

OXFORD IB COURSE PREPARATION

ECONOMICS

FOR IB DIPLOMA
COURSE PREPARATION

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To my budding scientists, Daphne, Myrto and Elias and of course to my Kris – CZ

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www.oxfordsecondary.com/ib-course-prep

INTRODUCTION TO THE DIPLOMA PROGRAMME

The Diploma Programme (DP) is a two-year pre-university course for students in the 16–19 age group. In addition to offering a broad-based education and in-depth understanding of selected subjects, the course has a strong emphasis on developing intercultural competence, open-mindedness, communication skills and the ability to respect diverse points of view.

You may be reading this book during the first few months of the Diploma Programme or working through the book as a preparation for the course. You could be reading it to help you decide whether the Economics course is for you. Whatever your reasons, the book acts as a bridge from your earlier studies to DP Economics, to support your learning as you take on the challenge of the last stage of your school education.

DP course structure

The DP covers six academic areas, including languages and literature, humanities and social sciences, mathematics, natural sciences and creative arts. Within each area, you can choose one or two disciplines that are of particular interest to you and that you intend to study further at the university level. Typically, three subjects are studied at higher level (HL, 240 teaching hours per subject) and the other three at standard level (SL, 150 hours).

In addition to the selected subjects, all DP students must complete three core elements of the course: theory of knowledge, extended essay, and creativity, action, service:

Theory of knowledge (approximately 100 teaching hours) is focused on critical thinking and introduces you to the nature, structure and limitations of knowledge. An important goal of theory of knowledge is to establish links between different areas of shared and personal knowledge and make you more aware of how your own perspective might differ from those of others.

The **extended essay** is a structured and formally presented piece of writing of up to 4,000 words based on independent research in one of the approved DP disciplines. It is also possible to write an interdisciplinary extended essay that covers two DP subjects. One purpose of the extended essay activity is to develop the high-level research and writing skills expected at university.

Creativity, action, service involves a broad range of activities (typically 3–4 hours per week) that help you discover your own identity, adopt the ethical principles of the IB and become a responsible member of your community. These goals are achieved through participation in arts and creative thinking (creativity), physical exercises (activity) and voluntary work (service).

Approaches to Learning (ATL)

The ATL categories are a group of strategies, attitudes and skills that help to build successful and engaged learners. They include thinking, communication, social, self-management and research skills.

ATL Skill	Meaning
Thinking	Emphasis is placed on skills such as metacognition, reflection and critical thinking.
Self-management	Self-management covers a wide variety of skills in two categories: <ul style="list-style-type: none"> • affective skills: resilience, self-motivation and mindfulness • organizational skills: managing your time and your tasks and goal-setting.
Communication	Communication includes the ability to listen, read and understand as well as to write, formulate arguments and communicate in a variety of forms.
Research	Research skills include practising responsible and ethical research and information literacy during independent, self-managed, inquiry learning.
Social	Social skills involve practising self-management of emotions and behaviours while working collaboratively with others towards a common goal, focusing on the ability to understand the perspective of others.

Key features of the IB Economics syllabus

The economics course aims to enable both SL and HL students to:

- develop a critical understanding of a range of economic theories, models, ideas and tools in the areas of microeconomics, macroeconomics and the global economy
- apply economic theories, models, ideas and tools and analyse economic data to understand and engage with real-world economic issues and problems facing individuals and societies
- develop a conceptual understanding of individuals and societies' economic choices, interactions, challenges and consequences of economic decision making.

SL and HL students of economics are presented with a common syllabus, with an HL extension in some topics. Both SL and HL students develop quantitative skills, but HL students will need to further develop these as appropriate, in analysing and evaluating economic relationships in order to provide informed policy advice.

The grid on the following page gives all the IB Diploma Programme Economics course topics. Bold indicates that all or part of a sub-topic is covered in this book.

Unit	Title	Sub-topic	Chapter in this book
1	Introduction to Economics	1.1 What is economics? 1.2 How do economists approach the world?	1.1
2	Microeconomics	2.1 Demand 2.2 Supply 2.3 Competitive market equilibrium 2.4 Critique of the maximizing behaviour of consumers and producers 2.5 Elasticity of demand 2.6 Elasticity of supply 2.7 Role of government in microeconomics 2.8 Market failure—externalities and common pool or common access resources 2.9 Market failure—public goods 2.10 Market failure—asymmetric information (HL only) 2.11 Market failure—market power (HL only) 2.12 The market's inability to achieve equity (HL only)	2.1 2.2 2.3 2.4 2.5 2.6 2.7 2.8 2.9
3	Macroeconomics	3.1 Measuring economic activity and illustrating its variations 3.2 Variations in economic activity—aggregate demand and aggregate supply 3.3 Macroeconomic objectives 3.4 Economics of inequality and poverty 3.5 Demand management (demand side policies)—monetary policy 3.6 Demand management—fiscal policy 3.7 Supply-side policies	3.1 3.2 3.3 3.4 3.5 3.6
4	The Global Economy	4.1 Benefits of international trade 4.2 Types of trade protection 4.3 Arguments for and against trade control/protection 4.4 Economic integration 4.5 Exchange rates 4.6 Balance of payments 4.7 Sustainable development 4.8 Measuring development 4.9 Barriers to economic growth and/or economic development 4.10 Economic growth and/or economic development strategies	4.1 4.2 4.3 4.4 4.5 4.6 4.7

Why this book?

This book provides a comprehensive introduction to the IB DP Economics course. The goal has been to explain key concepts and theories as clearly as possible, to ignite your interest in the subject and to ensure that you are well-prepared to embark upon this course. We will show you why economics is relevant on an individual, local, national, and also global level. Particular emphasis is placed on key elements of the IB DP such as approaches to learning (ATL), theory of knowledge (TOK) and community and service (CAS) to ensure that you are ready to take economics to the next level. This book covers the majority of topics you will encounter at the DP level, assuming that this is your first ‘hands-on’ contact with economics. It can be used as a preparation guide before you start DP Economics, but it will also prove a useful guide as you move through the DP Economics course.

The features of this book

In the coming pages, you will find a range of features to help you understand and engage with the skills that the Diploma Programme seeks to develop. These features are designed to improve your understanding and support the learning of new concepts.



TOK

TOK: During the economics course a number of issues will arise that highlight the relationships between TOK and economics. TOK questions presented in this book will help you understand and explore these relationships.

**Creativity, action,
service**



CAS: The economics course highlights many economic issues that have local, national and global manifestations. The CAS boxes in this book provide ideas that can help you plan, participate and implement CAS activities.

DP ready ATL Thinking Skills

ATL: ATL skills boxes are designed to give you a chance to practise the skills of a learner. These boxes are accompanied by different tasks designed to improve your understanding of the concepts being presented.



Search the web

Search the web: These boxes guide you to additional information that will facilitate your understanding, as well as the application of concepts and theories explained.



Internal link

Internal link: These boxes point to other places in this book where a particular topic is discussed.

Key terms—test yourself



Key terms: At the end of each section you will be asked to provide definitions of the most significant terms encountered to ensure that these can be effectively used. A full glossary can be found on the book website: oxfordsecondary.com/ib-course-prep.

1

Introduction to Economics



This unit presents the fundamental issues of economics. Terms such as “scarcity”, “choice” and “opportunity cost” are explained then visualized through a simple but powerful diagrammatic model: the production possibilities curve. The circular flow of income model is presented to illustrate the basic interrelationships in an economy. Key concepts such as equity, sustainability and interdependence are also introduced, followed by a brief timeline of economic thought that will help you understand the evolution of the subject.

In this unit you will learn about ...

- scarcity, choice and opportunity cost
- the production possibilities model
- the circular flow of income model
- economic methodology
- key ideas in economic thinking.

1.1 YOU CAN'T ALWAYS GET WHAT YOU WANT

The issue

This may be your first formal contact with economics, and yet news about the unemployment rate, higher or lower taxes, inflation, recession or growth, income inequality and climate change is constantly on television, in the newspapers and on social media. Economics affects our everyday lives. We constantly face problems or have to make decisions for which a knowledge of economics can be useful. Should I get a new pair of trainers or a new pair of jeans? Shall I buy the newest smartphone or keep my old one a little longer? This section asks: what is economics about?

Scarcity and choice

Economics is the study of scarcity and choice.

Scarcity refers to the excess of human wants over what can actually be produced to fulfill these wants. Human wants are unlimited, as individuals typically prefer to have more and better goods and more services. However, it is not possible to produce all of the goods and services to satisfy these wants. This is because resources are limited. The term “**resources**” refers to whatever is used to produce goods and services; resources are also known as the factors of production, as follows.

- **Land:** inputs into production provided by nature (such as land, metals and mineral deposits, forests, underground water, fish stocks and the atmosphere).
- **Labour:** the human input, both physical and mental, used in production.
- **Capital:** Produced means of production (such as machines, tools, equipment and factories).
- **Entrepreneurship:** the willingness and ability that some individuals have to take risks and to manage the other three factors of production.

Scarcity has an important consequence, it necessitates choice. Societies must choose which goods or services to produce and how much of each they want, given the available resources. If there were no scarcity, no choices would have to be made. Every choice involves sacrifice. For example, choosing to produce corn using the available land implies that some other agricultural product, such as wheat, has been sacrificed. This alternative that has been foregone is the opportunity cost of that choice. The **opportunity cost** of choosing any activity is the value of the next best alternative sacrificed. If resources were unlimited, no sacrifices would be necessary, and the opportunity cost of producing any good or service would be zero.

The problem of scarcity has a second important consequence. Since resources are scarce, it is important to produce the combination of goods and services that society values the most and also to avoid wasting any scarce resources. This relates to the idea of **efficiency**, which is making the best possible use of scarce resources, minimizing their waste. Therefore, economics is the social science that studies how societies make choices that lead to the best possible use of scarce resources in an attempt to satisfy unlimited human wants. The above definition classifies economics as a social science. **Social sciences** study human behaviour and social relationships and include psychology, anthropology, political science and others.

Besides scarcity, choice and efficiency, there are a few other key concepts that are central to economics and that will be discussed throughout this book. These are as follows.

- **Equity:** this refers to the idea of fairness. In economics, inequity is associated with rising inequality.

DP ready ATL Thinking Skills

Scarcity and opportunity cost

1. Explain whether the problem of scarcity is relevant for both rich and poor countries.
2. “If in many countries a lot of food is thrown away then food is not scarce.” To what extent do you agree with this statement?
3. Think of three choices you have recently made. These could be going to a party, choosing to study economics or buying a mobile (cell) phone, for example. Describe the opportunity cost of each choice.
4. A long time ago your uncle bought a bottle of wine for \$10 and now its market value has increased, and he could sell it for \$200. One option he has is to drink it. Another option is for him to keep it unopened and not sell it. Explain the opportunity cost in each case.



TOK

What distinguishes a social science from a natural science?

- **Economic well-being:** this relates to the living standards enjoyed by the members of an economy.
- **Sustainability:** this refers to the ability of the present generation to meet its needs without compromising the ability of future generations to meet their own needs. It relates to the idea that current generations should be good stewards of the environment.
- **Change:** the economic world is not static; it continuously changes. In economics the focus of investigations is on change. It is not the level of an economic variable but the change in that variable that economists are typically interested in.
- **Interdependence:** economic agents such as consumers, producers, governments and nations interact with each other. Any action of any economic agent will therefore impact other agents, indicating that all economic agents are interdependent. The intended and unintended consequences of these interdependencies must therefore be considered.
- **Intervention:** this refers to government involvement in the workings of markets, despite markets being considered as the best mechanism to organize economic activity. Markets often fail, creating room for government intervention. Note that not only is the extent of government intervention a contentious subject of debate, but also there is no guarantee that the outcome of any intervention will improve market outcomes.

Economics is divided into two main branches: microeconomics and macroeconomics, where “micro” means small and “macro” means big. More specifically, **microeconomics** is concerned with the individual parts of the economy; it deals with individual units within the economy such as firms, consumers or markets. **Macroeconomics** zooms out and is concerned with the economy as a whole; it deals with aggregates such as the overall level of unemployment, output, growth and prices in the economy.

The fundamental questions of economics

Let’s return to the basic economic problem of scarcity. Scarcity forces every economy to answer three fundamental questions.

1. **What to produce?** Choices must be made in all economies about which goods will be produced and in what quantities.
2. **How to produce?** All economies must make choices on how to use their resources in order to produce goods and services. Should a good be produced using more labour and less capital (machines) or perhaps rely more on capital and less on labour?
3. **For whom to produce?** All economies must make choices about how the goods and services produced are to be distributed among the population. Should everyone enjoy education and health services? Should everyone enjoy the same amount of all goods?

The form of organization of each economy can lead to different ways of answering the three fundamental questions. At one extreme lies the command economy, where the state owns all



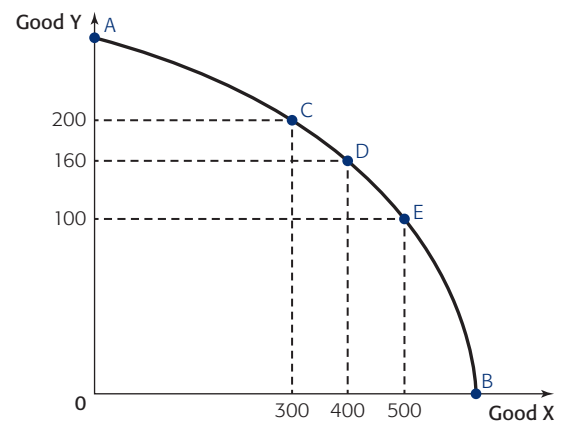
capital and land and so answers the three fundamental questions. At the other extreme lies the free-market economy, where households and firms answer the three fundamental questions through their interaction in markets. Households decide what goods to consume. Firms decide what goods to produce and what resources to use. The resulting production and consumption depend on all these individual demand and supply decisions in markets. In a mixed economy, the answers to the three fundamental questions are given partly by the state and partly through the market. In practice, all economies are mixed, yet the roles and importance of the state and of markets can differ substantially.

The production possibilities model

The **production possibilities curve (PPC)** provides a very simplified but useful picture of an economy at a point in time. It refers to a country with a fixed amount of resources and some level of technology producing only two goods or services. This is unrealistic but still, as you will see, powerful enough to illustrate a number of key concepts. The PPC shows the maximum combinations of these two goods or services that this economy can produce by fully using all of its resources with the available technology—so the points on the curve show no wasted resources and production is efficient. Typically, the PPC is concave (that is, bowed in) towards the origin.

Let's visualize a PPC. Assume that an economy devotes all of its resources to the production of two goods: X and Y (X and Y can be any goods or services, such as wheat and cotton, or health care and national defence).

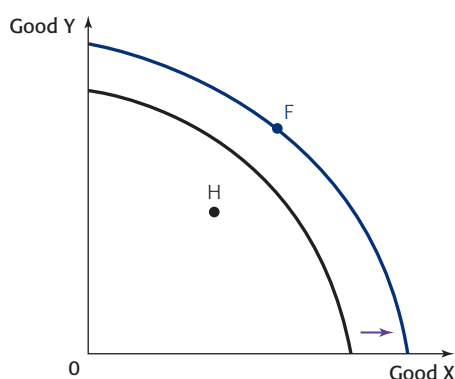
As shown in Figure 1.1.1, at point A the economy is using all its resources to produce good Y, so no amount of good X can be produced. At the other extreme, point B illustrates that the economy is using all its resources to produce good X, so good Y cannot be produced. At point C, resources are allocated in the production of both good X and good Y: the economy can produce 300 units of good X and 200 units of good Y. At point D, 400 units of X can be produced but only 160 units of good Y. Finally, at point E, 500 units of good X can be produced but even fewer units of good Y, only 100, can be produced.



▲ Figure 1.1.1 Production possibilities curve (PPC)

The PPC also illustrates choice and opportunity cost. As Figure 1.1.1 shows, if the economy chooses to produce more of good X it will have to sacrifice the production of some of good Y. This is shown by moving along the PPC from point C to point D. This sacrifice of good Y is the opportunity cost (OC) of the additional amount of good X that is produced. Specifically, we realize that the OC of producing an additional 100 units of good X (400 units instead of 300 units) are the 40 units of good Y (160 instead of 200) that must be sacrificed. The fact that scarcity requires that producing more of one good necessitates producing less of the other is what explains the negative slope of the PPC.

The PPC also illustrates the phenomenon of the increasing OC. Consider moving from point D to point E. The OC of producing an additional 100 units of good X (500 units instead of 400 units) are the 60 units of good Y (100 instead of 160) that are sacrificed. However, producing these additional 100 units of good X is now more costly as 60 units instead of 40 units of good Y have been sacrificed. This means that as the economy produces more of one good, it is forced to sacrifice increasing amounts of the other good. The reason for this is that resources tend to be specialized. As the economy concentrates more of its production on one good, it must start using resources that are less suitable for its production; that is, resources that would have been more appropriate to produce the other good. The PPC is concave rather than being a negatively sloped straight line because opportunity cost increases as more and more of X is produced.



▲ **Figure 1.1.2** Inside and outside the PPC

What if the economy is operating inside the PPC producing a combination such as point H in Figure 1.1.2? In this case the available resources are not being fully utilized, for example, there is unemployment. Point H is therefore an inefficient production combination. It follows that if unemployment increases, then the new point will lie somewhere closer to the origin, as fewer units of at least one of the two goods will be produced. In contrast, if unemployment decreases, the economy will move to another combination closer to the curve itself.

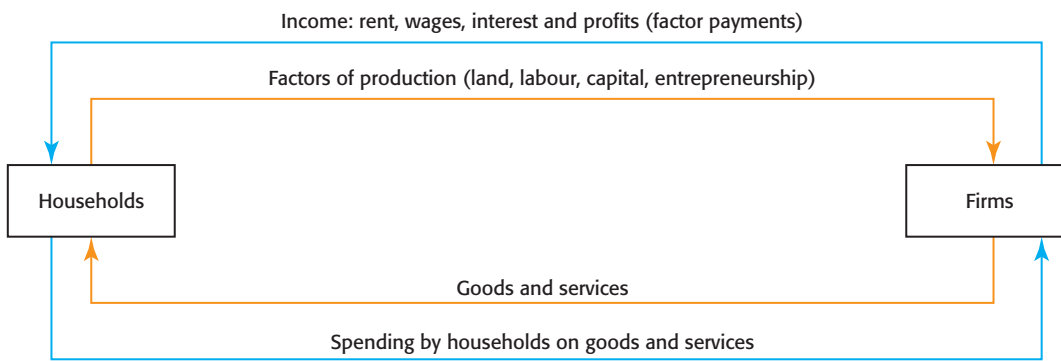
Could an economy be operating at a point outside the PPC, such as point F? No, because the available resources and current level of technology do not allow the economy to enjoy such output combinations. Point F is an unattainable production combination. If more or better resources become available and/or technology improves, combinations of output that were initially unattainable (such as F) can be produced. This can be shown through an outward shift of the PPC.

The circular flow of income model

The circular flow of income model is a simple diagram that allows us to visualize and understand the economy.

Let's start with a simple explanation. Consider an economy with two "inhabitants": households and firms. Households own the four factors of production—land, labour, capital and entrepreneurship—which they offer to firms. In exchange for the factors of production, firms offer payments to households in the form of rent (for land), wages (for labour), interest (for capital) and profits (for entrepreneurship). The sum of these payments makes up income. Firms use the factors of production to produce goods and services that they sell to households; households make expenditures on the goods and services produced by firms.

In this basic view of the economy there are transactions that take place by two kinds of flow: "real" flows such as labour, raw materials, goods or services in one direction, and flows of money that pay for these things in the opposite direction.



▲ **Figure 1.1.3** Flows in an economy

In Figure 1.1.3, the real flows are shown in orange and the money flows in blue.

The money flows shown in Figure 1.1.3 are equal. The income that flows from firms to households (as payments made for the use of the factors of production) is equal to the spending by households that flows back to firms (as payment for the goods and services produced). This is the circular flow of income.

Now let's go a step further. For our basic **circular flow model** to resemble the real-world economy more closely, we must add leakages and injections.

Adding a banking sector

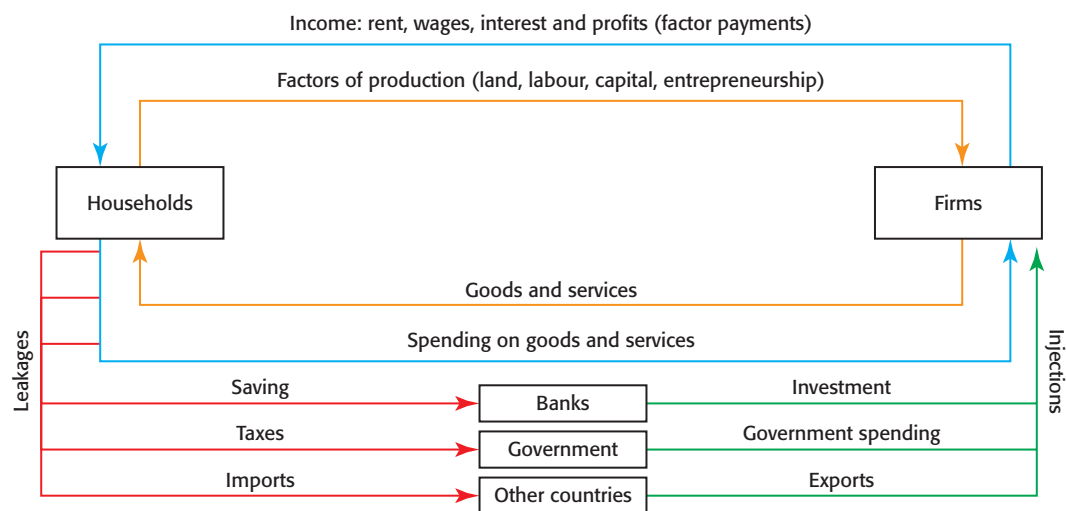
Households do not necessarily spend all their income on goods and services, because part of it may be saved. Savings represent income that is not spent on goods and services and, in turn, is a leakage from the circular flow. At the same time, it is not only households that spend on goods and services. Firms also spend when they buy capital goods. This is known as investment. Investment is an injection into the circular flow. Savings and investments are enabled by the banking sector. Banks attract savings and then lend the funds that firms need for their investments. In this way, income leaks out due to savings but is injected back through investment.

Adding a government sector

In every economy there is also a government sector. How does this affect the circular flow? Households must pay taxes. This implies that a part of income is paid in taxes and is therefore not spent on the goods and services produced by firms. The government uses the tax revenue collected to finance government spending, such as the building of roads and schools, and so this spending is an injection back into the circular flow.

Adding a foreign sector

Most countries trade with other countries and are therefore "open economies". This means that domestic goods and services are exported while foreign ones are imported. Imports are a leakage as they represent household spending on foreign goods and services. Exports reflect foreign spending on domestic goods and services, so they are an injection back into the circular flow.



▲ **Figure 1.1.4** Flows in an economy including leakages and injections

DP ready ATL Thinking Skills

The circular flow of income

Carefully draw your own diagram showing the circular flow of income. Explain what would be the effect on national income if:

- households decided to save more
- the government decided to initiate spending cuts and raise taxation.
- the government of a trading partner decides to relax import duties.

Figure 1.1.4 shows the expanded version of the circular flow, which includes leakages and injections.

Leakages from the circular flow of income consist of savings, taxes and imports. They are matched by injections into the circular flow of income, which are investment, government spending and exports. Yet leakages and injections may not equal each other. What happens then? Think of the circular flow as a swimming pool containing a certain amount of water. Now, imagine there is a crack in the pool and water leaks out while someone is adding water using the garden hose. If the water injected into the pool exceeds the amount of water leaking out, then the pool will tend to overflow. In contrast, if the water leaking through the crack exceeds the amount of water injected, then the pool will tend to drain. In terms of income, if injections into the circular flow are larger than leakages, the income flow becomes larger whereas if injections are smaller than leakages, the income flow becomes smaller.

Economic methodology

The methodology employed by economists is similar to that employed by natural scientists. Economists attempt to construct models that are then used to explain and predict. These models show simplified relationships between various economic variables. Most models can be described, but they can also be represented with diagrams. They are constructed by making general hypotheses about the causes of economic phenomena, for example, that consumer demand will rise when consumer incomes rise. These hypotheses are often based on observations. The aim is to draw conclusions from the constructed models. To arrive at conclusions it has to be assumed that nothing else that can influence the relationship under consideration has changed in the meantime. This is known as the **ceteris paribus** assumption. The Latin **ceteris paribus** translates as “other things being equal”.

Models can be judged according to how successful they are in explaining and predicting. If the resulting prediction is wrong, the model must be either adapted or abandoned. This process is referred to as refutation.

TOK

Is the *ceteris paribus* assumption realistic? Do other disciplines make a similar assumption?

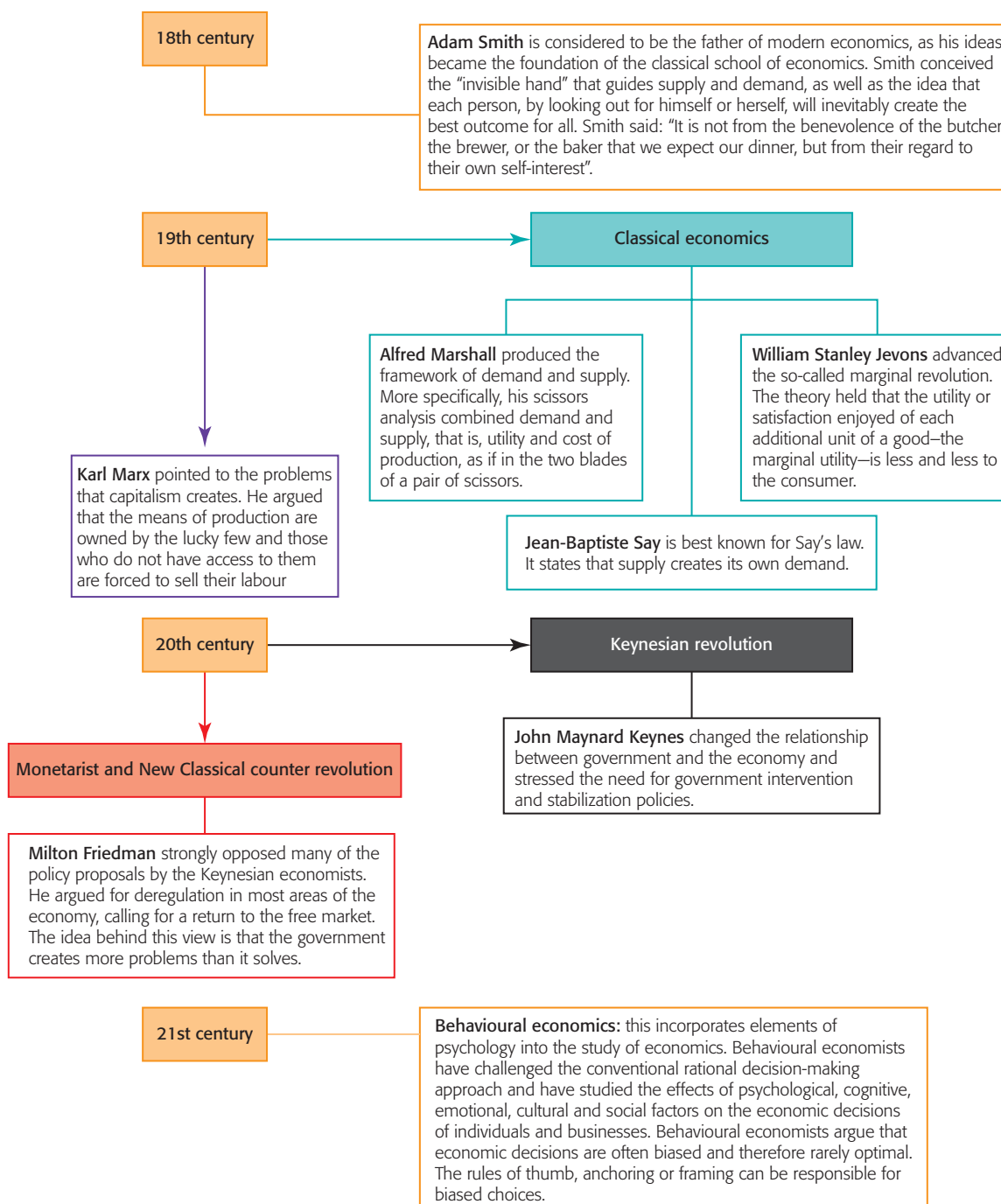
Economists play a major role in helping governments to devise economic policy. In order to understand this role, it is necessary to distinguish between **positive** and **normative economic statements**. A positive statement is a statement of fact. It can be proven right or wrong. “Unemployment is rising” or “inflation will be higher than 6 per cent by next year” are examples of positive statements. A normative statement is a value judgment: a statement about what ought to be, about whether something is good or bad, desirable or undesirable. “It is right to tax the rich more than the poor” or “the government ought to reduce inflation”, are examples of normative statements. They cannot be proved or disproved by a simple appeal to the facts.



TOK

What criteria should be adopted for evaluating normative statements in economics?

Economic thought



▲ Figure 1.1.5 Economic thinking

Watch this

Search YouTube using these terms: Ariely control of our decisions TEDx. This video gives an insight into behavioural economics.

Key terms—test yourself



Define these terms: scarcity, resources, opportunity cost, efficiency, social sciences, microeconomics, macroeconomics, leakages, injections, *ceteris paribus*.



Search the web

For a more comprehensive timeline of economic thought, search using these terms: economics an illustrated timeline.

DP ready ATL Thinking Skills

Important economists

Which two of the people who have shaped economic thought over the centuries would you invite to dinner? Explain your answer.

Focus point

Economics is the social science that studies how societies make choices that lead to the best possible use of scarce resources, in an attempt to satisfy unlimited human wants. The production possibilities model and the circular flow of income model are representations of the economy. The production possibilities curve shows the possible combinations of two goods that an economy can produce in a given period of time. The circular flow model shows the interrelationships between firms and households in an economy. All models are built on the *ceteris paribus* assumption which is a key feature of economic methodology.