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1. What is the purpose of an economic model?

An economic model is a simplified representation of real economic processes used to analyze relationship between variables and predict the effects of economic decisions. The main purpose is to strip away complexity so that the impact of the changes can be studied and theories can be tested.

2. How can marginal analysis be used to explain rational behaviour?

Marginal analysis examines how an additional unit of a good or action affects benefits and costs. Rational behaviour assumes that individuals decide by comparing the marginal benefit with the marginal cost. If the marginal benefits exceeds marginal cost, the action is considered rational & worthwhile.

3. Give an example of a behavioral assumption in an economic model.

What is the purpose of using behavioral assumption in an economic model?

An example of a behavioral assumption is bounded rationality, where people make decisions with limited information and simplified reasoning rather than full optimization.

Behavioral assumptions are used to make models more realistic by incorporating psychological and social factors that influence decision-making, improving the model's predictive accuracy.

4. A person makes decisions by habit. This person considers neither the benefits nor the costs of his or her actions. Can the person be considered rational?

In classical economics, such a person is not considered rational because rationality requires weighing benefits and costs. In behavioral economics, habitual economics can be viewed as bounded rationality if the habit was once optimal or if the person lacks full information.

5. In what ways do economic theories and models abstract from reality? Why are unrealistic models useful?

Economic theories abstract from reality by simplifying complex relationships. Unrealistic models are useful because they isolate key mechanisms, simplify analysis and provide a basic understanding of economic processes, serving as a foundation for more complex, realistic models.