SECTION 1.2 ECONOMIC THEORY

This section considers the use of theories to perform economic analysis. What are economic theories? Why do we need to abstract from "real life"? What are the components of a theory? What are some common errors people make in doing analysis? And lastly, why do economists disagree?

· A **theory** is an established explanation of known facts or phenomena. Economic theories are statements or propositions about patterns of human behaviour that are expected to take place under certain circumstances.

· Economic theories cannot take into account every event that may have influenced an action. As a result, we **abstract** from some aspects of reality to better focus on the important explanations for the facts we want to explain. Like a road map, economic theories must abstract from many of the particular details of situations to better focus on the behavior to be explained. An economic theory provides a broad view, not a detailed examination, of human economic behavior.

· A **hypothesis** is a testable proposition about how people will behave or react to a change in economic circumstances.

· **Empirical analysis** must be used to test a hypothesis to see if the theory fits the facts. Testing a hypothesis is more difficult in economics than it is in the natural or physical sciences because economists do not usually work in a laboratory where variables can be adjusted in a controlled environment. If an economic hypothesis is supported by facts, it can then be tentatively accepted as an economic theory. However, it is always on probation - it is accepted until it no longer predicts well.

· The Latin phrase **ceteris paribus** means "let everything else be equal" or "holding everything else constant". In order to assess the effect one variable has on another, researchers must be careful to hold other things constant.

· The fact that two events occur together **(correlation)** does not necessarily mean that one caused the other to occur **(causation).** One must be careful not to confuse correlation with causation and to be clear on the direction of causation.

· The **fallacy of composition** is that if something is true for an individual, it is not necessarily true for a group. Arriving early to class to get a preferred seat works if only you take this action. If everyone in the class arrived early, seats would be as difficult to find as before.

· **Positive analysis** looks at how people do behave, not how they should behave. **Normative analysis** involves a judgment about what should be or what should happen.

· Like all other scientists, economists frequently disagree but there is probably less disagreement than is commonly believed. Disagreement may arise from normative beliefs or from differing views on the validity of an economic theory. However, surveys of economists show there is wide agreement on many issues including rent control, import tariffs, and the minimum wage.