

CHAPTER 1: SECTION 2

The Economic Way of Thinking

Thinking in Terms of Costs and Benefits

- ▶ A person will want to do a particular activity only if the benefits are greater than the costs. Weighing the costs and benefits of a decision is a process called cost-benefit analysis.
- ▶ The word **marginal**, in economics, means additional. Suppose that your lunch costs \$5, and that you are considering buying a soda to go with your lunch. This soda will have a cost that is in addition to your \$5 meal. The additional cost is called the marginal cost.

Thinking in Terms of Incentives

- ▶ Economists use the word **incentive** to describe something that encourages or motivates a person to take action. For example, if your parents offer you \$10 to mow the lawn, the incentive, the \$10, may motivate or encourage you to mow the lawn.

Thinking in Terms of Trade-Offs

- ▶ Individuals face trade-offs. More of one thing necessarily means less of something else. Often you make decisions between something you like and something you dislike. What trade-offs have you faced today?
- ▶ Societies also face trade-offs. For example, the federal government has only so much money from tax revenues. If more of its tax dollars go to education, fewer are available to be spent on road and highway maintenance. What other types of trade-offs might the government consider when determining if more tax dollars should be spent on education? (Answers: health care, defense, etc.)

Thinking in Terms of What Would Have Been

- ▶ When you think in terms of “what would have been,” you begin to understand the opportunity costs for “what is.”
- ▶ It takes a certain kind of vision to see what would have been, using your mind, and not your eyes. For example, suppose the federal government sets aside funds for a new interstate highway system. Thousands of people are hired to work on the project, and the benefits are easy to see—more jobs and better roads.

- ▶ However, there is more than meets the eye in this scenario. The taxpayers had to pay for the new highway system. What did the taxpayers give up by paying taxes to fund the new highway? They gave up the opportunity to buy goods for themselves, such as clothes, computers, and books.
- ▶ What would have been produced and consumed had the highway not been built? If more computers had been produced instead of highways, more people would have worked in the computer industry and fewer would have worked in highway construction.

Thinking in Terms of Unintended Effects

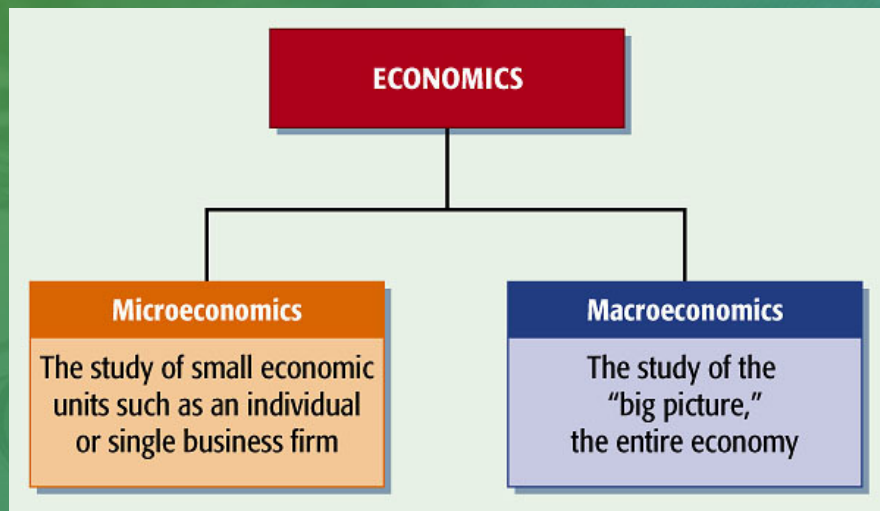
- ▶ Economists often look for the unintended effects of actions that people have taken.
- ▶ If a store owner increases prices, will he necessarily make more money? Often an attempt to increase sales, by increasing prices, can lead to the unintended effect of fewer sales.

Thinking in Terms of the Small and the Big

- ▶ Economics is divided into two branches: microeconomics and macroeconomics.
- ▶ **Microeconomics** is the study of the small picture, such as the behavior and choices of individuals or a single business or industry. For example, in microeconomics, an economist would study and discuss the unemployment that exists within an industry, such as the auto industry.

- ▶ **Macroeconomics** is the study of the big picture. Economists studying macroeconomics may look at the behavior and choices of the entire economy. To continue our example, in macroeconomics, an economist would study the unemployment that exists in the entire nation. (See Transparency 1-4; you might add your own or students' examples to the chart.)

TRANSPARENCY 1-4: Two Major Branches of Economics



Microeconomics examples

Housing prices in your hometown

Macroeconomics examples

Housing prices nationwide

Thinking in Terms of Theories

- ▶ Why is the crime rate higher in some countries than in other countries? What causes some nations to be rich and others to be poor? These questions do not have easy, obvious answers. To answer them, economists build theories.
- ▶ A **theory** is an explanation of how something works, designed to answer a question for which there is no obvious answer.

- ▶ Theories may not always seem reasonable. Suppose you lived during the period of the Roman Empire and someone proposed to you that the Earth was round. At that time many would have thought this was an unreasonable theory, but today most everyone would agree that the Earth is indeed round.
- ▶ Scientists believe that we should evaluate theories based not on how they sound to us, or whether they seem right, but on how well they predict. If they predict well, then we should accept them.