

The Foundation of Economics

What is Economics?

- Economics is the branch of knowledge concerned with the production, consumption and transfer of wealth.
- It is the study of how scarce resources are allocated to fulfill the infinite wants of consumers.

Adam Smith (1723 – 1790)

- Known as father of modern economics
- Wrote the first and most important books on the subject of economics, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776)
- Smith believed in “free market”

(free market is one where consumers may buy what they like and producers may produce what they like, with no government interference)

Smith suggested that a laissez-faire (don't interfere) approach should be followed, leaving customers and producers to make their own decisions

□ **NEEDS:** are the basic necessities that a person must have in order to survive

e.g. food, water, warmth, shelter and clothing

□ **WANTS:** are the desire that people have

e.g. things that people would like to have, such as bigger homes, iphones, etc.

The Economic Problem



A wind farm. Copyright: iStock.com

- Unlimited Wants
- Scarce Resources –
Land, Labour, Capital
- Resource Use
- Choices

The Economic Problem

- **What goods and services should an economy produce?** – should the emphasis be on agriculture, manufacturing or services, should it be on sport and leisure or housing?
- **How should goods and services be produced?** – labour intensive, land intensive, capital intensive? Efficiency?
- **Who should get the goods and services produced?** – even distribution? more for the rich? for those who work hard?

SCARCITY

- The excess of wants resulting from having limited resources (land, labor, capital and entrepreneurs) in satisfying the endless wants of people.
- It is a universal problem for societies – it is not limited to poor countries.
- To the economist, all goods and services that have a price are relatively scarce. This means that they are scarce relative to people's demand for them.

Factors of Production

□ Land

- natural resources available for production
- renewable resources: those that replenish
- non-renewable resources: cannot be replaced

□ Labor

- physical and mental effort of people used in production

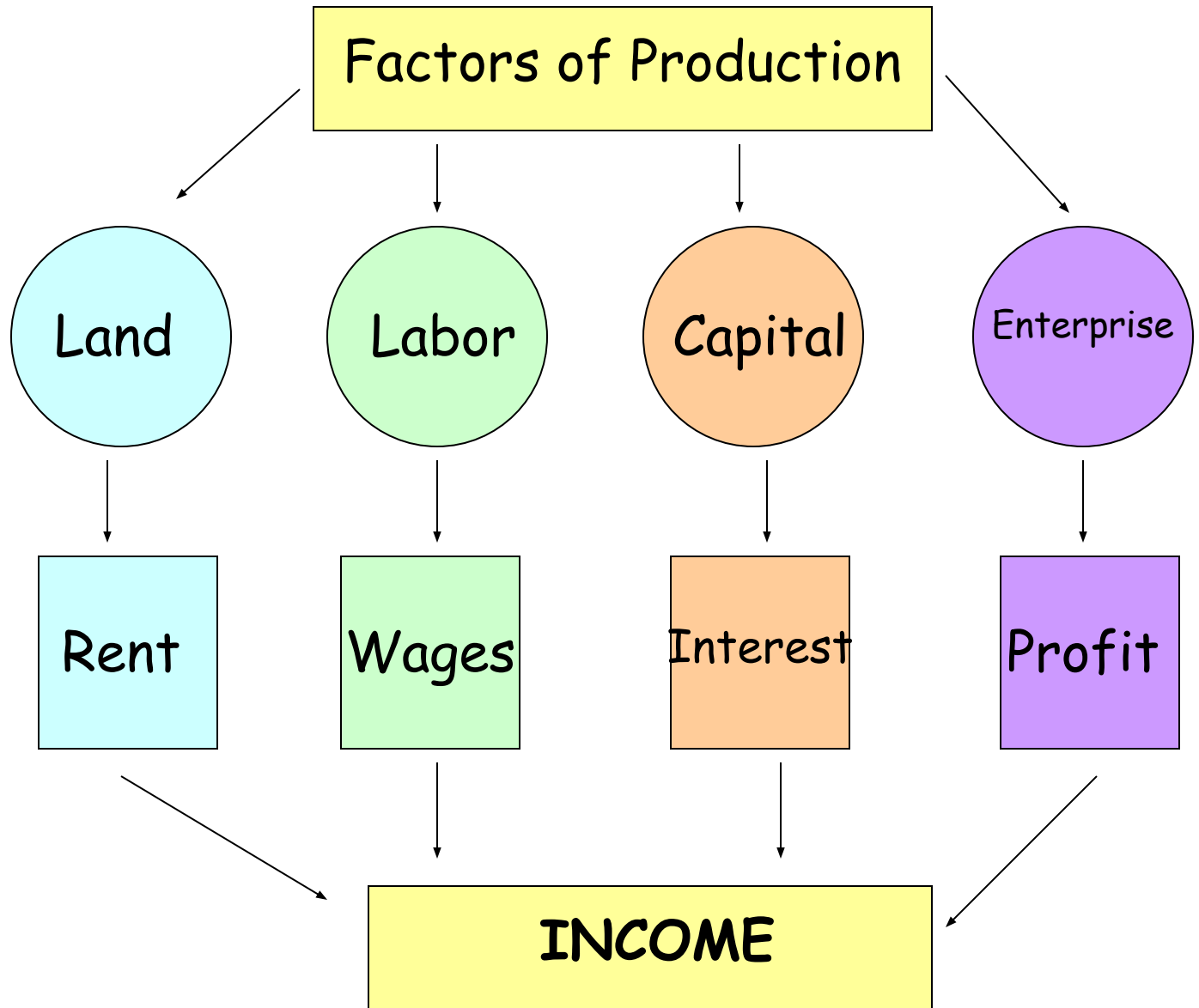
□ Capital

- all non-natural (manufactured) resources that are used in the creation and production of other products

□ Enterprise (Entrepreneurship)

- refers to the management, organization and planning of the other three factors of production

Payments
to factors
of
Production



Opportunity Costs

All economic questions and problems arise from scarcity. Economics assumes people do not have the resources to satisfy all of their wants. Therefore, we must make choices about how to allocate those resources. We make decisions about how to spend our money and use our time.

Opportunity Costs

- The cost of the next best use of your time or money when you choose to do one thing rather than another is opportunity cost.
- Let's say you have five dollars. What would you like to spend it on? There are a million things you would love to spend five bucks on, but let's imagine there are only three things out there you really want to buy: gum, soda, and movie tickets. Look at the price chart below and answer the questions.

Look at the price chart below and answer the questions.

Good	Price	
☐ Gum	\$.50	1. How many sodas can you buy instead of one movie ticket?
☐ Soda	\$1.00	2. How many pieces of gum can you buy instead of one soda?
☐ Movie Ticket	\$5.00	

Trade Offs

- Decisions involve tradeoffs. When you make a choice, you give up an opportunity to do something else.

The next Best Thing...

- The highest-valued alternative you give up is the opportunity cost of your decision.

- You won a radio station contest and you are now \$300 dollars richer. You can finally start looking for a new system in your car. Determine what criteria you think are important for choosing a system and identify the tradeoffs made when selecting one stereo over another.
- You will encounter similar decisions for the rest of your life – what college to attend, what house to purchase, what kind of car to purchase, when to have children, how many children do you want to have, what school to send your children to, etc.
- Researching opportunity cost of all options in any decision making process is vital in order to make the best available choice.
- Also keep this in mind, Americans spend 85% of their financial resources on things that will not last for more than three years...



- Identical twins Ashley and Mary Kate graduate with Bachelors degrees and receive the same job offer. Ashley passes up the job offer to pursue a Masters degree while Mary Kate takes the job offer and begins working.
- Two years pass and Ashley graduates and begins working. By this time Mary Kate has been promoted to a position that is comparable to Ashley's starting position, and Mary Kate's salary has increased to an amount that is comparable to Ashley's starting salary.

So who made the better decision, Ashley or Mary Kate?

- In business and in life, every choice we make comes at a cost since we forgo other possible alternatives in the process; this cost — whether it's money, time, education, health, et cetera — is known as an opportunity cost.
- In the example, one could argue that Ashley made the better decision since a Masters degree would be valuable if both lost their jobs and found themselves in a competitive job market. Yet when you look at the situation in terms of opportunity costs, Ashley's Masters degree came at a cost of two years salary. *If* Ashley and Mary Kate stay on equal career paths from here on out, Mary Kate ends up making the better decision.

An opportunity cost is the value or benefit of the next best alternative.

Opportunity costs even come into play in the pursuit of happiness

Opportunity costs are all around us and they differ from individual to individual. Take one look at Steve Jobs and Bill Gates and think of the opportunity costs if they had decided to forgo their entrepreneurial pursuits and continue their college education instead.

Things would be very different now.

Ultimately, opportunity costs apply to anything which is of value to a person and being conscious of how they apply to your situation can help in making a satisfactory choice/decision by considering the value or benefit of the next best alternative.