

Topic 1A: Thinking Like an Economist

Business Economics, Organization, and Management
(BUEC 211)

James Macek

Alberta School of Business
University of Alberta

Most economics professors are **not** billionaires (nay, millionaires). So why should we teach you Economics?

The One Word That Explains Why Economics Professors Are Not Billionaires

This would change the financial experts you listen to



David O. [Follow](#)

Jun 19 · 8 min read ★



Most economics professors are **not** billionaires (nay, millionaires). So why should we teach you Economics?

The One Word That Explains Why Economics Professors Are Not Billionaires

This would change the financial experts you listen to



David O. [Follow](#)

Jun 19 · 8 min read ★



What is *the one word*?

Hint: Economics isn't just about how to make money ...

Economics isn't just about running a business or making money. It is a **way of thinking** based on a few facts:

- Resources are scarce, how do we allocate them more efficiently?
- People respond to incentives

Money, punishment, taxes and subsidies, risk of injury, reputation, profits, sex, effort, morals

- Environments adjust until they reach **equilibrium**

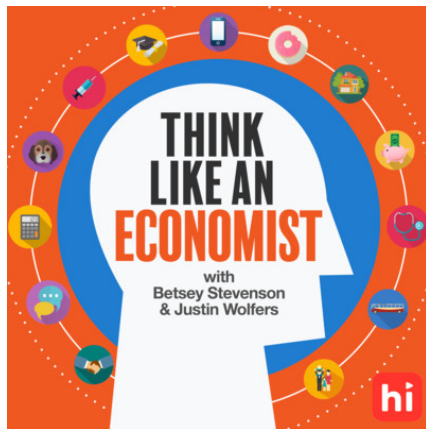
People make adjustments until their choices are optimal given others' actions

Prices rise to **incentivize** the production of a scarce good and to **incentivize** consumers to find substitutes

Economics isn't just about running a business or making money. It is a **way of thinking** based on a few facts:

- Economic agents have goals (consumers want options, firms want to profit)
- Constraints impair agents' goal seeking (budget, technology, resources, costs)
- Agents optimize subject to constraints
- Joint optimization across agents leads to equilibrium

Wolfers and Stevenson's Basic Principles



<https://art19.com/shows/think-like-an-economist> (CTRL + left click)

Principle #1: Cost-Benefit Principle

- Consumers, firms (and even you!) have goals

- Compare costs and benefits of each decision

- Why measure costs/benefits in dollars? **Common unit of value**

Economic theory can be used to ascribe monetary value to things like **time, stress, risk, safety, enjoyment, and reputation**

“Economists care as much about money as architects do inches” – a *unit of measurement*

- Key questions:

Are you getting a good deal?

What are the tradeoffs?

Principle #2: Opportunity Cost

Opportunity cost = **best foregone alternative** (the highest valued alternative that must be given up to engage in an activity)

All decisions should be benchmarked against the opportunity cost

- Should I take this class or that one?
- Should I major in BUEC vs. MKTG?
- Should I accept a job or an internship?

Principle #2: Opportunity Cost

Opportunity cost = **best foregone alternative** (the highest valued alternative that must be given up to engage in an activity)

All decisions should be benchmarked against the opportunity cost

- Should I take this class or that one?
- Should I major in BUEC vs. MKTG?
- Should I accept a job or an internship?

Equivalently, a decision is only good *relative to its alternatives*.

Opportunity Cost Example

Arlene quits her \$125,000 job to care for her parents. What is the opportunity cost?

1. Zero
2. Depends on going rate for home-care providers
3. At least \$125,000
4. Value of satisfaction she receives
5. Value of all alternatives forgone

Principle #3: Marginal Principle

Determining the best decision to make is often equivalent to asking whether or not you should take a **small and incremental action**.

Should you:

- Hire one more employee?
- Add or drop one more class?
- **Wolfers**: Should I watch one more episode? Should I eat one more slice?

Focus on marginal **(incremental)** benefit vs. marginal **(incremental)** cost.

Principle #3: Marginal Principle

Determining the best decision to make is often equivalent to asking whether or not you should take a **small and incremental action**.

Should you:

- Hire one more employee?
- Add or drop one more class?
- **Wolfers**: Should I watch one more episode? Should I eat one more slice?

Focus on marginal **(incremental)** benefit vs. marginal **(incremental)** cost. If the **marginal benefit** equals the **marginal cost**, then **STOP!**

Principle #4: Interdependence Principle

“No Decision is an Island”

Four interdependencies of the choices you make:

- Interdependence Between Your **Own Choices**

If you spend time studying, you can't spend that time working.
(connection to Opportunity Cost)

- Interdependence Through **Time**

Your present choices affect your future possibilities

- Saving today means more consumption tomorrow
- Eating healthier now changes future health

Ceterus paribus, a.k.a. “All else equal” ... but is it?

Principle #4: Interdependence Principle

“No Decision is an Island”

Four interdependencies of the choices you make:

- Interdependence with **Other People's Choices**

Your best choice depends on what others do.

- If others buy a smartphone, its value to you increases (network effects).
- If others drive during rush hour, the road becomes congested.

- Interdependence through **Different Markets**

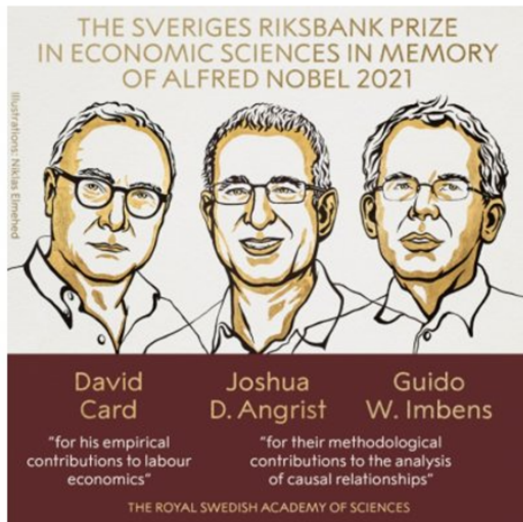
- High interest rates in the credit market $\implies$ high interest rates in the mortgage market $\implies$ you may refrain from buying a house and instead rent . . .
- Any more “butterfly effects”?

Ceterus paribus, a.k.a. “All else equal” . . . but is it?

Economists often “speak” in **models** that explain and predict human behavior.

- The language of models is **mathematics**, expressed *algebraically* (equations) and/or *geometrically* (graphs).
- This can be intimidating at first – but math is a **tool**, not the goal.
- The goal is to clarify ideas and understand behavior, not to “show off” mathematical skill.

How to Analyze Economics in Reality? — Models



Economics is broader than just abstract, mathematical models:

- Economists run **experiments**.
- Economists **analyze data**.
- Economists **make predictions** about how people and markets behave.
- Economists **test** models with data.

Caution: Don't conflate models with reality!

- Models help us **understand** reality, but they are **simplifications**.
- A good economist is always aware of:

The **limits** of their model

The key **underlying assumptions**

The role of “**ceteris paribus**” (all else equal)

“**...and then what?**” (is the system in equilibrium?)

“**...compared to what?**” (counterfactual analysis)

Positive and Normative Statements

Economics alone can't tell you the **right** decision.

Positive statements

- Describe **what is** or **what will happen**.
- Example: *If you increase the costs of production, consumer prices will go up.*
- Can include **uncertainty** about outcomes, but they are empirically testable.

Normative statements

- Concern what somebody believes **should** happen.
- Example: *The government should tax greenhouse gas emissions.*
- Involve **value judgments** and cannot be refuted by empirical evidence alone.

Identify Normative vs. Positive Statements

Which of the following statements represent positive analysis and which represent normative analysis?

1. The legalization of cannabis will lead to an increase in cannabis use by teenagers.
2. The federal government should spend more on AIDS research.
3. Rising paper prices will increase textbook prices.
4. The price of coffee at Starbucks is too high.

Identify Normative vs. Positive Statements

Which of the following statements represent positive analysis and which represent normative analysis?

1. The legalization of cannabis will lead to an increase in cannabis use by teenagers.
2. The federal government should spend more on AIDS research.
3. Rising paper prices will increase textbook prices.
4. The price of coffee at Starbucks is too high.

Answer: 1 and 3 are **positive** statements; 2 and 4 are **normative** statements.

What is Microeconomics and Macroeconomics?

Microeconomics

- Individual and firm decision-making.
- Prices and markets.
- Labor market decisions.
- Strategic behavior and game theory.

Macroeconomics

- Interactions of households, firms, and government over time.
- Aggregate variables: GDP, unemployment, inflation, etc.
- How these measures respond to shocks.

Managerial Economics:

- Effectively **applied microeconomics** with a focus on management.

- Emphasis on:

Theory of the firm.

Profit maximization.

Understanding consumer choice

Competition and market structure.

Strategy and decision-making under constraints and uncertainty

What's Next?

In the next part of the course, we turn to:

Demand and supply

- How markets reach equilibrium
- How shocks to demand or supply affect prices and quantities
- Conceptualize demand and supply **elasticities**

What's Next?

In the next part of the course, we turn to:

Demand and supply

- How markets reach equilibrium
- How shocks to demand or supply affect prices and quantities
- Conceptualize demand and supply **elasticities**

For additional context, listen to the Think like an Economist podcast and read through Chapter 1 of the text.

Also, read through two **math primer** notes on Canvas – you will need them if you don't remember MATH 154 content.