Chapter 1
The Nature of Economics

Learning Objectives
After you have read this chapter, you should be able to
1. define economics;
2. distinguish between microeconomics and macroeconomics;
3. recognize the rationality assumption;
4. recognize elements of an economic model, or theory;
5. recognize that economics is ultimately concerned with human behavior;
6. define resource;
7. distinguish between positive economics and normative economics, and be able to classify specific statements under each category.

Outline
1. Economics, a social science, is defined as 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 undertaken 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. 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 broadly enough 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.

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

5. 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.

6. Positive economics is objective and scientific in nature, and deals with testable if this, then that hypotheses.

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

### Key Terms

- Aggregates
- Incentives
- Models (or theories)
- Ceteris paribus assumption
- Macroeconomics
- Resources
- Economics
- Microeconomics
- Wants
- Empirical

### Key Concepts

- Normative economics
- Rationality assumption
- Positive economics
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. Microeconomics deals with (individual units, the whole economy).
5. A nation’s unemployment level is analyzed in (microeconomics, macroeconomics).
6. (Macroeconomics, Microeconomics) studies the causes and effects of inflation.
7. Economists maintain that a member of a group usually attempts to make decisions that are in (her own, the group’s) interest.
8. The rationality assumption is that individuals (believe, act as if ) they are rational.
9. Economic models are (simplified, realistic) representations of the real world.
10. The ceteris paribus assumption enables economists to consider (one thing at a time, everything at once).
11. Ceteris paribus, the lower cost of arranging a divorce online instead of paying a divorce lawyer to handle the paperwork gives a couple seeking a divorce an incentive to (use an online divorce service, hire a divorce lawyer).
12. Economists maintain that incentives (are, are not) important to decision making.
14. Economists take the (individual, group) as the unit of analysis.
15. 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. When economists attempt to predict the number of Web servers that an Internet bank will utilize, they are studying macroeconomics.
T  F  5. Economists maintain that people respond in a predictable way to economic incentives.
T  F  6. The rationality assumption is that individuals attempt, quite consciously, to make rational economic decisions, and will admit to it.
T F 7. It is justifiable to criticize theories on the realism of the assumptions employed.
T F 8. Households cannot be thought of as producers.
T F 9. Because economics is a science, economists do not make normative statements.
T F 10. Medical issues such as the recent increase in childhood obesity rates are outside the scope of economics.

**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 of the following areas of study is concerned, primarily, with microeconomics?
   (a) the personal computer industry
   (b) inflation
   (c) the national unemployment rate
   (d) national income determination

4. Macroeconomic analysis deals with
   (a) the personal computer 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.

5. 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.
6. 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  

7. 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  

8. Which of the following is true of the problem of childhood obesity?  
   (a) Parental choices about their own time allocations and schools’ financial incentives have led to  
       less exercise and more snack consumption that have contributed to childhood obesity.  
   (b) Obesity is more widespread among children of stay-at-home mothers than among children of  
       working mothers.  
   (c) The growing popularity of video games among children has helped reduce childhood obesity  
       rates.  
   (d) Obesity rates for most children’s age groups have continually declined in recent years.  

9. 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.  

10. 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.  

11. Which of the following is a normative economic statement?  
    (a) If price rises, people will buy less.  
    (b) If price rises, people will buy more.  
    (c) If price rises, the poor will be injured; therefore price should not be permitted to rise.  
    (d) If price rises, people will buy less; therefore we ought to observe that quantity demanded falls.  

12. Which 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.
13. Normative economic statements

(a) are testable hypotheses.
(b) are value-free.
(c) are subjective, value judgments.
(d) can be scientifically established.

14. Which of the following is a normative economic statement?

(a) When more death-penalty sentences are reduced to life imprisonment, that 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>
</tr>
</thead>
<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>
</tr>
<tr>
<td>(c) self-interest</td>
<td>(h) study of individual behavior</td>
</tr>
<tr>
<td>(d) positive economics</td>
<td>(i) study of economic aggregates</td>
</tr>
<tr>
<td>(e) microeconomics</td>
<td>(j) rational behavior</td>
</tr>
</tbody>
</table>

Answers

Completion Questions

1. choices 9. simplified
2. social 10. one thing at a time
3. choices; wants 11. use an online divorce service
4. individual units 12. are
5. macroeconomics 13. broadly
6. macroeconomics 14. individual
7. her own 15. positive
8. act as if

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 example is about microeconomics.
5. T
6. F That assumption is merely that people act as if they are rational.
7. F All theories employ unrealistic assumptions; what matters is how well they predict.
8. F Households can be thought of as combining goods and time to produce outputs such as meals.
9. F Economists, like other scientists, can and do make normative statements.
10. F Choices of all types, including calorie consumption and levels of exercise that affect childhood obesity rates, can be subjected to economic analysis.

Multiple Choice Questions

1. (c)  8. (a)
2. (d)  9. (b)
3. (a)  10. (a)
4. (c)  11. (c)
5. (b)  12. (b)
6. (d)  13. (c)
7. (c)  14. (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.

Ceteris paribus [KAY-ter-us PEAR-uh-bus] assumption The assumption that nothing changes except the factor or factors being studied.

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 things 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 other things to satisfy people’s wants.

Wants What people would buy if their incomes were unlimited.