Module 1

Basic Economic Concepts

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This module introduces you to:

- **Origin of word: Economy**
- **Economics main concepts**
- **Definition of economics**
- **The differences between microeconomics and macroeconomics.**
- **The Focus of Economics**
- **How is Economics used?**
- **5 Key Economic Assumptions**
- **How People Make Decisions**
- **Economic Models**
- **Economic Systems**

Origin of word: Economy

- **The word economy comes from the Greek word for "one who manages a household."**
- **households and economics have much in common.**
  A household faces many decisions:

  It must decide which members of the household do which tasks and what each member gets in return.

  Who cooks dinner?

  Who does the laundry?
- **In short, the household must allocate its scarce resources among its various members, taking into account each member's abilities, efforts and desires.**
- **A society faces many decisions too:**

  A society must decide what jobs will be done and who will do them.

  It needs some people to grow food, other people to make clothing.

  A society must also allocate the output of goods and services that it produces.
- **The management of society's resources is important because resources are scarce.**
  Scarcity means that the society has limited resources and therefore cannot produce all the goods and services people wish to have.

Economics

- **Economics is driven by two certain realities.**
- **First, the society has limited resources.**
- **Second, our wants and desires are unlimited. We all want more.**
- **Economics is generally defined as the study of how our limited resources are allocated to satisfy our unlimited wants for goods and services.**

- **Economics – the study of how society manages its scarce resources.**
- **So as a society we have to decide.**

Scarcity

- **(The limited nature of society's resources.)**
- **Society has insufficiency or shortness of resources and therefore cannot produce all the goods and services people need.**
- **The combination of limited resources and unlimited wants implies a shortage, or scarcity.**
- **Scarcity forces us to make choices.**

Tradeoffs

- **Decisions about what to do, which necessarily involve decisions about what not to do**
- **when we sacrifice one thing to obtain another, that's called a trade-off. Only have enough cash to buy a car or an apartment, but not both? That's a trade-off. Trade-offs creates <u>opportunity costs</u>, one of the most important concepts in economics.**
- **Whenever you make a trade-off, the thing that you do *not* choose is your opportunity cost.**
- **Opportunity cost is the route not taken : You bought that car? Then the apartment was your opportunity cost.**
- **"The highest valued alternative sacrificed in making any choice."**

Efficiency and Equity

- **Society faces tradeoff between efficiency and equity.**
- **Efficiency is a measurable concept that can be determined by determining the ratio of useful output to total input. It minimizes the waste of resources while successfully achieving the desired output.**

means that society is getting the maximum it can from its scarce resources

- **Equity – means that the benefits of those resources are distributed equally among society's members.**
- **Policies such as taxes and welfare make incomes more equal but these policies reduce returns to hard work, and, therefore the economy doesn't produce as much.**

Economic Problems

In order to solve the problem of scarcity all societies, must to answer three basic questions.

- **<u>What to produce?</u>**

the best combination of goods and services to meet their needs

- **<u>How to produce?</u>**

the best combination of factors to create the desired output of goods and services.

- **<u>For whom to produce?</u>**

who will get the output from the country's economic activity, and how much they will get.

The Factors of Production

- **The factors of production are the inputs that are used in the production of goods or services in order to make an economic profit. (<u>How to produce?)</u>**
- **The factors of production include:**
- **Land: this is a short-hand expression for any natural resource in addition to land**
- **Labor: this includes labor defined in terms of quantity the number of workers) and quality (the skills these workers possess**

- **Capital: this includes the physical plants, machinery and equipment used to produce other goods and services**
- **entrepreneurship is The human resource that organizes land, labor, and capital.**

Land earns rent. **Labor earns wages.**

Capital earns interest. **Entrepreneur earns profit**

Positive and Normative Analysis

- **Positive Analysis : Descriptive, factual statements to describe the world as it is. Based on facts. Avoids value judgments (what is).**
    - **Normative Analysis: On the other hand, economists refer to prescriptive, value-based statements to describe the world. Includes value judgments (what ought to be).**

The key word is should.

The task of economic science is to discover positive statements that are consistent with what we observe in the world and that enable us to understand how the economic world works.

Consider the distribution of income. Positive economic theory would explain how certain government policies affect the distribution of income but not address the question of whether the different government policies are desirable or not. Normative economic theory, on the other hand, may develop some justification that an equal distribution of income is desired and then recommend certain government policies to achieve that distribution of income.

Definition of Economics

Economics: Social science concerned with the efficient use of limited resources to achieve maximum satisfaction of economic wants.

Economics Study of how individuals and societies deal with _________.

the study of how individuals and societies use limited resources to satisfy unlimited wants.

Microeconomics vs. Macroeconomics

Economics is the social science that studies the human action (individuals, businesses, governments, and entire societies), relates to human choice and the utilization of scarce resources.
Economics divides in two main parts:

- **Microeconomics**
- **Macroeconomics**

MICROeconomics

- **Is the branch of economics that is focused on the actions of individual, such as firms and consumers, and how their behavior determines prices and quantities in specific markets.**
- **One of the objectives of microeconomics is to analyze market mechanisms that establish relative prices among goods and services and the allocation of limited resources among many alternative uses.**
- **Significant fields of study in microeconomics include general equilibrium, markets under asymmetric information, choice under uncertainty, and economic applications of game theory.**

MACROeconomics

- **Is a branch of economics dealing with the performance, structure, behavior, and decision-making of an economy as a whole, as opposed to individual markets. This includes national, regional, and global economies.**
- **Significant fields of study in Macroeconomics include the study of aggregated indicators such as GDP, unemployment rates, and price guides for the purpose of understanding how the whole economy functions, as well as the relationships between such factors as national income, output, consumption, unemployment, inflation, saving, investment, international trade and international finance.**

How is Economics used?

- **Economists use the scientific method to make generalizations and abstractions to develop theories. This is called theoretical economics.**
- **These theories are then applied to fix problems or meet economic goals. This is called policy economics.**

5 Key Economic Assumptions

1. **Society's wants are unlimited, but ALL resources are limited (scarcity).**
2. **Due to scarcity, choices must be made. Every choice has a cost (a trade-off).**
3. **Everyone's goal is to make choices that maximize their satisfaction. Everyone acts in their own "self-interest."**
4. **Everyone acts rationally by comparing the marginal costs and marginal benefits of every choice**
5. **Real-life situations can be explained and analyzed through simplified models and graphs.**

How People Make Decisions?

1. People face tradeoffs

To get one thing that we like, we usually have to give up another thing that we like. Making decisions requires trading off one goal against another.

- **Only have enough cash to buy a car or an apartment, but not both? That's a trade-off.**

2. The Cost of Something Is What You Give Up to Get It

Whenever you make a trade-off, the thing that you do not choose is your opportunity cost.

- **Opportunity cost is the route not taken: You bought that car? Then the apartment was your opportunity cost.**
- **Because people face tradeoffs, making decisions requires comparing the costs and benefits of alternative courses of action. In many cases, however,**

the cost of some action is not as obvious as it might first appear.
Example: Going to university vs. going to work
Benefit: intellectual enrichment and a lifetime of better job opportunities.
Cost: You might be tempted to add up the money you spend on tuition, books, rooms and board.

3. Rational People Think at the Margin

In economics the term marginal = additional

- **"Thinking on the margin", or MARGINAL ANALYSIS involves making decisions based on the additional benefit vs. the additional cost.**
- **Comparing extra benefits and costs of a critical choice**
  Marginal Benefits => MB
  Marginal Costs => MC

4. People Respond to Incentives

Because people make decisions by comparing costs and benefits, their behavior may change when the costs or benefits change. That is, people respond to incentives.
Decision to choose one good over another occurs when MB > MC.

Economic tools:

1. Economic model

- **Economists create and test economic models.**
- **An economic model: is simplified version of a more complex reality or a description of some aspect of the economic world that includes only those features that are needed for the purpose at hand.**
- **Economic model used to :**
  1. **show relationships between variables**
  2. **explain the economy's behavior**
  3. **develop policies to improve economic performance**
  4. **Individuals use it to make purchasing decisions**

5. Governments use it to predict the probable impact of a policy before it is adopted. Also microeconomic models could be used to evaluate projects before they could be commenced

- **Most economic models are composed of diagrams and equations**

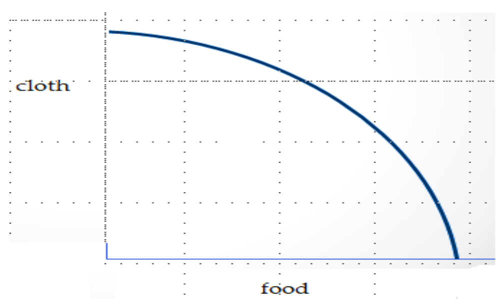
- **<u>The Production Possibilities Curve (PPC)</u>**

- **A production possibilities curve is a model that shows alternative ways that an economy can use its scarce resources**

- **This model graphically demonstrates scarcity, trade-offs, opportunity costs, and efficiency.**

4 Key Assumptions:

- **Only two goods can be produced**
- **Full employment of resources**
- **Fixed Resources (Ceteris Paribus)**
- **Fixed Technology**



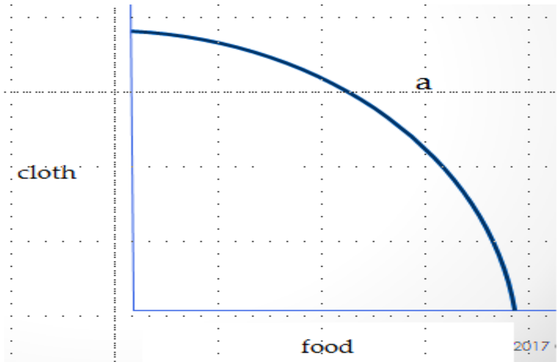
- **To illustrate the PPF, we focus on two goods at a time and hold the quantities of all other goods and services constant.**

- **At the model economy everything remains the same except the two goods we're considering**

- **Production is efficient at any points on the curve. This implies that the economy is getting all it can from the scarce resources it has available.**

- **Production is inefficient at any point inside the curve because it means that the economy doesn't use all its resources.**

- At point “a” resources are either unemployed or misallocated.



- Production is not possible at any point outside of the curve given the economy’s current level of resources and technology.

- Consider the production possibilities schedule for an example:

Food	cloth
150	0
120	20
90	40
60	60
30	80
0	100

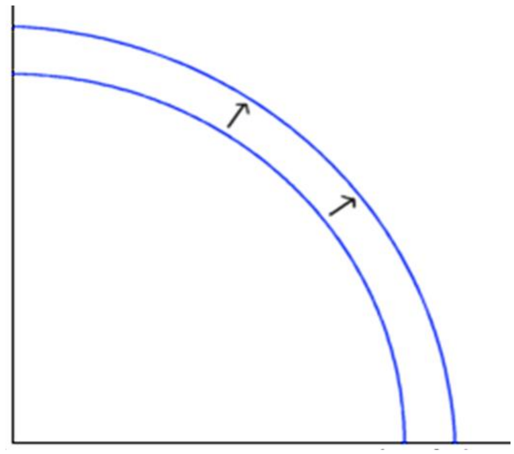
- Note that:

- Every choice along the PPF involves a tradeoff.

- On this PPF, we must give up some food to get more cloth or vice versa. (opportunity cost).

- Opportunity cost: is the amount of another item that must be given up to release sufficient resources to produce one more unit of the first item.

- The PPF can shift if resource availability or technology changes

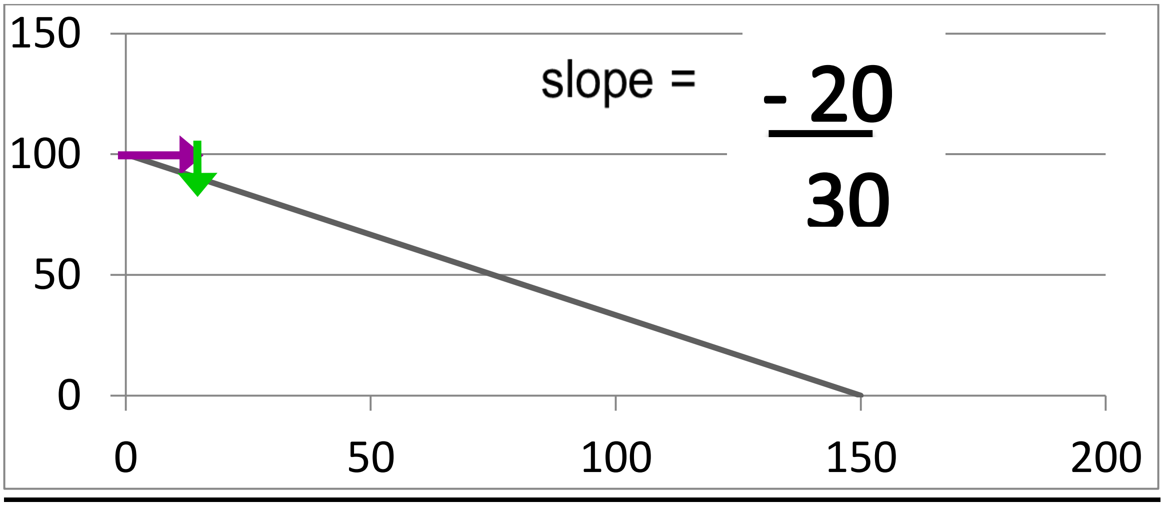


The shape of PPF

- The PPF could be a straight line, or bow-shaped
- Depends on what happens to opportunity cost as economy shifts resources from one industry to the other.
- If opp. cost remains constant, PPF is a straight line.
- If opp. cost of a good rises as the economy produces more of the good, PPF is bow-shaped.
- The shape of the PPF indicates that the opportunity cost of product 1 in terms of product 2 increases as the country produces more product 1 and fewer product 2 .
- This occurs because some resources are better suited to the production of product 1 than product 2 (and vice versa)

The PPF and Opportunity Cost

- The slope of the PPF gives us the opportunity cost of one good in terms of the other.
- The slope of a line equals the amount the line rises when you move to the right by one unit.



- **So, PPF is bow-shaped when different workers have different skills, different opportunity costs of producing one good in terms of the other and when there is some other resource, or mix of resources with varying opportunity costs.**
- **A bow-shaped PPF explains the concept of increasing opportunity cost.**

ECONOMIC SYSTEM

- **Every society must answer three questions: The Three Economic Questions**

  What goods and services should be produced?

  How should these goods and services be produced?

  Who consumes these goods and services?

- **The way these questions are answered determines the economic system**
- **An economic system is the method used by a society to produce and distribute goods and services.(Are systems of resource allocation and resource ownership.)**

1. **Centrally-Planned (Command) Economy**
2. **Free Market Economy**
3. **Mixed Economy**

- **An economic system is composed of two features :**

- **A mechanism for allocating resources .**
- **A mode of resource ownership**

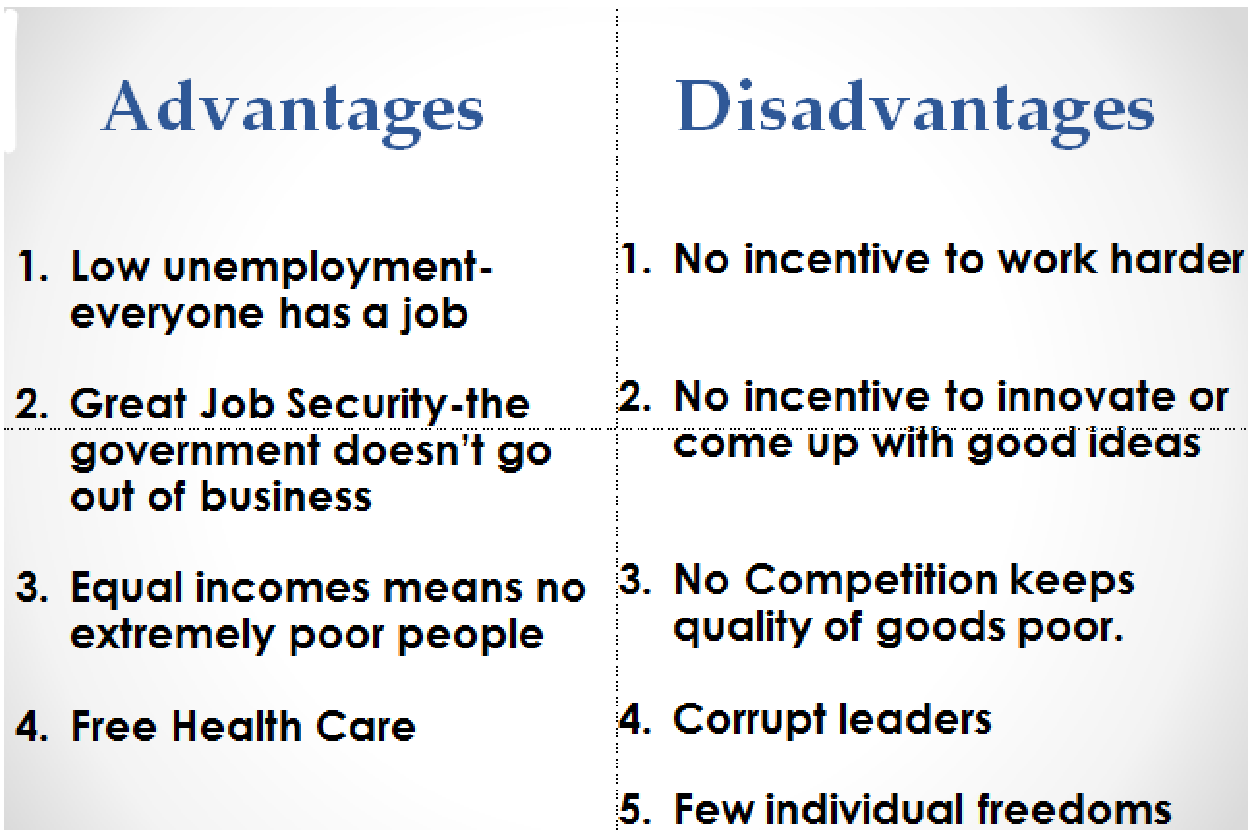
Centrally Planned Economies(Communism)

- **In a centrally planned economy (communism) the government…**

1. **owns all the resources.**
2. **decides what to produce, how much to produce, and who will receive it.**

   Examples:

   Cuba, China, North Korea, former Soviet Union



Free Market System (Capitalism)

- **resources are allocated primarily by the market and owned primarily by private individuals.**

- **Today, most nations have market capitalist economies, including all of the countries of North America and Western Europe, and most of those in Asia, Latin America, and Africa.**

Characteristics of Free Market

1. **Little government involvement in the economy. (Laissez Faire = Let it be)**
2. **Individuals OWN resources and answer the three economic questions.**
3. **The opportunity to make PROFIT gives people INCENTIVE to produce quality items efficiently.**
4. **Wide variety of goods available to consumers.**
5. **Competition and Self-Interest work together to regulate the economy (keep prices down and quality up).**
6. **Reword for Communism**

Example of Free Market

- **Example of how the free market regulates itself:**
- **If consumers want computers and only one company is making them… Other businesses have the INCENTIVE to start making computers to earn PROFIT.**
- **This leads to more COMPETITION…. Which means lower prices, better quality, and more product variety.**
- **We produce the goods and services that society wants because "resources follow profits".**
- **The End Result: Most efficient production of the goods that consumers want, produced at the lowest prices and the highest quality.**

Mixed Economy

- **A mix of all of the other economies**
- **Some government involvement, consumer driven, aspects of economy based on traditional values.**