deals with such economy-wide phenomena as unemployment, the price level, and national income.

3. In every nation, there are three fundamental questions that must be addressed, and there are two opposing answers.
   a. The three questions concern the problem of how to allocate society’s scarce resources:
      i. What and how much will be produced?
      ii. How will items be produced?
      iii. For whom will items be produced?
   b. How a nation goes about answering these three questions depends on its economic system.
      i. In an economic system of centralized command and control, an authority such as the government decides how to answer the questions.
      ii. In a price system, the answers to the questions are determined by private parties, and prices signal to everyone which resources are relatively scarce and which resources are relatively abundant.

4. Economists assume that individuals are motivated by self-interest and respond predictably to opportunities for gain.
   a. The rationality assumption is that individuals act as if they were rational.
   b. Self-interest often means a desire for material well-being, but it can also be defined to incorporate goals relating to love, friendship, prestige, power, and other human characteristics.
   c. By assuming that people act in a rational, self-interested way, economists can generate testable theories concerning human behavior.

5. Economics is a social science.
   a. Economists develop models, or theories, which are simplified representations of the real world.
   b. Models help economists to understand, explain, and predict real-world economic phenomena.
   c. Like other social scientists, economists usually do not perform laboratory experiments. They typically examine what has already occurred in order to test their theories.
   d. Economic theories, like all scientific theories, are simplifications—and hence are “unrealistic.”
   e. Economists, as do all scientists, employ assumptions. One important economic assumption is “all other things being equal.”
   f. Models are evaluated on their ability to predict and not on the realism of assumptions.
   g. Economic models relate to behavior, not thought processes.

6. Economists maintain that the unit of analysis is the individual. Members of a group are assumed to pursue their own goals rather than the group’s objectives.
7. Some economists have proposed an approach known as behavioral economics.
   a. Behavioral economics emphasizes psychological limitations and complications that inhibit rational decision making by individuals.
   b. Proponents of behavioral economics have proposed the bounded rationality hypothesis, which suggests that near, but incomplete, rationality leads people to utilize basic rules of thumb to choose among alternatives.

8. Positive economics is objective and scientific and deals with testable *if this, then that* hypotheses.

9. Normative economics is subjective and deals with value judgments, or with what *ought* to be.

### Key Terms

| Aggregates | Economics | Microeconomics |
| Behavioral economics | Empirical | Models (or theories) |
| Bounded rationality | Incentives | Resources |
| *Ceteris paribus* assumption | Macroeconomics | Wants |

### Key Concepts

| Economic system | Positive economics |
| Normative economics | Rationality assumption |

### Completion Questions

Fill in the blank, or circle the correct term.

1. Because it is impossible to have all that we want, people are forced to make ________________.

2. Economics is a *(natural, social)* science.

3. Economics is the study of how people make ________________ to satisfy their ________________.

4. In a price system, ________ signal to everyone which resources are relatively scarce and which resources are relatively abundant.

5. Microeconomics deals with *(individual units, the whole economy)*.

6. A nation’s unemployment level is analyzed in *(microeconomics, macroeconomics)*.

7. *(Macroeconomics, Microeconomics)* studies the causes and effects of inflation.

8. Economists maintain that a member of a group usually attempts to make decisions that are in *(her own, the group’s)* interest.
9. The rationality assumption is that individuals (believe, act as if) they are rational.

10. Economic models are (simplified, realistic) representations of the real world.

11. The *ceteris paribus* assumption permits us to consider (one thing at a time, everything at once).

12. *Ceteris paribus*, payment of bonuses to physicians for pushing preventive health care gives physicians an incentive to (treat only actual illnesses, suggest treatments to deter illnesses).

13. Economists maintain that incentives (are, are not) important to decision making.


15. Economists take the (individual, group) as the unit of analysis.

16. Behavioral economics is an approach that assumes that individuals are (fully, nearly) rational.

17. Economic statements that are testable and are of an “if/then” nature are (positive, normative).

### True-False Questions

Circle the **T** if the statement is true, the **F** if it is false. Explain to yourself why a statement is false.

T  F  1. Economics is the study of how people think about economic phenomena.

T  F  2. Economists’ definition of self-interest includes only the pursuit of material goods.

T  F  3. Macroeconomics deals with aggregates, or totals, of economic variables.

T  F  4. The three fundamental economic questions are as follows: (a) Who should decide what to produce, (b) what methods ought to be utilized in production, and (c) who should receive the items that are produced?

T  F  5. When economists attempt to predict the number of Web servers that an Internet bank will utilize, they are studying macroeconomics.

T  F  6. Economists maintain that people respond in a predictable way to economic incentives.

T  F  7. The rationality assumption is that individuals attempt, quite consciously, to make rational economic decisions and will admit to it.

T  F  8. It is justifiable to criticize theories on the realism of the assumptions employed.

T  F  9. Households cannot be thought of as producers.

T  F  10. A statement of fact is an example of a positive statement.

T  F  11. Because economics is a science, economists do not make normative statements.
Multiple Choice Questions

Circle the letter that corresponds to the best answer.

1. Economics is
   a. a natural science.
   b. nonscientific.
   c. a social science.
   d. usually studied through lab experiments.

2. Wants include desires for
   a. material possessions.
   b. love.
   c. power.
   d. All of the above

3. Which one of the following is NOT one of the three fundamental economic questions?
   a. How will items be produced?
   b. Who deserves produced items?
   c. For whom will items be produced?
   d. What and how much will be produced?

4. Which one of the following areas of study is concerned, primarily, with microeconomics?
   a. the tablet device industry
   b. inflation
   c. the national unemployment rate
   d. national income determination

5. Macroeconomic analysis deals with
   a. the tablet device industry.
   b. how individuals respond to an increase in the price of gasoline.
   c. inflation.
   d. how a change in the price of energy affects a family.

6. Economists maintain that Ms. Chung will usually make decisions that promote the interests of
   a. her colleagues at work.
   b. herself.
   c. her class.
   d. her race.
7. Economic models
   a. use unrealistic assumptions.
   b. are seldom tested in laboratories.
   c. are concerned with how people behave, not with how they think.
   d. All of the above

8. An economic model is justifiably criticized if
   a. its assumptions are not realistic.
   b. it cannot be tested in a controlled, laboratory experiment.
   c. it fails to predict.
   d. All of the above

9. According to the rationality assumption, people
   a. do not intentionally make decisions that would leave them worse off.
   b. do not ever take into account the interests or well-being of others.
   c. can never consider each of the most relevant alternatives.
   d. use rules of thumb to make choices.

10. Economics
    a. is a natural science.
    b. is concerned with how people respond to incentives.
    c. is unconcerned with value judgments.
    d. deals with assumptions and therefore is unrealistic.

11. As is true of a road map showing how a traveler can move about a geographic region, a model of economic behavior typically
    a. omits trivial details and emphasizes factors most relevant to the problem under consideration.
    b. makes no simplifying assumptions, so that every feature of a problem is taken into account.
    c. must be rejected if it leaves out some information, even if it makes correct predictions.
    d. includes each and every element of a problem confronting an individual or group.

12. Which one of the following is a normative economic statement?
    a. If prices rise, people will buy less.
    b. If prices rise, people will buy more.
    c. If prices rise, the poor will be injured. Therefore, prices should not be permitted to rise.
    d. If prices rise, people will buy less. Therefore, we ought to observe that quantity demanded falls.
13. Which one of the following is a positive economic statement?
   a. Full employment policies should be pursued.
   b. If minimum-wage rates rise, then unemployment will rise.
   c. We should take from the rich and give to the poor.
   d. The government should help the homeless.

14. Normative economic statements
   a. are testable hypotheses.
   b. are value-free.
   c. are subjective, value judgments.
   d. can be scientifically established.

15. Which one of the following is a normative economic statement?
   a. When more death-penalty sentences are reduced to life imprisonment, the homicide rate increases.
   b. An increase in the rate of executions is associated with a fall in homicides.
   c. Improved prison conditions increase the disincentive effects of capital punishment.
   d. Capital punishment is a morally wrong way to try to deter homicides.

Matching

Choose the item in Column (2) that best matches an item in Column (1).

<table>
<thead>
<tr>
<th>(1)</th>
<th>(2)</th>
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<tbody>
<tr>
<td>(a) normative economics</td>
<td>(f) nonscientific value judgments</td>
</tr>
<tr>
<td>(b) macroeconomics</td>
<td>(g) objective, scientific hypotheses</td>
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<tr>
<td>(c) self-interest</td>
<td>(h) study of individual behavior</td>
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<tr>
<td>(d) positive economics</td>
<td>(i) study of economic aggregates</td>
</tr>
<tr>
<td>(e) microeconomics</td>
<td>(j) rational behavior</td>
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</tbody>
</table>


## Answers

### Completion Questions

1. choices
2. social
3. choices; wants
4. prices
5. individual units
6. macroeconomics
7. Macroeconomics
8. her own
9. act as if
10. simplified
11. one thing at a time
12. suggest treatments to deter illnesses
13. are
14. broadly
15. individual
16. nearly
17. positive

### True-False Questions

1. F Economics is the study of how people make choices to satisfy their wants.
2. F Economists have a broader definition of self-interest. Wants include power, friendship, love, and so on.
3. T
4. F The three fundamental questions are (a) What and how much will be produced, (b) how will items be produced, and (c) for whom will it be produced?
5. F The example is about microeconomics.
6. T
7. F That assumption is merely that people act as if they are rational.
8. F All theories employ unrealistic assumptions. What matters is how well they predict.
9. F Households can be thought of as combining goods and time to produce outputs such as meals.
10. T
11. F Economists, like other scientists, can and do make normative statements.

### Multiple Choice Questions

1. (c)
2. (d)
3. (b)
4. (a)
5. (c)
6. (b)
7. (d)
8. (c)
9. (a)
10. (b)
11. (a)
12. (c)
13. (b)
14. (c)
15. (d)
Matching
(a) and (f)  (d) and (g)
(b) and (i)  (e) and (h)
(c) and (j)

Glossary

Aggregates  Total amounts or quantities. Aggregate demand, for example, is total planned expenditures throughout a nation.
Behavioral economics  An approach to the study of consumer behavior that emphasizes psychological limitations and complications that potentially interfere with rational decision making.
Bounded rationality  The hypothesis that people are nearly, but not fully, rational, so that they cannot examine every possible choice available to them but instead use simple rules of thumb to sort among the alternatives that happen to occur to them.
Ceteris paribus [KAY-ter-us PEAR-uh-bus] assumption  The assumption that nothing changes except the factor or factors being studied.
Economic system  A society’s institutional mechanism for determining the way in which scarce resources are used to satisfy human desires.
Economics  The study of how people allocate their limited resources to satisfy their unlimited wants.
Empirical  Relying on real-world data in evaluating the usefulness of a model.
Incentives  Rewards for engaging in a particular activity.
Macroeconomics  The study of the behavior of the economy as a whole, including such economywide phenomena as changes in unemployment, the general price level, and national income.
Microeconomics  The study of decision making undertaken by individuals (or households) and by firms.
Models, or theories  Simplified representations of the real world used as the basis for predictions or explanations.
Normative economics  Analysis involving value judgments about economic policies; relates to whether outcomes are good or bad. A statement of what ought to be.
Positive economics  Analysis that is strictly limited to making either purely descriptive statements or scientific predictions; for example, “If A, then B.” A statement of what is.
Rationality assumption  The assumption that people do not intentionally make decisions that would leave them worse off.
Resources  Things used to produce goods and services to satisfy people’s wants.
Wants  What people would buy if their incomes were unlimited.