



Micro

McFachern

ECON

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CHAPTER
2 *Economic Tools and
Economic Systems*

**Designed by
Amy McGuire, B-books, Ltd.**

Choice and Opportunity Cost

- ◆ Scarcity
- ◆ Make a choice
 - ◆ Pass up another opportunity
- ◆ Opportunity cost
 - ◆ The value of the best alternative forgone
 - ◆ Opportunity lost
 - ◆ Monetary aspect
 - ◆ Non-monetary aspect



LO¹

The Opportunity Cost of College

- ◆ Value of best alternative forgone
 - ◆ Forgone income (full-time job; \$20,000)
 - ◆ Minus income earned as a student (part-time work: \$10,000)
- ◆ Plus direct cost of college
 - ◆ Tuition, fees, books (\$6,000)
- ◆ $\$20,000 - \$10,000 + \$6,000 = \$16,000$
- ◆ **Not included: room, board, personal expenses**



Opportunity Cost

- ◆ Opportunity cost is subjective
 - ◆ ‘the road not taken’
- ◆ Calculating opportunity cost
 - ◆ Requires time and information
- ◆ Time: the ultimate constraint
- ◆ Opportunity cost varies with circumstance
 - ◆ Depends on the alternative



LO¹

Sunk Cost and Choice

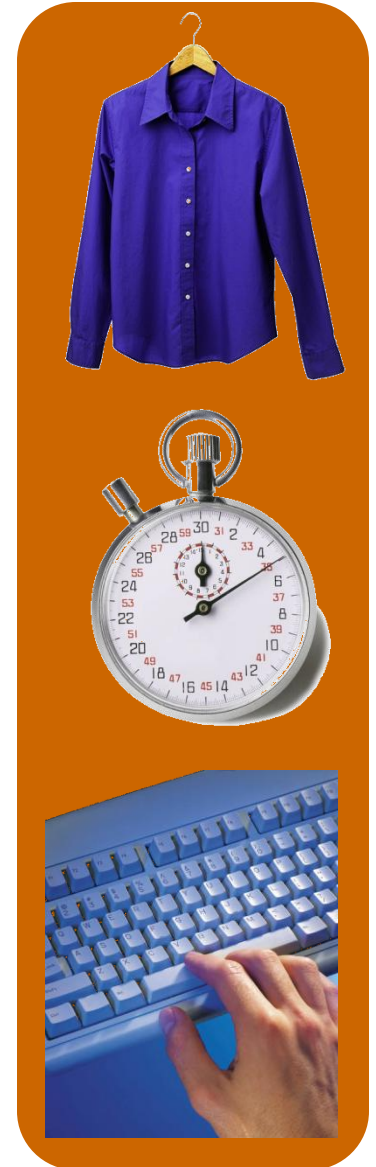
- ◆ Sunk cost
 - ◆ Incurred cost
 - ◆ Cannot be recovered
 - ◆ Ignored when making economic choices
- ◆ Economic decision makers
 - ◆ Relevant: costs affected by the choice
 - ◆ Irrelevant: sunk costs

LO¹



Law of Comparative Advantage

- ◆ Specialize in the task that you do better
- ◆ Law of comparative advantage
 - ◆ Specialize in producing a good IF
 - ◆ Lower opportunity cost of producing it
- ◆ Specialization and exchange
 - ◆ Better off
- ◆ Absolute advantage
 - ◆ Use fewer resources



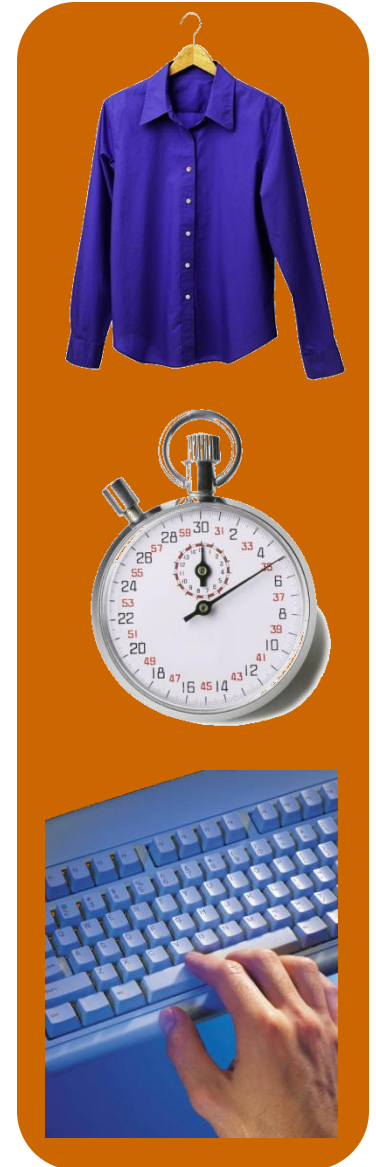
Specialization and Exchange

◆ Barter

- ◆ Trade products for other products
- ◆ Simple economies
 - ◆ Few goods
 - ◆ Little specialization

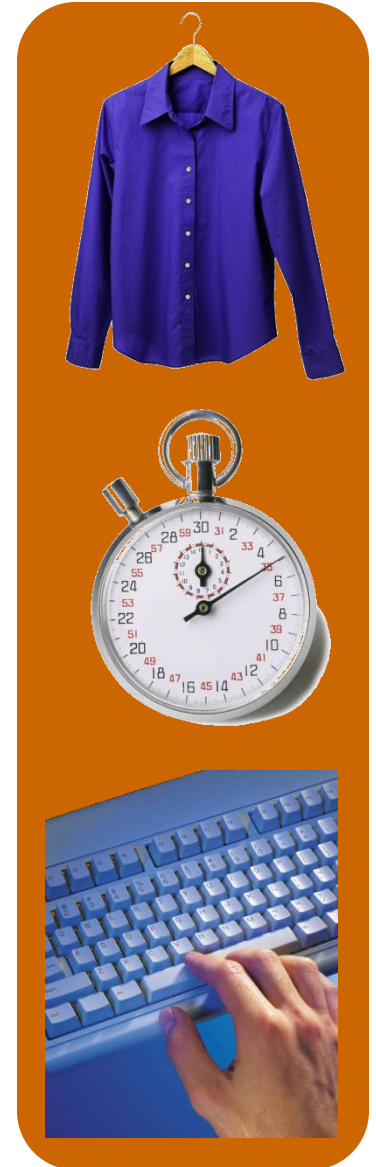
◆ Money

- ◆ Medium of exchange
- ◆ Facilitates exchange
- ◆ Greater specialization



Division of Labor

- ◆ Division of labor
 - ◆ Specialization; Increased productivity
 - ◆ Individual preferences; natural ability
 - ◆ Experience
 - ◆ No need to shift between tasks
 - ◆ Laborsaving machinery
 - ◆ Downside:
 - ◆ Repetitive, tedious
 - ◆ Routine tasks - robots



Efficiency and the PPF

- ◆ **Production Possibilities Frontier (PPF)**
- ◆ **Assumptions**
 - ◆ **Output: consumer and capital goods**
 - ◆ **Productions: 1 year**
 - ◆ **Fixed resources (quantity, quality)**
 - ◆ **Fixed technology**
 - ◆ **Fixed 'rules of the game'**
- ◆ **Resources – scarce for the economy**
- ◆ **Economy's production options**

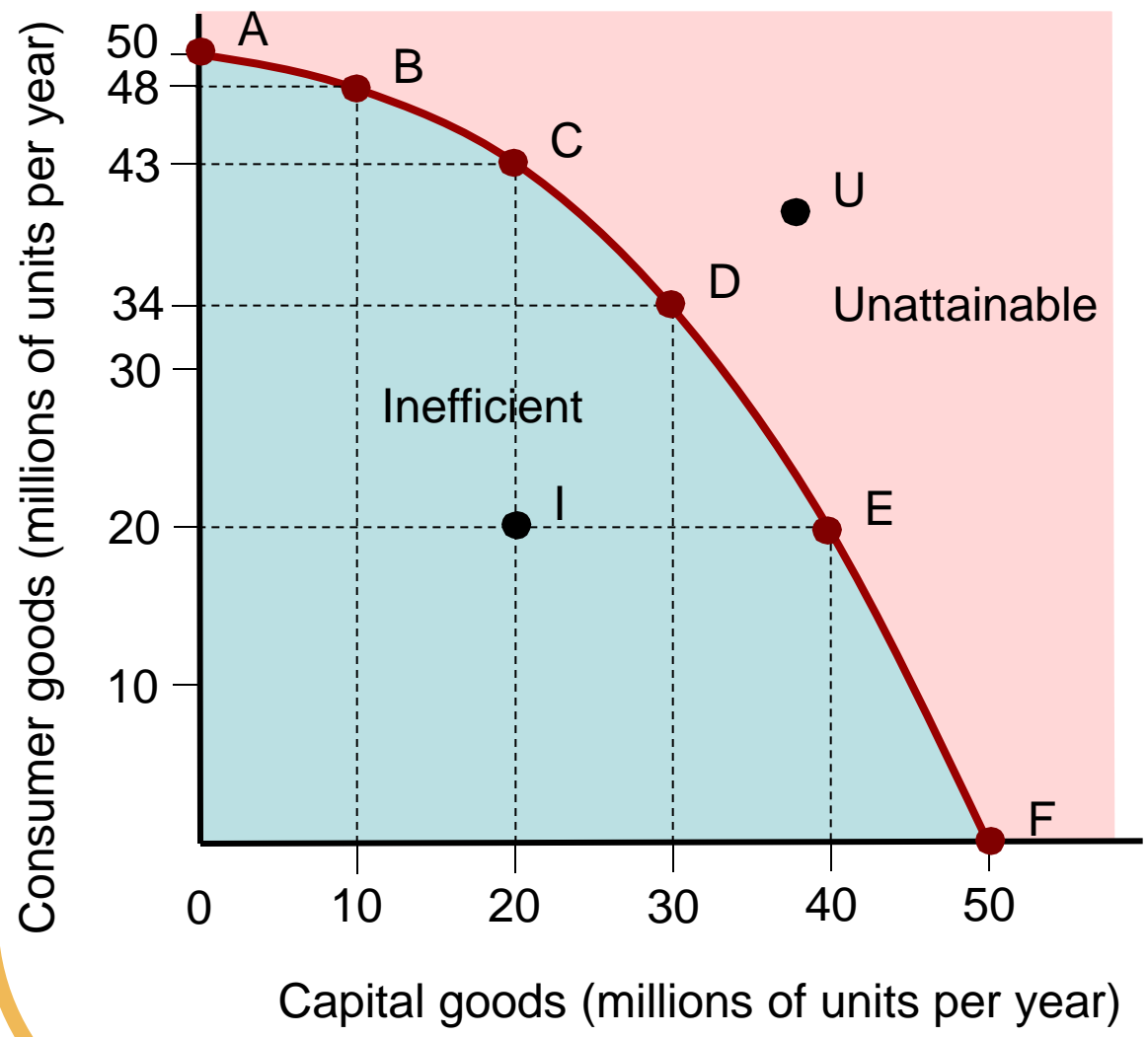
LO³

Efficiency and the PPF

- ◆ **PPF**
 - ◆ Possible combinations of
 - ◆ Consumer and Capital goods that
 - ◆ Can be produced using
 - ◆ All resources efficiently
- ◆ Inefficient combinations
- ◆ Unattainable combinations

LO³

Exhibit 1



The Economy's Production Possibilities Frontier

PPF (AF): Economy uses all resources and technology efficiently

PPF: bowed out; law of increasing opportunity cost

Inefficient: inside PPF

Unattainable: outside PPF

The Shape of the PPF

- ◆ **Movement down along PPF**
 - ◆ **Give up some consumer goods to get more capital goods**
- ◆ **Bowed-out shape**
- ◆ **Law of increasing opportunity costs**
- ◆ **Slope of PPF**
 - ◆ **Opportunity cost of 1 unit capital good**

LO³

What Can Shift the PPF?

- ◆ **Economic growth**
 - ◆ **Expansion in the economy's PPF**
- 1. Changes in resource availability**
 - ◆ **Outward shift of PPF – increase in:**
 - ◆ **Size, health of labor force**
 - ◆ **Skills of labor force**
 - ◆ **Availability of other resources**
- 2. Increases in capital stock**
 - ◆ **More output; outward shift of PPF**

LO³

What Can Shift the PPF?

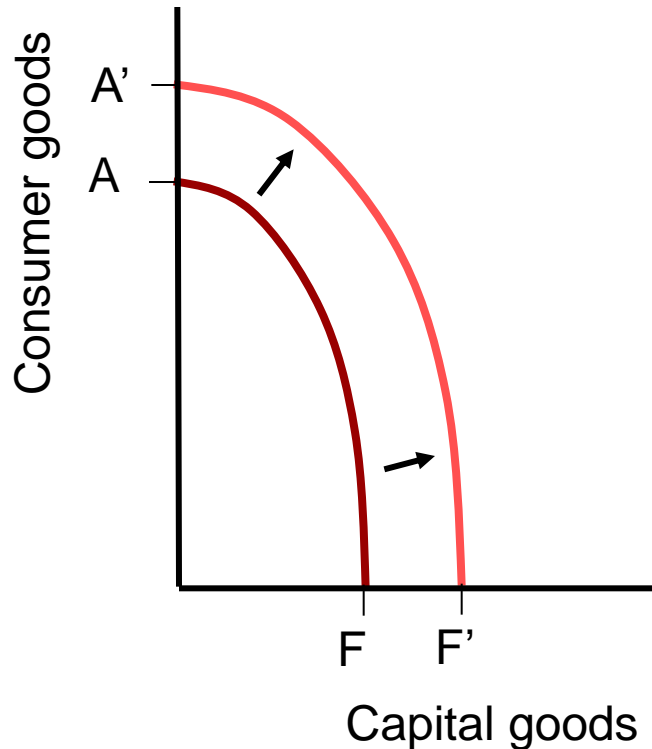
- 3. Technological change**
 - ◆ Employs resources more efficiently
 - ◆ Outward shift of PPF
- 4. Improvements in the rules of the game**
 - ◆ Formal and informal institutions
 - ◆ Economic growth
 - ◆ Outward shift of PPF

LO³

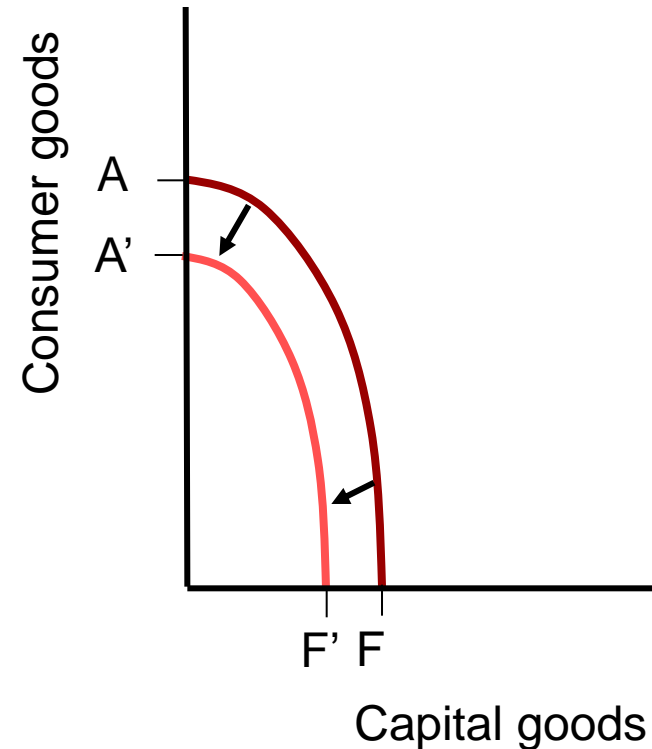
Exhibit 2(a), (b)

Shifts of the Economy's Production Possibilities Frontier

(a) Increase in available resources



(b) Decrease in available resources



(a) Outward shift of PPF – increase in available resources; better technology
- enhanced production of both capital and consumer goods

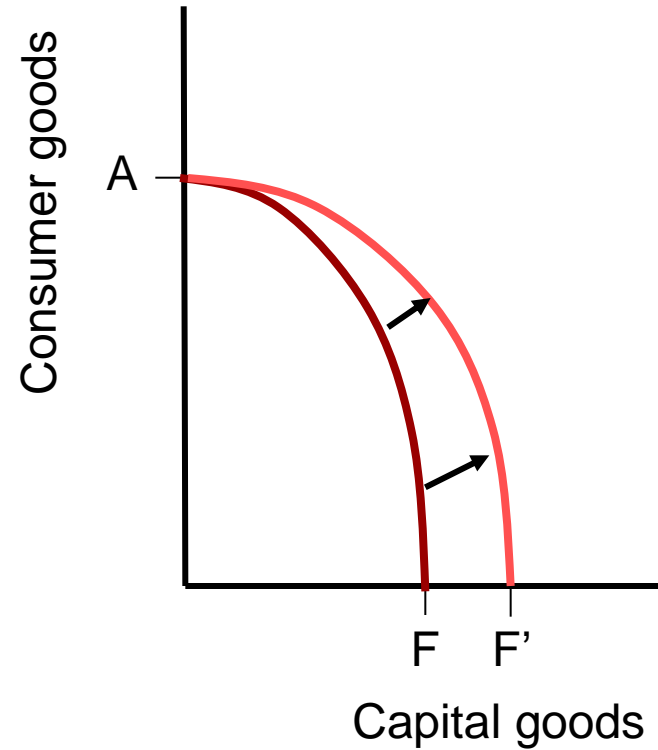
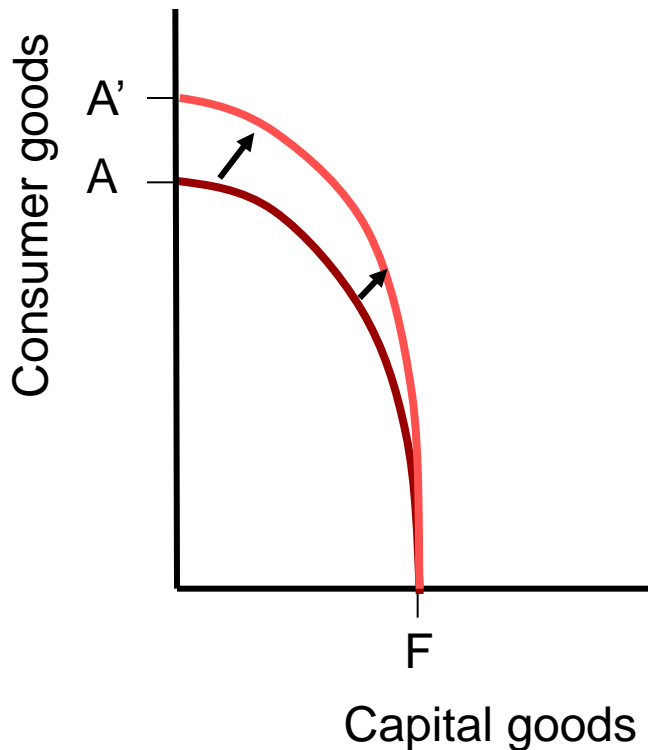
(b) Inward shift of PPF – decrease in available resources
- decreased production of both capital and consumer goods

Exhibit 2(c), (d)

Shifts of the Economy's Production Possibilities Frontier

(c) *Change in resources, technology, or rules that benefits consumer goods*

(d) *Change in resources, technology, or rules that benefits capital goods*



Rules of the Game and Economic Development

Case Study

- ◆ “Ease of doing business”
- ◆ Friendly business climate
 - ◆ High standard of living
 - ◆ Sophisticated economy
- ◆ Difficult business climate
 - ◆ Low standard of living
 - ◆ Poor economy



Exhibit 3

Best 10 and Worst 10 Among 181 Countries Based on Ease of Doing Business, According to the World Bank

Best 10	Worst 10
1. Singapore	172. Niger
2. New Zealand	173. Eritrea
3. United States	174. Venezuela
4. Hong Kong	175. Chad
5. Denmark	176. São Tomé and Príncipe
6. United Kingdom	177. Burundi
7. Ireland	178. Republic of Congo
8. Canada	179. Guinea-Bissau
9. Australia	180. Central African Republic
10. Norway	181. Democratic Republic of Congo

- ◆ **Sell an imported product**
 - ◆ **Denmark**
 - ◆ **3 documents**
 - ◆ **1 official signature**
 - ◆ **5 days**
 - ◆ **Burundi**
 - ◆ **19 documents**
 - ◆ **55 official signatures**
 - ◆ **24 days**

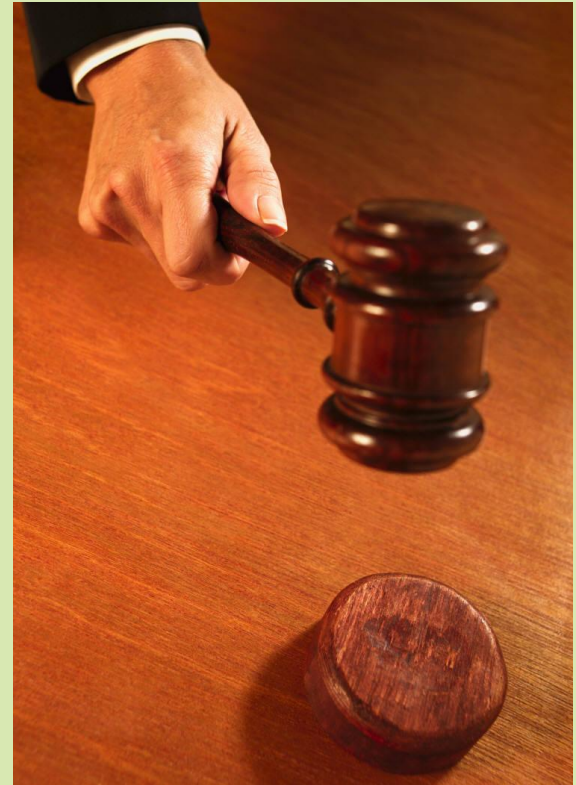


- ◆ **Business taxes**
 - ◆ **Belarus**
 - ◆ 11 taxes; 122% of profit
 - ◆ 113 tax payments to 3 government agencies
 - ◆ 1,188 hours tax preparation
 - ◆ **Hong Kong**
 - ◆ 2 taxes; 14% of profit
 - ◆ 1 electronic filing
 - ◆ 80 hours tax preparation



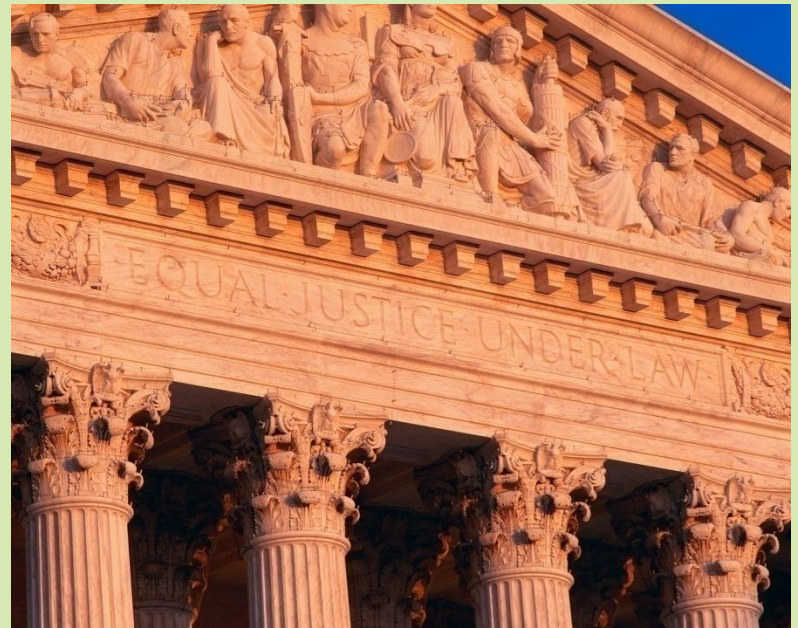
Rules of the Game and Economic Development

- ◆ Effectiveness and reliability of courts
- ◆ Collect a \$1,000 debt
 - ◆ East Timor
 - ◆ \$1,800 court and attorney fees
 - ◆ 69 procedures; wait 3 years
 - ◆ Denmark
 - ◆ Cost \$65
 - ◆ 15 procedures
 - ◆ 6 months



Rules of the Game and Economic Development

- ◆ Possible explanations for bad business environment
 - ◆ Bad administrative systems
 - ◆ Favoritism in governmental jobs
 - ◆ Corruption
 - ◆ Bribes



What We Learn from the PPF?

- ◆ Efficiency
- ◆ Scarcity
 - ◆ Opportunity cost
 - ◆ Law of increasing opportunity cost
 - ◆ Economic growth
- ◆ Choice
 - ◆ Costs
 - ◆ Benefits

LO³

Economic Systems

- ◆ **Three questions**
 - ◆ **What?**
 - ◆ **How?**
 - ◆ **For Whom?**
- ◆ **Economic system**
 - ◆ **Mechanisms**
 - ◆ **Institutions**
 - ◆ **Answer the three questions**



LO⁴

Economic Systems

- ◆ **Criteria**
 - ◆ **Ownership of resources**
 - ◆ **Allocation of resources**
 - ◆ **Incentives**
- ◆ **Range from**
 - ◆ **Pure capitalism, to**
 - ◆ **Pure command system**



Pure Capitalism

- ◆ Private property rights
- ◆ Unrestricted markets
 - ◆ Answer the three questions
 - ◆ Resources – most productive use
 - ◆ Goods and services – most valued
 - ◆ Voluntary buying and selling
- ◆ Adam Smith: “invisible hand”



LO⁴

Pure Capitalism: Flaws

- ◆ No central authority
- ◆ People with no resources could starve
- ◆ Monopoly
- ◆ Side effects for people not involved
- ◆ No public goods



LO⁴

Pure Command System

- ◆ **Public/communal ownership of property**
- ◆ **Government planners**
 - ◆ **Central plans**
 - ◆ **Direct resources**
 - ◆ **Coordinate production**
 - ◆ **Answer the three questions**
- ◆ **Communism**



LO⁴

Pure Command System: Flaws

- ◆ Resources
 - ◆ Used inefficiently
 - ◆ Wasted (no incentives)
- ◆ Preferences of planners
- ◆ Limited variety of products
- ◆ Less freedom of economic choice



LO⁴

Mixed and Transitional Economies

- ◆ Increasing role of government
 - ◆ In capitalist economies
- ◆ Increasing role of markets
 - ◆ In command economies
- ◆ Mixed economies
- ◆ Government
 - ◆ Economic activity
 - ◆ Regulates the private sector
- ◆ Economies based on custom or religion



LO⁴