

# The Central Concepts of Economics

**From:**

**Book 2: Chapter 1 (A, B, C)**



# Scarcity and Efficiency: The Twin Themes of Economics

- A situation of **scarcity** is one in which goods are limited relative to desires.
- Given unlimited wants, it is important that an economy make the best use of its limited resources.
- **Efficiency** denotes the most effective use of a society's resources in satisfying people's wants and needs.
- **Economic efficiency** requires that an economy produce the highest combination of quantity and quality of goods and services given its technology and scarce resources.



# Economics

- **Economics** is the study of how societies use scarce resources to produce valuable goods and services and distribute them among different individuals.
- The ultimate goal of economic science is to improve the living conditions of people in their everyday lives.
- Divided into two major subfields:
  - **Microeconomics**: concerned with the behavior of individual entities such as markets, firms, and households.
  - **Macroeconomics**: concerned with the overall performance of the economy.



# Positive Economics versus Normative Economics

- Positive economics describes the facts of an economy, while normative economics involves value judgments.
- Positive economics: describes and explains various economic phenomena (what is)
- normative economics: focuses on the value of economic fairness or what the economy should be.



# Positive vs Normative – Examples

- The government should provide basic healthcare to all citizens.
- Government-provided healthcare increases public expenditures.
- Arguing for a higher minimum wage for the benefit of workers.
- An assertion that higher minimum wages would lead to a higher GDP.



# Three Fundamental Economic Problems

- **What** commodities are produced and in what quantities?
  - should the emphasis be on agriculture, manufacturing or services, should it be on sport and leisure or housing?
- **How** are goods produced?
  - who will do the production, with what resources, and what production techniques they will use.
- **For whom** are goods produced?
  - even distribution? more for the rich? for those who work hard?



# Market, Command, and Mixed Economies

- Different ways that a society can answer the questions of what, how, and for whom?
- A **command** economy is one in which the government makes all important decisions about production and distribution.
- A **market** economy is one in which individuals and private firms make the major decisions about production and consumption. (it's extreme case is called a **laissez-faire** economy)
- No contemporary society falls completely into either of these polar categories. Rather, all societies are **mixed** economies, with elements of market and command.



# Inputs and Outputs

- **Inputs** are commodities or services that are used to produce goods and services. Another term for inputs is **factors of production**.
  - **Land** – or, more generally, natural resources – represents the gift of nature to our societies. E.g. land, energy resources, environmental resources.
  - **Labor** consists of the human time spent in production – working in automobile factories, writing software, teaching school, or baking pizzas.
  - **Capital** resources form the durable goods of an economy, produced in order to produce yet other goods. E.g. machines, roads, computers, software, trucks, steel mills, automobiles, washing machines, and buildings.





# Inputs and Outputs (Cont'd)

- **Outputs** are the various useful goods or services that result from the production process and are either consumed or employed in further production.
- Consider the 'Production' of pizza.
  - What are inputs and output?
- In education. Inputs and outputs?



# The Production-Possibility Frontier (PPF)

- The **production-possibility frontier** (or PPF ) Show the different combinations of goods and services that can be produced with a given amount of resources.
  - No 'ideal' point on the curve
  - All choices along a PPF display **productive efficiency**
  - Any point inside the curve (underutilized) suggests resources are not being utilised efficiently
  - Any point outside the curve (Infeasible) not attainable with the current level of resources
  - Useful to demonstrate economic growth and opportunity cost



# Example: Guns and Butter

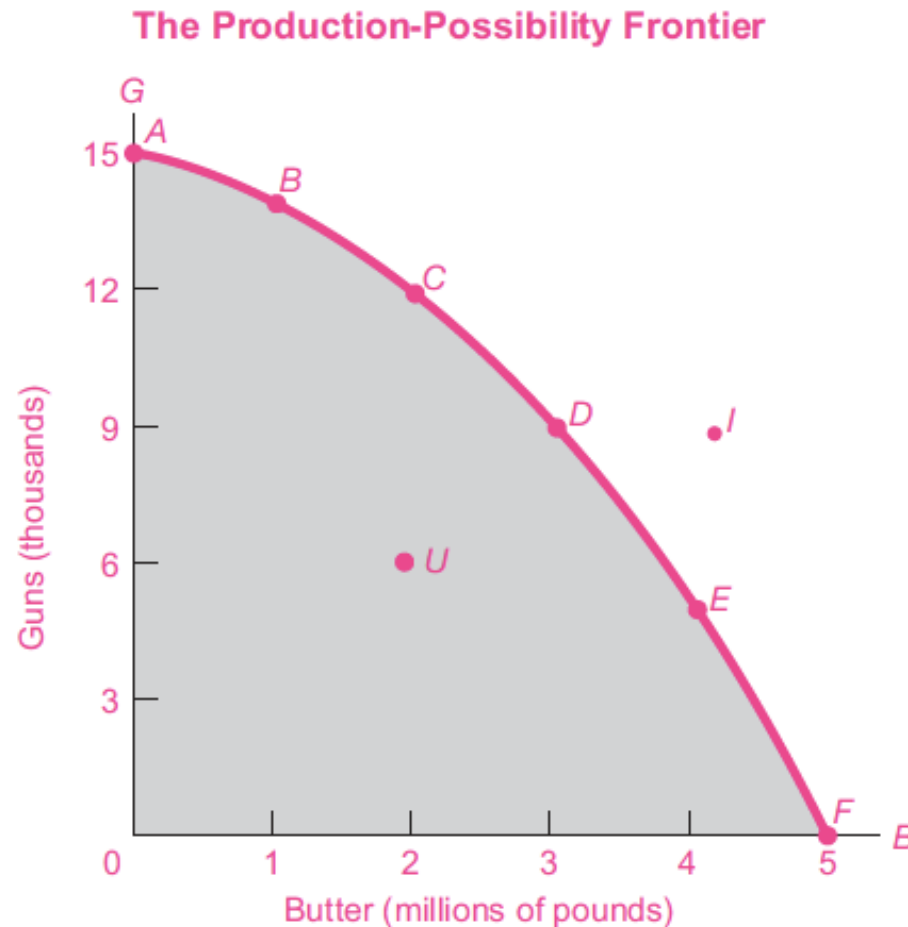
- Consider an economy which produces only two economic goods: guns and butter.

Alternative Production Possibilities		
Possibilities	Butter (millions of pounds)	Guns (thousands)
A	0	15
B	1	14
C	2	12
D	3	9
E	4	5
F	5	0

**TABLE 1-1. Limitation of Scarce Resources Implies the Guns-Butter Tradeoff**

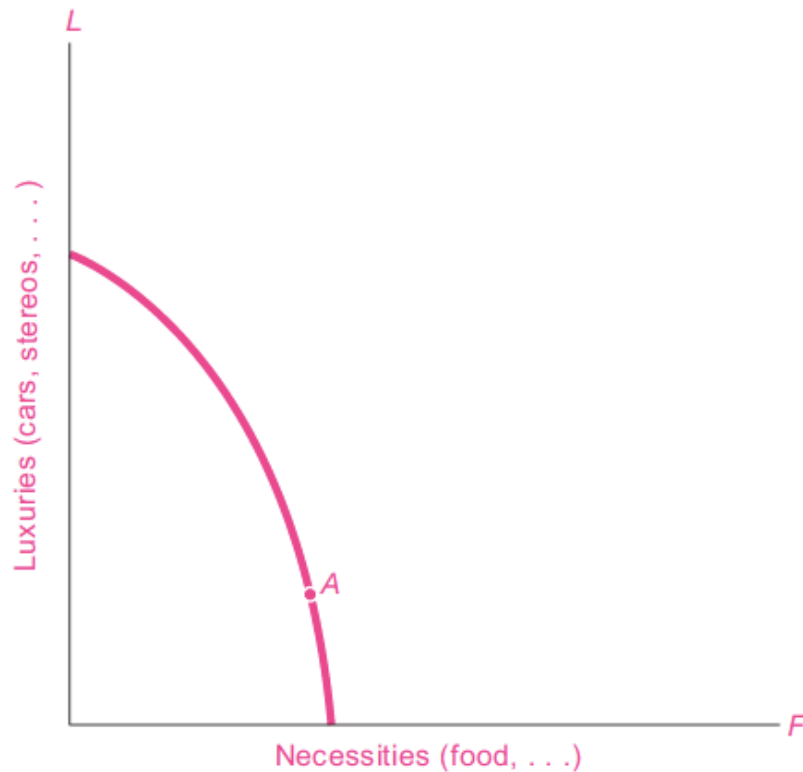


# Example: Guns and Butter (Cont'd)

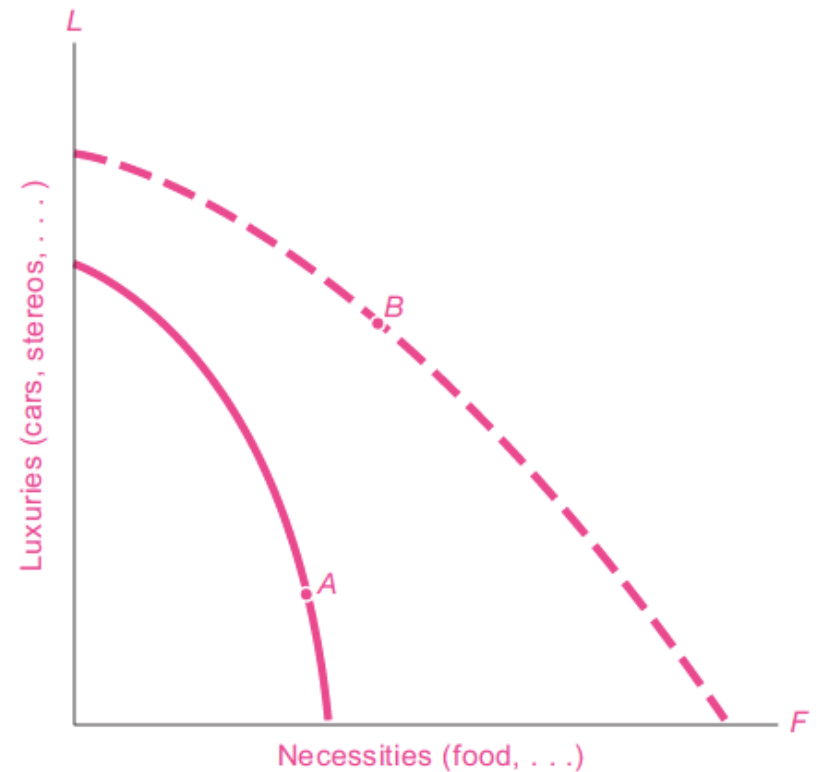


# Applying the PPF to Society's Choices

(a) Poor Nation



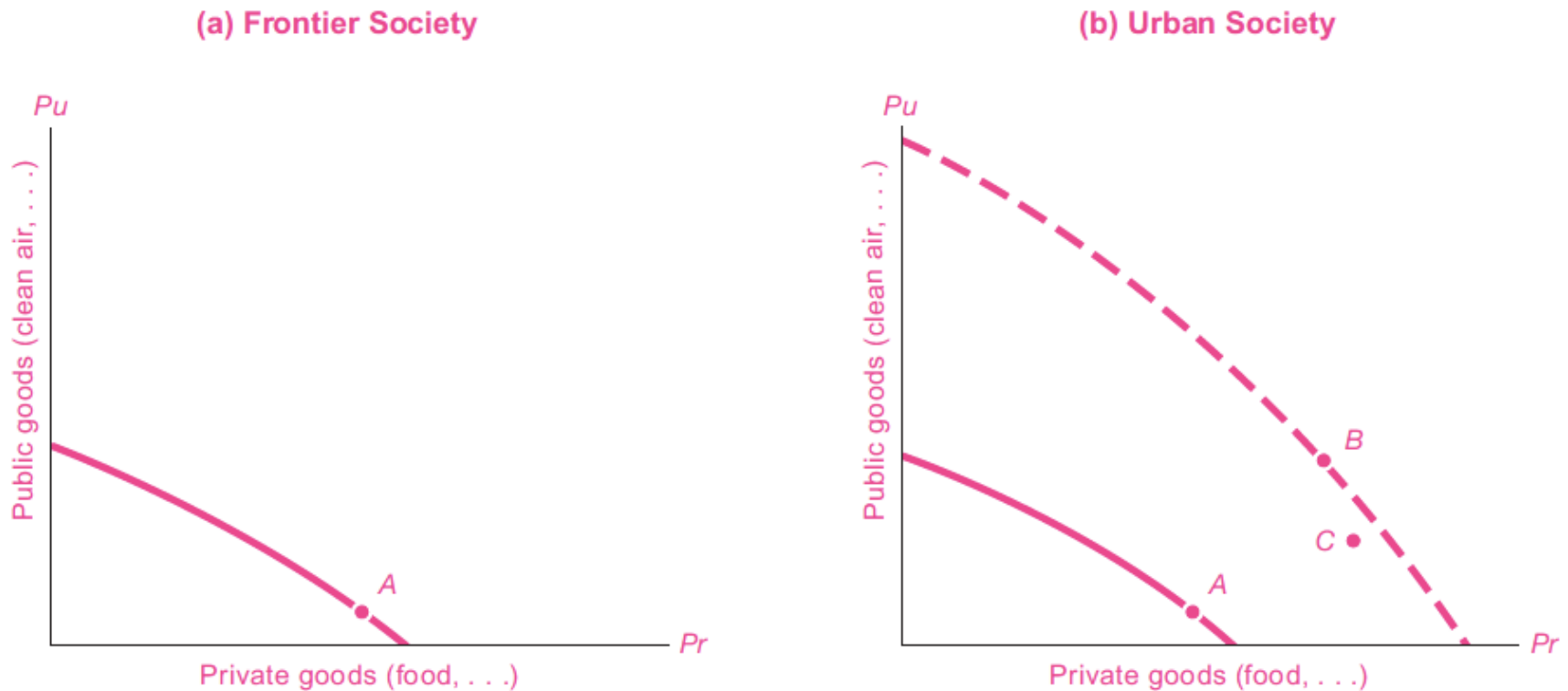
(b) High-Income Nation



**FIGURE 1-3.** Economic Growth Shifts the *PPF* Outward



# Applying the PPF to Society's Choices

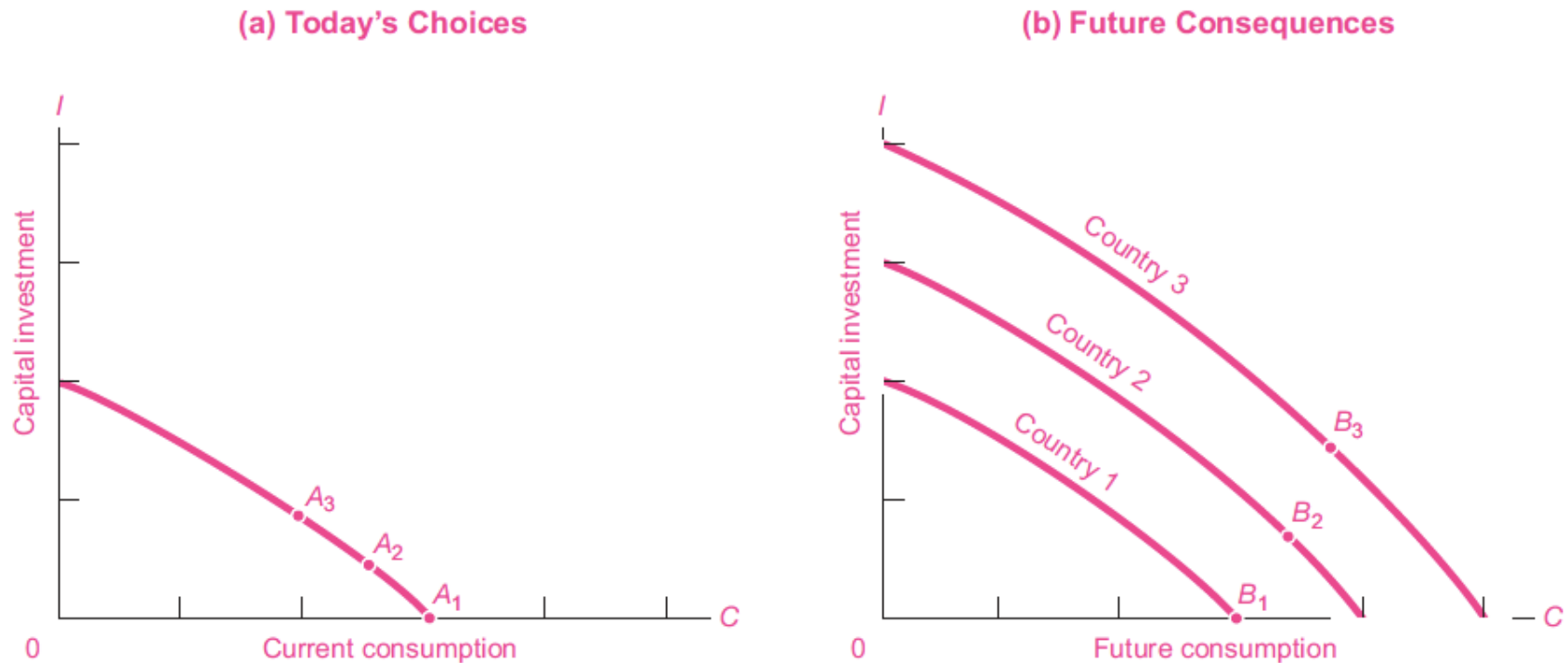


**FIGURE I-4.** Economies Must Choose between Public Goods and Private Goods

Private goods: bought at a price  
Public goods: paid for by taxes



# Applying the PPF to Society's Choices



**FIGURE I-5.** Investment for Future Consumption Requires Sacrificing Current Consumption



# Opportunity Costs

- In a world of scarcity, choosing one thing means giving up something else. The **opportunity cost** of a decision is the value of the good or service forgone.
- Decisions involve tradeoffs. When you make a choice, you give up an opportunity to do something else.
- The highest-valued alternative you give up is the opportunity cost of your decision.
- Guns-butter tradeoff example





# Opportunity Costs – Scenario

- Identical twins A and B with Bachelors degrees and receive the same job offer. A passes up the job offer to pursue a Masters degree while B takes the job offer and begins working.
- Two years pass and A graduates and begins working. By this time B has been promoted to a position that is comparable to A's starting position, and B's salary has increased to an amount that is comparable to A's starting salary.
- Who made the better decision, A or B?



# Opportunity Costs (Cont'd)

- 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, etc. — is known as an opportunity cost.
- 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.



# To Practice

- Book 2 (Page 24)
- Question No. 1 to 4

