Economic Fundamentals Notes

• Why are we interested in slope?
  • Economists are interested in marginal changes.
    • Economists look at changes in the status quo. In particular, they compare the change in benefits (marginal benefit) to the change in costs (marginal cost).
    • As long as the marginal benefit is greater than or equal to the marginal cost, the change is a good one. As we will see later, this means continuing an activity until marginal benefit (MB) equals marginal cost (MC).
    • Examples – death penalty for rape and accident reduction (air bags vs. spikes).

• Economics is the social science that analyzes choices. In particular, it examines the choices that must be made because people have unlimited wants and the resources available to fulfill those wants are scarce.

• Unlimited wants – we want more kinds of goods and more of them than we have any realistic prospect of attaining.

• Scarce resources –
  1. Land and other natural resources (water, timber, ores, etc.)
  2. Capital – a man-made resource that is used in the production of other goods. Not money!
  3. Labor
  4. Entrepreneurial ability – a special type of human resource. An entrepreneur organizes production, makes business decisions (such as what to produce and how), takes risks, and innovates.

• Our first model shows the choice that society must make between two types of goods.
• Production possibilities – the alternative combinations of good and services that could be produced in a given time period using all available resources and the best possible technology.
• Production possibility curve (PPC) or production possibility frontier (PPF) – shows the boundary of possible combinations of two types of goods and services.
• See, for example, Table 1.1 and Figure 1.1 or Figure 1.2.
• Notice that in all cases these curves are drawn at a particular point in time. If time were to pass, things (such as the quantities of resources available or the technology) would change. Such a change would shift the curve.
• Remember that this is our ceteris paribus assumption.

• Points on the PPC are productively efficient (including the end points – A and F above).
  • Productive efficiency occurs when a particular mix of goods and services is produced in the least costly way possible.
  • Note that your book refers to productive efficiency as efficiency. See page 9 for their definition.
• Any point inside the PPC is productively inefficient (or inefficient). See Figure 1.4.
• Points outside the PPC cannot be attained at this point in time. Time must pass and things like resource quantities and/or technology must improve for them to be possible. See Figure 1.4.

• Productive efficiency is not the only thing that is important however. Producing nothing but toilet paper, even if it is done in a productively efficient manner is obviously not desirable. Society must also be concerned with allocative efficiency.
  • Allocative efficiency means producing what society wants. Obviously this will be a point on the PPC, but which one depends upon society’s preferences.
  • Allocative efficiency is determined by setting the marginal cost (MC) to society of producing a particular good or service equal to the marginal benefit (MB) of producing that particular good or service.

• Opportunity cost – The most valuable opportunity that must be foregone. This could be measured in terms of a good or service, or money, or time, but is always the most valued alternative.
• Opportunity costs are reflected in the shape of the PPC.
  • With only two goods available to our simple society, the most valued alternative is always the other potential good or service.
  • The PPC shows the tradeoff between two goods or services. The only way to get more of one is to give up some of the other.
  • More specifically, the concave (bowed-out) shape of the PPC reflects the law of increasing opportunity costs.
• The PPC shows the increasing tradeoff between two types of goods or services. The only way to get more of a good or service is to give up increasing amounts of another good or service.
• This is a law because of the specialized characteristics of resources. (For example, not all land is equally well suited to the production of oranges and wheat.)

• Some other features of economic analysis:
  • Rationality – economists assume that people know their own self-interest and behave in such a way as to make themselves as happy as possible. People make different choices, not because they are irrational, but because they have different preferences, information, and circumstances.
  • Models – economic reality is complex. To perform any useful analysis or make any useful predictions, it is necessary to use models, which are simplified representations of the way facts are related in reality. Economists try to identify and include the most relevant factors.

• Positive and normative analysis:
  • Positive analysis – deals with facts (what is).
  • Normative analysis – deals with what ought to be (value judgements).

• Microeconomics and macroeconomics:
  • Microeconomics – branch of economics that deals with choices made by individual economic units (such as households or firms) and the markets that coordinate their actions.
  • Macroeconomics – branch of economics that deals with the economy as a whole (i.e. the aggregation of all the individual economic units). Studies large-scale economic phenomena, such as inflation, unemployment, and economic growth.

• Liberal vs. Conservative
  • These terms have changed meaning over the years. What was once termed liberal is now considered conservative.
  • Many conservative tenets are actually classical liberal (i.e. historically considered liberal).

• Conservative
  • Favor limited government, sometimes called a laissez faire approach.
  • Laissez faire means “leave it alone” or “leave it be” in French. It is a doctrine that advocates nonintervention by the government.
  • This approach was first put forth by Adam Smith in his classic work An Inquiry into the Nature and Causes of the Wealth of Nations (called The Wealth of Nations for short) written in 1776.
  • In this book, Smith observed that households and firms interacting in markets act as if they are guided by an “invisible hand” that leads them to desirable market outcomes. Prices are the instrument with which the invisible hand directs economic activity. Prices reflect both the value of a good to society (marginal benefit) and the cost to society of
making the good (marginal cost). Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social benefits and costs of their actions. As a result, prices guide these individual decision-makers to outcomes that maximize the welfare of society as a whole.

- Example – hurricane in Florida.
- The use of market prices to signal desired outputs or resource allocations is called the market mechanism.

- Liberal
  - Favor government intervention in the market.
    - Karl Marx, while not always anti-capitalist, would be considered one of this movement's forefathers. His classic works include Das Kapital (1867) and the Communist Manifesto (1848).
    - Marx, however, went beyond simple government intervention to advocate government ownership of all economic resources.
    - John Maynard Keynes, writing during the Great Depression, supported government intervention of the sort that currently exists.

- The economies that exist today, including that in the U.S. are mixed economies. This means that both market signals and government directives are used to allocate goods and services.
  - When markets fail to correctly allocate resources or goods and services, this is called market failure.
    - Examples – pollution and the tragedy of the commons.
  - When government directives fail to correctly allocate resources or goods and services (or fail to improve upon market outcomes), this is called government failure.
    - Examples – Soviet Union and rent controls.