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The Economic Way of Thinking

Introduction and Description

Advanced Placement Economics has thousands of details that can confuse students. The students need a framework to organize these details. This lesson acquaints the students with basic economic concepts and methodology. It begins with some key economic ideas, which represent a new set of lenses through which the students may view the world. The lesson ends with a test of economic myths that should get the students' attention. This exercise also gives the teacher a way of reinforcing the economic concepts taught at the beginning of the lesson.

Objectives

1. Define *opportunity cost*.
2. Define the *economic way of thinking*.
3. Apply *scarcity* concepts to a variety of economic and noneconomic situations.

Time Required

Two class periods or 90 minutes

Materials

1. Activity 1
2. Visual 1.1

Procedure

1. Project Visual 1.1 and discuss the economic way of thinking. Here are some discussion ideas for each point on the transparency.

   - **Everything has a cost.**
     This is the basic idea that "there is no such thing as a free lunch," meaning that every action costs someone time, effort or lost opportunities to do something else. Introduce the term *opportunity cost* here. Stress the concept that people incur costs when making decisions, even when people appear to pay nothing.

   - **People choose for good reasons.**
     People always face choices, and they should choose the alternative that gives them the most advantageous combination of costs and benefits. You might stress here that if people have different values, they may make different choices. This might be a good place to discuss *normative* versus *positive economics*. Economists tend to be a tolerant lot because they realize people choose for good reasons. Also stress that *people* choose. Much of the AP Economics course concerns business and government decision making. But business and government decisions are made by people.

   - **Incentives matter.**
     This course is really about incentives. It has been said that economics is about incentives and everything else is commentary. *Supply and demand analysis* is about incentives. The *theory of the firm* and *factor markets* are about incentives. Government decision making is about incentives. When incentives change, people's behavior changes in predictable ways.

   - **People create economic systems to influence choices and incentives.**
     Cooperation among people is governed by written and unwritten rules that are the core of an economic system. As rules change, incentives and behavior change. The success of market systems and the failure of communism are rooted in incentives.

   - **People gain from voluntary trade.**
     People trade when they believe the trade makes them better off. If they expect no benefits, they don't trade. Part of the AP Economics course focuses on international trade. However, once again it is people, not countries, that trade. A market system is about trade. Economics is about trade.

- **Economic thinking is marginal thinking.**
  Marginal choices involve the effects of additions and subtractions from current conditions. Much of this course is about marginal costs and benefits. Marginal thinking will be stressed in Units 3 and 4, where the theory of the firm and factor markets are discussed. Nevertheless, marginal decision making should be discussed in every unit.

- **The value of a good or service is affected by people's choices.**
  Goods and services do not have intrinsic value; their value is determined by the preferences of buyers and sellers. Because of this, trading moves goods and services to higher-valued uses. This is why trading is so important. The price of a good or service is set by supply and demand.

- **Economic actions create secondary effects.**
  Good economics involves analyzing secondary effects. For example, rent controls make apartments more affordable to some consumers. Controls also make it less profitable to build and maintain apartments. The secondary effect is a shortage of apartments and houses for rent.

- **The test of a theory is its ability to predict correctly.**
  Students will discuss dozens of theories in an AP Economics course. All these theories have simplifying assumptions. However, the proof of the pudding is in the eating. If the theory correctly predicts the consequences of actions, it is a good theory. Nothing is "good in theory but bad in practice."

2. Tell the students that they are going to take a brief quiz. Have the students turn to Activity 1 in the student workbook. Give them a few minutes to answer the questions.

3. When everyone is finished, either poll the students on their answers, or simply announce that all the answers are false. Students will think this is a cheap trick.

4. Discuss the answers, and as you do, explain some of the basic laws of economics. Economics is the study of human behavior, and principles have been developed to explain this behavior.

Do You Think Like an Economist?

All the answers are false.

Questions 1 through 4 concern scarcity. Goods are scarce because we have limited resources and unlimited wants. Therefore, one can't have everything one wants. Whenever people make a choice, they sacrifice something else. The "something else" we sacrifice is called the *opportunity cost*. To be scarce, something must be limited and desirable. Scarce goods have prices.

Question 1. Sunshine isn't scarce because it isn't limited; it is a free good.

Question 2. Polio isn't scarce because it isn't desirable.

Question 3. Scarcity is a relative, not an absolute, concept. Because resources are scarce and wants are unlimited, almost everything is scarce. If you pay an opportunity cost to use a good or service, it is scarce. If you pay a positive price for a good or service, it is scarce. Water may cover three-fourths of the earth, but we pay an opportunity cost and a positive price for clean water everywhere. Of course, water may be scarcer in the desert than in the wetlands. Only a government can actually make water cheaper in a desert.

Question 4. An important opportunity cost of going to college is lost earnings. If you could earn $20,000 a year by working, you will sacrifice $80,000 during four years of college.

Questions 5 and 6 concern the laws of supply and demand. People tend to buy more of something when the price is lower and less when the price is higher. This price includes money as well as such things as time, aggravation, inconvenience and moral guilt. Sellers will try to sell more of something if the price is higher and less of it if the price is lower. This conflict is resolved through the market.

Question 5. Question 5 is false because, if all other things are equal, less mass transportation will be purchased if the price is higher. The price could be increased in terms of dollars, inconvenient schedules, crime and filthy cars. The demand curve for transportation would have to be perfectly inelastic, or vertical, for the answer to this question to be True.

Question 6. The price of something depends on supply and demand, not on usefulness or on some criterion of quality. Water is more useful than diamonds, but it has a lower price. What you pay for a good or service depends on the market price determined by supply and demand.

Questions 7 and 8 concern gains from trade. When people trade voluntarily, both parties expect to gain, or they wouldn't trade. One reason for this gain is the law of *comparative advantage*. If one person does legal work better than another and if a second person word-processes documents better than the first, they would gain by trade. But would a lawyer who is the fastest word processor in town hire a secretary? Yes, because of comparative advantage: Each person would specialize in what he or she does comparatively better. An hour spent word processing is an hour not spent in legal work, and the opportunity cost for the lawyer would be very high. The lawyer will specialize in legal work and the secretary in word processing. The total output of goods and services will increase. This concept can also be applied to countries.

Questions 9 and 10 concern businesses and the role of profits.

Question 9. A monopoly charges a higher price than a competitive market price, but the monopolist cannot repeal the law of demand. If the price is too high, the monopolist might sell nothing. A monopolist will try to establish a price at a point that will make the greatest profit. This price is higher than a competitive price and will result in less production.

Question 10. *Profits* are an incentive for business to succeed. A business that doesn't care about its customers will not make high profits. As Adam Smith (1723-1790) said, "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard for their own interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages."

Do You Think Like an Economist?

Circle T for *true* or F for *false* in the statements that follow.

T F 1. Because it is desirable, sunshine is scarce.

T F 2. Because it is limited, polio is scarce.

T F 3. Because water covers three-fourths of the earth's surface and is renewable, it cannot be considered scarce.

T F 4. The main cost of going to college is tuition, room and board.

T F 5. If mass transportation fares are raised, almost everyone will take the trains anyway.

T F 6. You get what you pay for.

T F 7. If someone makes an economic gain, someone else loses.

T F 8. If one nation produces everything better than another nation, there is no economic reason for these two nations to trade.

T F 9. A nonregulated monopoly tends to charge the highest possible price.

T F 10. A business owner's decision to show more care for consumers is a decision to accept lower levels of profits.

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