



1.2 How do economists approach the world?

Learning objectives

1.2 How do economists approach the world?	Depth	Diagrams & calculations
<p>Economic methodology</p> <ul style="list-style-type: none">• The role of positive economics<ul style="list-style-type: none">• The use of logic• The use of hypotheses, models, theories• The <i>ceteris paribus</i> assumption• Empirical evidence• Refutation• The role of normative economics<ul style="list-style-type: none">• Value judgments in policy making• The meaning of equity and equality	AO2	

Learning objectives

1.2 How do economists approach the world?	Depth	Diagrams & calculations
<p>Economic thought</p> <ul style="list-style-type: none">• Origin of economic ideas in a historical context<ul style="list-style-type: none">• 18th century: Adam Smith and <i>laissez faire</i>• 19th century: classical microeconomics (utility); the concept of the margin; Classical macroeconomics (Say's law); Marxist critique of classical economic thought	AO2	

Learning objectives

1.2 How do economists approach the world?	Depth	Diagrams & calculations
<ul style="list-style-type: none">• 20th century: Keynesian revolution; rise of macroeconomic policy; monetarist/new classical counter revolution• 21st century: increasing dialogue with other disciplines such as psychology and the growing role of behavioural economics; increasing awareness of the interdependencies that exist between the economy, society and environment and the need to appreciate the compelling reasons for moving toward a circular economy	AO2	



Starter



What similarities and differences are there between the natural sciences (such as Physics) and the social sciences (such as Economics)?

Economic methodology

Economic methodology refers to the ways in which economists study the discipline. As a social science, scientific methods are adopted to build knowledge through a structured process:

1. Make observations
2. Ask questions
3. Form a hypothesis
4. Make predictions
5. Test hypothesis
6. Draw conclusions

Economic methodology

What are the differences between the two sets of statements below?

Set A

- The decrease in consumption and investment during the pandemic has led to a decrease in economic growth.
- The unemployment rate has increased from 5% to 8% in the past quarter.
- The price of oil remains highly volatile, and the uncertainty has led to a decrease in investments.

Set B

- The government should reduce taxes in order to stimulate consumption and investment.
- The best way of reducing the impact of rising unemployment is to increase unemployment benefits.
- Given the volatility of oil prices, the government must subsidize petrol for low-income households.

Economic methodology

Positive economics

- Statements that can be tested, accepted, refuted, or amended based on evidence.
- Focuses on what is, was, or will be.
- Explains how the economy works.
- Relies on scientific methods, i.e., logic, hypotheses, models, economic theories, assumptions, and empirical evidence.

Normative economics

- Subjective value judgements that often form the basis of economic policy making.
- Focuses on what *should* be.
- Considers how the economy *should* work.
- Relies on personal perspectives, values, and beliefs.

Economic methodology

Positive Economics	Normative Economics
Free healthcare will increase government spending by 20%.	Healthcare should be free for all citizens at the expense of the government.
An increase in corporate tax rates will lead to higher unemployment.	Corporates tax rates are too high.
Tariffs reduce demand for imported goods and services.	The government ought to impose tariffs to protect local industries.

Normative economics – equity and equality

Equity	Equality
Refers to the state of being fair .	Refers to the state of being equal with respect to something.
Normative concept as it is subjective .	Positive concept as it is objective .
An equitable distribution of income refers to a fair and just distribution which depends on value judgments and perspectives about what is fair.	An equal distribution of income means everyone receives the same level of income.



Real world example

Article: [Are diamonds really that scarce?](#)

Read the article and identify 3 examples of positive statements and normative statements.

Positive economics

Positive economics uses **logic** and **reasoning**.

Example

When considering how reduced income tax affects consumer expenditure, economists may use logic and reasoning to analyse that reduced income tax increases disposable income.

Furthermore, a portion of the increased disposable income may be used to satisfy needs and wants via increased expenditure on goods and services.

Thus, economists can explain certain events and make predictions for future events by using logic and reasoning .

Positive economics

Positive economics uses **hypotheses, models, and theories**.

Example

When considering how reduced income tax affects consumer expenditure, economists may make a hypothesis based on the circular flow of income model. Reduced income tax results in increased disposable income for consumers. This may result in an increase in consumer spending, increase in savings, and/or an increase in import expenditure.

Thus, economists can explain certain events and make predictions for future events by using hypotheses, models, and theories.

Positive economics

Positive economics uses **empirical evidence**.

Example

When considering how reduced income tax affects consumer expenditure, economists may use historical data to analyse the relationship between changes in income tax and changes in the level of real gross domestic product (real GDP).

Thus, economists can use empirical evidence to support claims but also to refute claims by using empirical evidence.

Positive economics

Positive economics uses the **ceteris paribus assumption**.

Example

When considering how reduced income tax affects consumer expenditure, economists assume that other factors that may also impact consumer expenditure (such as interest rates and the level of consumer confidence), are held constant.

Thus, with the **ceteris paribus** assumption, economists can analyse how one variable may affect another, without considering all the other factors that may affect the dependent variable.

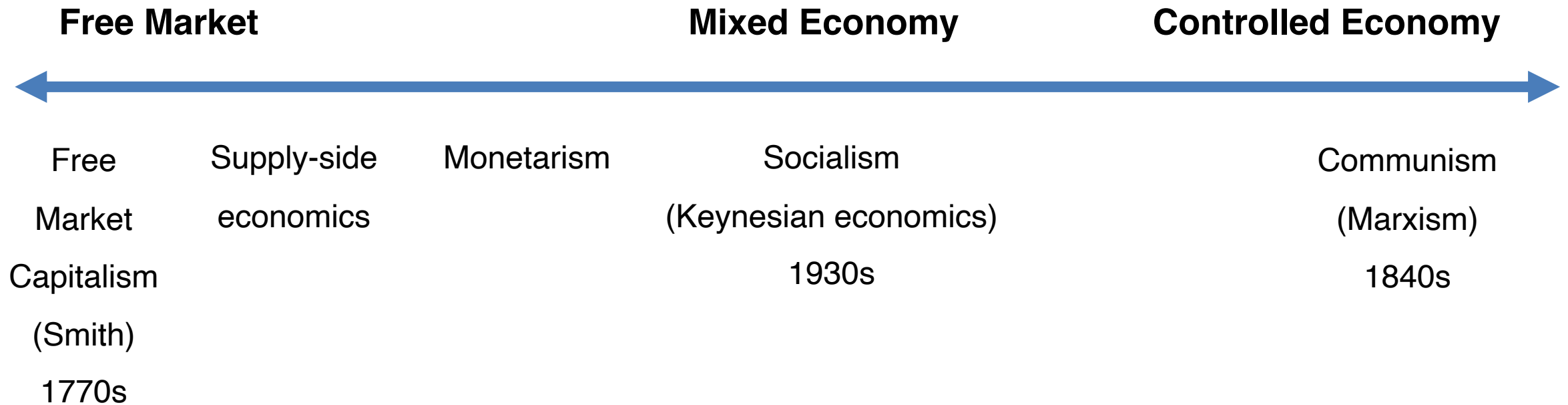


Economic thought

Economic thought - Starter

Video: [Economic Schools of Thought](#)

Watch the video and place the different schools of thought on a spectrum of economic systems.



Research activity

Task: Pick a famous economist and create a presentation to share your research with the class.

Your slides should include:

- A short autobiography
- Which economic school of thought they belonged to.
- The person's most famous economic theory.
- Which economists influenced their work.
- Which subsequent economists or economic theories were based on their work.
- Praise and criticism of their economic theories.



Origin of economic ideas – 18th century

Adam Smith and laissez faire

Adam Smith believed that economies operate best without government intervention; market forces and ‘the invisible hand’ will guide decisions, naturally leading to an efficient allocation of resources.



Origin of economic ideas – 19th century

Classical microeconomics (utility)

Utility refers to the satisfaction which consumers derive from consuming goods and services.

Alfred Marshall developed utility theory – that consumers aim to **maximize satisfaction** from their economic decisions, assuming they are rational.

Origin of economic ideas – 19th century

Classical macroeconomics (Say's law)

Jean-Baptiste Say supported the laissez faire approach and believed that '*supply creates its own demand*'. Say stated that free market economies tend towards full employment without government intervention.



Origin of economic ideas – 19th century

Marxist critique of classical economic thought

The labour theory of value – In the 19th century, it was believed that the value of a good can be determined solely by the **amount of labour** which went into producing it. Karl Marx criticized the classical economic thought and argued that capitalists were exploiting workers in order to make profits.

Meanwhile, Adam Smith criticized the Marxian labour theory of value by arguing that the value of a good is not only dependent on the labour involved, but the satisfaction which the consumer derives from consuming the good as well.

Origin of economic ideas – 20th century

Keynesian revolution

John Maynard Keynes believed that **the government must intervene** in order to stabilize and lift an economy out of a recession.

Keynes argued that **expansionary fiscal policy** is necessary to stimulate aggregate demand and allow the economy to return to full employment.



The Original Economics Rap Battle!

1. Identify the concepts illustrated in the video.
2. Using the lyrics, explain how the two schools of thoughts differ.

Origin of economic ideas – 20th century

Monetarist/new classical counter revolution

In contrast to Keynesian theory, monetarist theory states that government intervention prevents the free market from achieving full employment.

Monetarists believe that the use of **expansionary monetary policy** is more effective than expansionary fiscal policy in stimulating aggregate demand.



Real world example

Podcast: [Keynes' Consuming Ideas On Economic Intervention](#)

1. Explain how insufficient demand causes unemployment to rise.
2. State the type of unemployment which arises due to insufficient demand.
3. Distinguish between Obama and Richard Burr's views on the role of the government in managing the economy.

Origin of economic ideas – 21st century

Behavioural economics



Behavioural economics studies how individuals make economic decisions through psychological experimentation. This field of study is useful for predicting human behaviour and the effects of government policies.

Most classical economic theories assume that consumers are **rational** and make decisions that allow them to maximize utility. However, humans do not always behave rationally and are guided by psychological biases.



Real world example – research activity

Article: [Wine Study Shows Price Influences Perception](#)

With reference to the article, discuss the view that ‘consumers always act rationally’.

Origin of economic ideas – 21st century

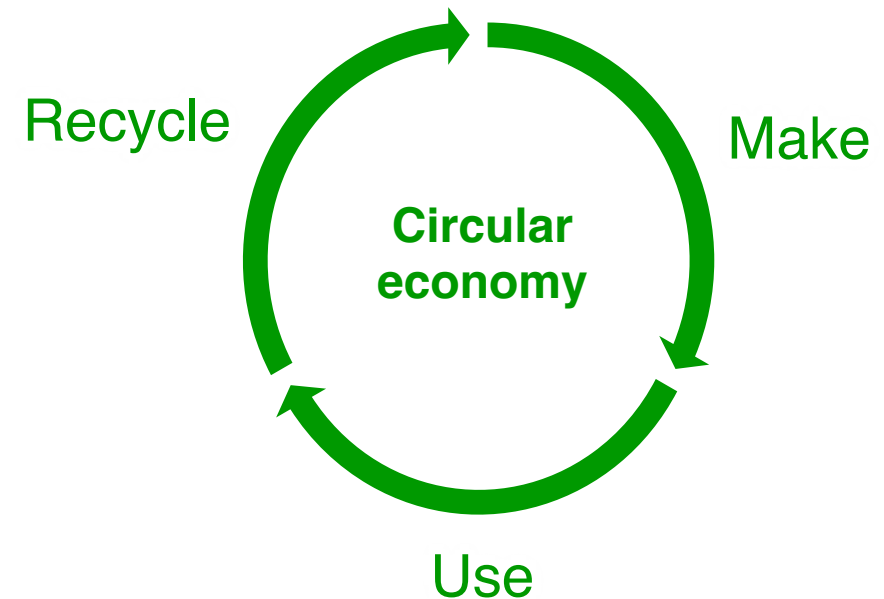
The interdependencies between the economy, society, and environment

Traditionally, economies have been linear and have adopted the 'take-make-waste' approach.

A circular economy focuses on sustainable practices that allows us to meet future needs.



Linear economy





Circular Economy

Watch the video to find out more about the circular economy.

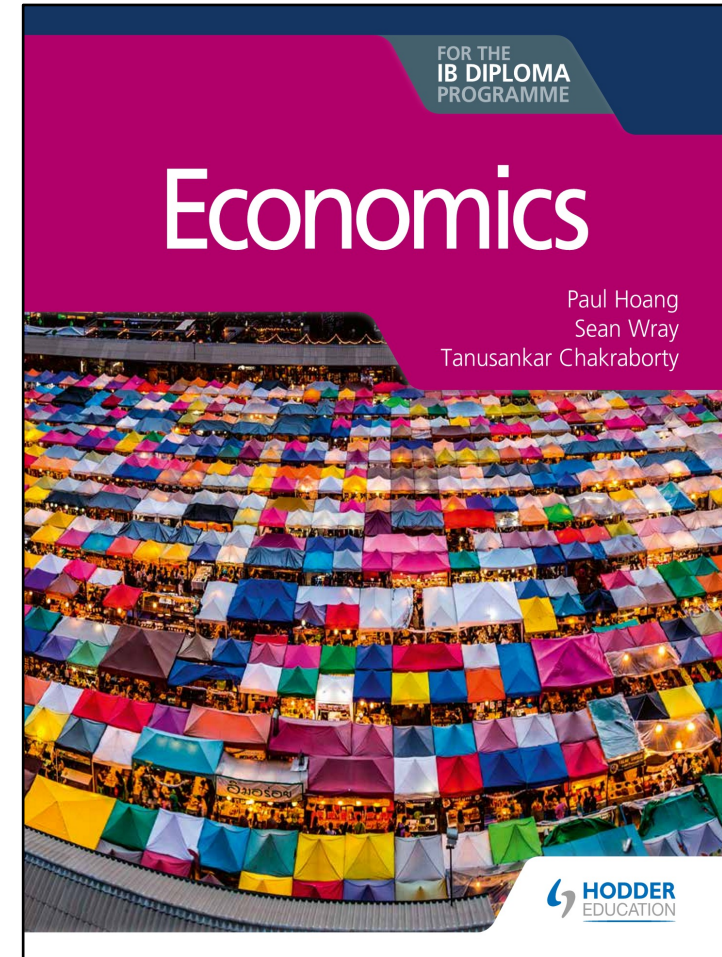
What key concepts are illustrated in the video?

Over to you...

Hoang, Wray, & Chakraborty (2020)

Economics for the IB Diploma Programme

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Test your knowledge on this unit: [Kahoot!](#)