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

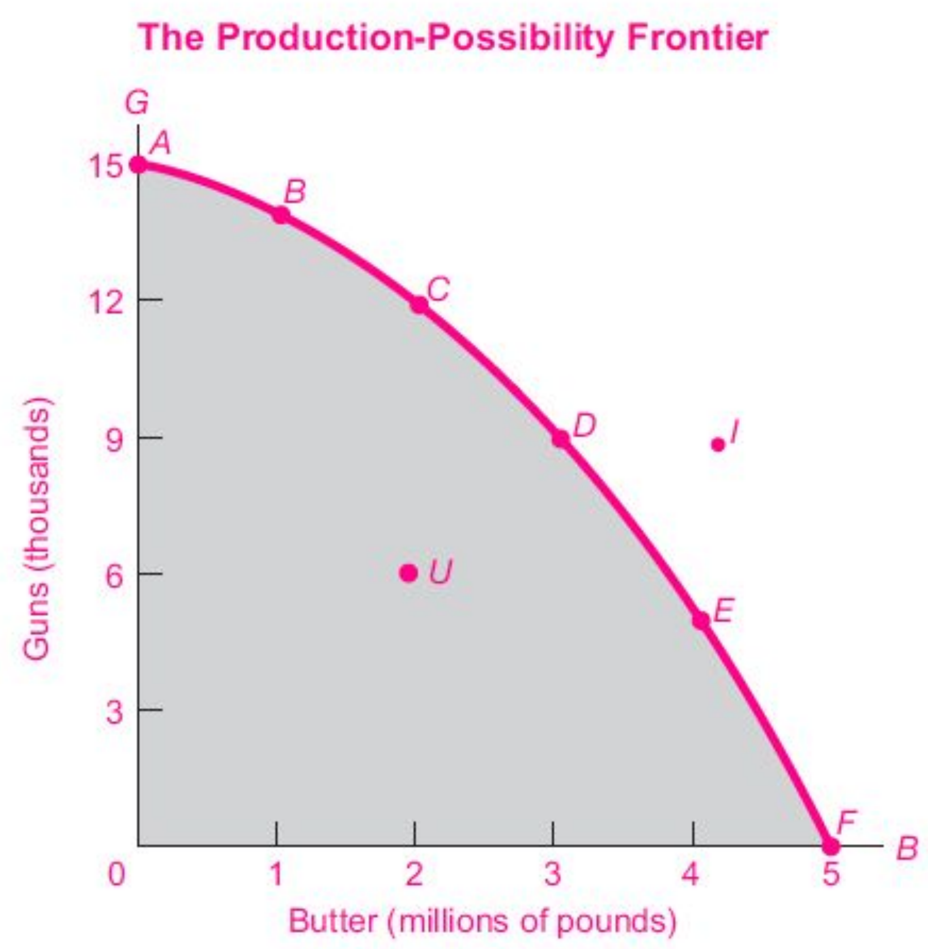
- Consider an economy which produces only two economic goods: guns and butter.

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

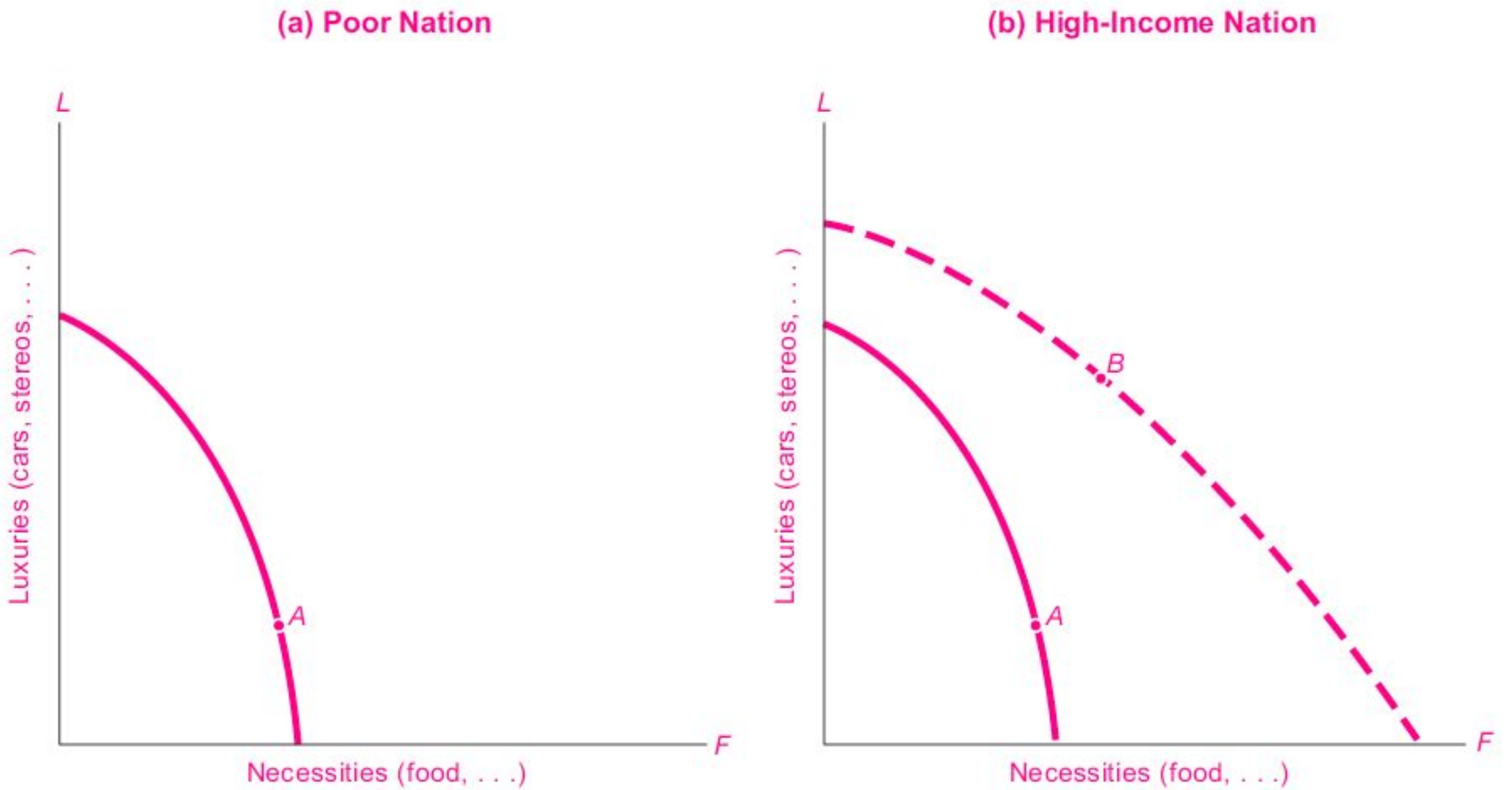


FIGURE 1-3. Economic Growth Shifts the *PPF* Outward

Applying the PPF to Society's Choices

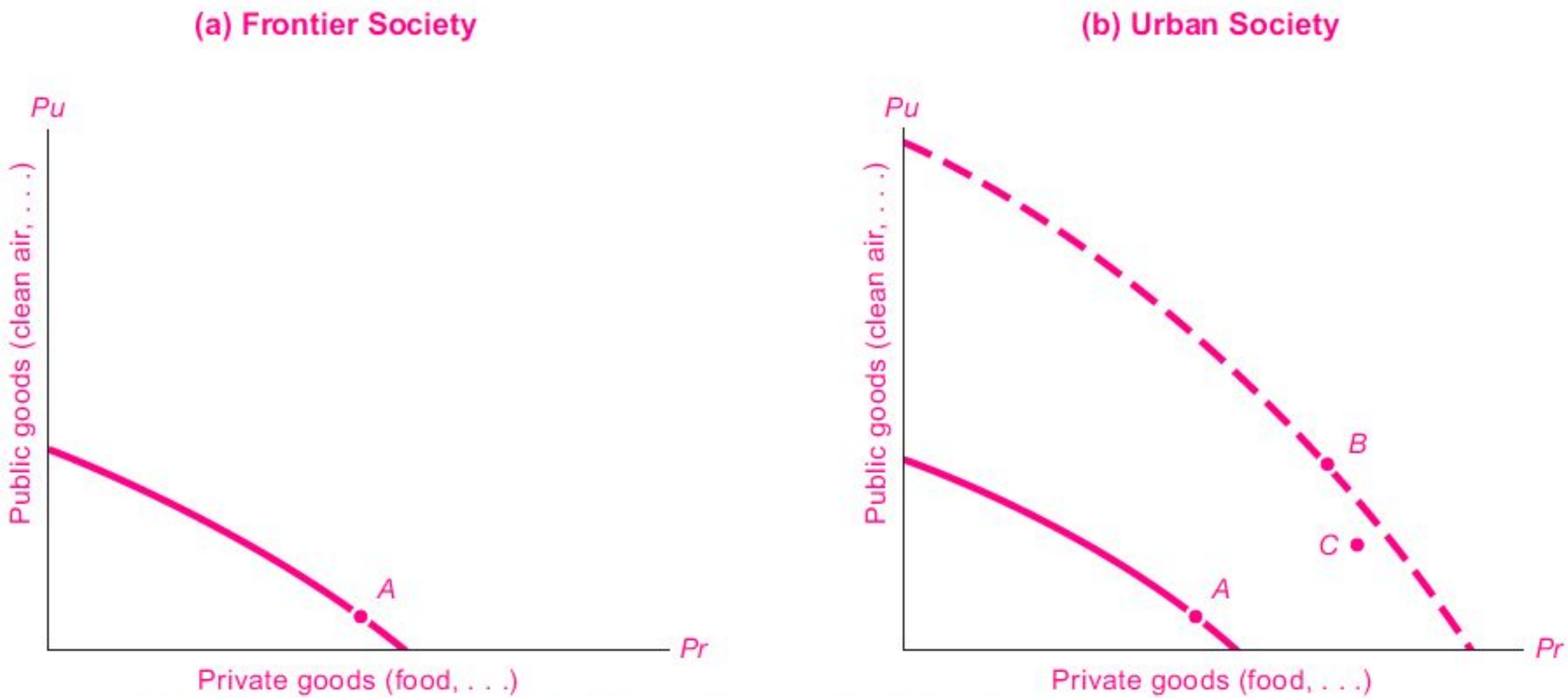


FIGURE 1-4. Economies Must Choose between Public Goods and Private Goods

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

Applying the PPF to Society's Choices

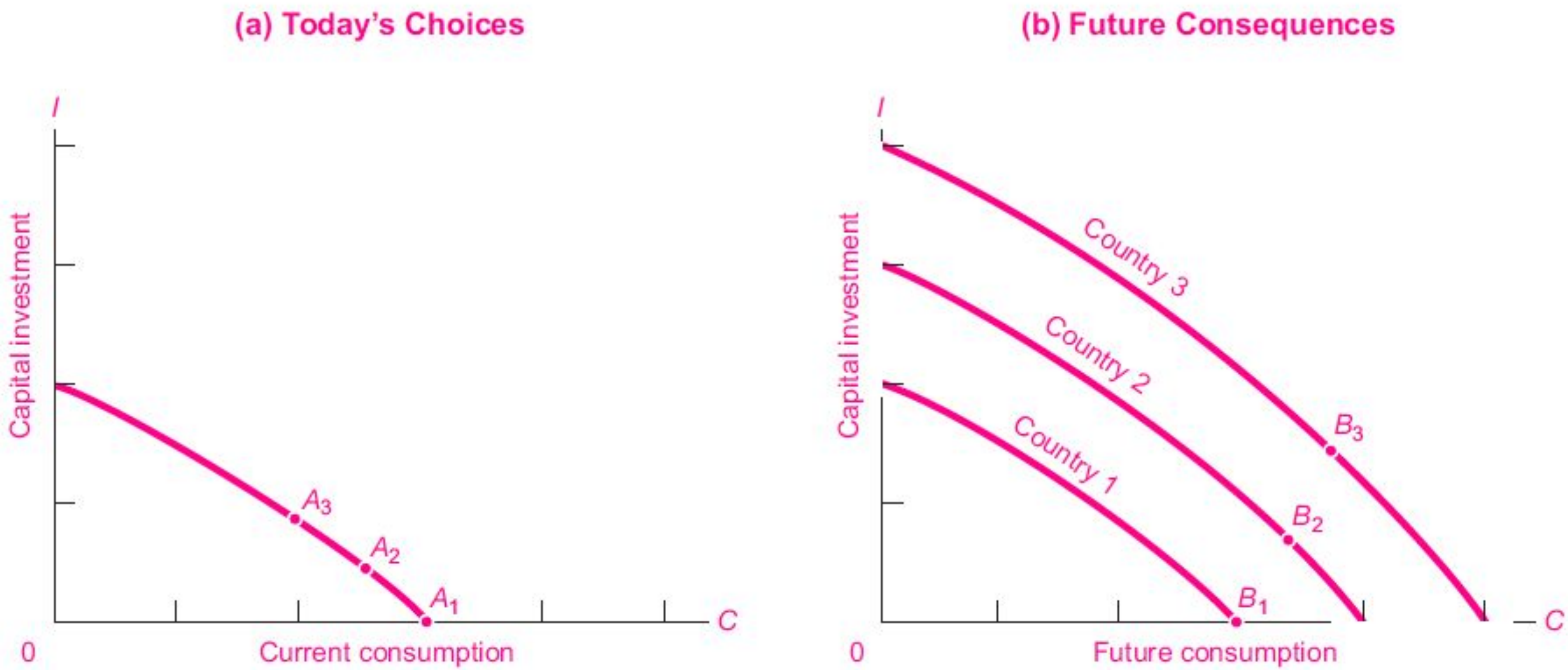


FIGURE 1-5. Investment for Future Consumption Requires Sacrificing Current Consumption

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 <u>tradeoffs</u>. 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