

## Some Tools for the Economist

**Full Length Text** — Part: 1 Chapter: 2  
**Micro Only Text** — Part: 1 Chapter: 2  
**Macro Only Text** — Part: 1 Chapter: 2

To Accompany "Economics: Private and Public Choice 11th ed."  
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## What Shall We Give Up?

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## Opportunity Cost

- **Opportunity cost:**  
The highest valued activity sacrificed in making a choice.
  - Opportunity costs are incurred when a choice is made.
  - They are subjective and vary across persons.
  - If an option becomes more costly, an individual will be less likely to choose it.
- The **opportunity cost** of college:
  - Monetary cost: tuition, books.
  - Non-monetary cost: forgone earnings.
  - If the opportunity cost of college rises (*e.g. tuition rises*), then one will be less likely to attend college.

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### Trade

- Mutual gain is the foundation of trade.
  - Value can be created by exchanges that move goods to individuals who value them more.
- **Transactions costs:** the time, effort, and other resources needed to search out, negotiate, and consummate an exchange.
  - Transactions costs reduce our ability to produce gains from potential trades.

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### Trade

- How does the Internet reduce transactions costs and thereby enhance trade?
  - eBay
  - E-trade
  - Amazon.com
- **Middleman:** A person who buys and sells, or arranges trades.
  - Middlemen reduce transactions costs.

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### Questions for Thought:

1. It takes 1 hr. to travel from New York City to D.C. by air, but it takes 5 hrs. by bus. If the air fare is \$110 and the bus fare is \$70, which is cheaper for someone whose opportunity cost of travel time is \$6 per hour? For someone whose opportunity cost is \$10 per hour? \$14 per hour?
2. Consider the choices of women aged 30 to 50 years with (a) a college education and (b) less than a high school education. In which case will the share of women in the work force be highest? Which will have the larger average number of children? Why?

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**Questions for Thought:**

3. Why do people engage in exchange?

4. In many states, the resale of tickets to sporting events at prices above the original purchase price ("ticket scalping") is prohibited. Is this a good idea? Who is hurt and who is helped by the prohibition?

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**The Importance of Property Rights**

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**Private Property Rights**

- **Property rights:**  
The right to use, control, and obtain benefits from a good or service.
- **Private property rights** involve:
  - the right to exclusive use.
  - legal protection against invaders.
  - the right to transfer to another.

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### Private Property and Incentives

- Private ownership is a key to prosperity because it provides people with a strong incentive to take care of things and develop resources in ways that are highly valued by others.
- Private owners can gain by using their resources in ways beneficial to others.
- They have a strong incentive to care for and manage what they own.
- They have an incentive to conserve for the future (especially if the property's value is expected to rise).

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### Private Property and Incentives

- Private ownership is a key to prosperity because it provides people with a strong incentive to take care of things and develop resources in ways that are highly valued by others.
- With private property rights, owners are liable if their property is used in a manner that damages the property of others.
- Private ownership links responsibility with the right of control.
- In contrast, commonly owned property will be poorly maintained and over-utilized rather than conserved for the future.

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### Private Property and Markets

- When private property rights are protected and enforced, permission of the owner is required for use of a resource.
- If you want to use a good or resource, you must either buy or lease it from the owner.
- Individuals are faced with the cost of using scarce resources.
- Market prices provide a strong incentive for private owners to consider the desires of others and to use and develop resources that are highly valued by others.

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**Questions for Thought:**

1. (a) Can private owners do anything they want with the things that they own?  
(b) Why is private ownership important?  
(c) Do the owners of land and buildings near your campus have an incentive to use those assets to provide things that students value highly? Why or why not?
2. Does a 60 year old tree farmer have an incentive to plant and care for Douglas fir trees that will not reach optimal cutting size for 50 years? Explain.

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**Questions for Thought:**

3. Selling your organs is a violation of federal law, a felony punishable by up to five years in prison or a \$50,000 fine. Because of this, in September 1999 eBay intervened when a person put one of his kidneys up for sale on eBay (the bidding reached \$5.7 million before it was pulled).

Is the United States a better place to live because such transactions are prohibited? Why or why not?

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**Production Possibilities Curve**

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### Production Possibilities Curve

for Susan's grades in English and Economics (10 hrs of study)

- Susan is a student who only has 10 hours of study to divide between her *economics* and *English* classes.
- If she spends most of her time studying economics, she can earn an *A* in economics ... and a *D* in her English class.
- If she splits her time between the two, she can earn a *B* in economics ... and a *B* in her English class.
- If she spends most of her time studying English, she can earn a *D* in economics ... and an *A* in her English class.
- Mapping out all the possibilities of how Susan can divide her time (limited resources) between these activities shows us her **Production Possibilities Curve (PPC)**.

Expected grade in Economics 101

Production Possibilities Curve (PPC)

Expected grade in English 101

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### Production Possibilities Curve

for a nation's economy (given limited resources)

- Consider an economy which has limited resources to divide between the production of clothing and food.
- If it allocates all of its resources toward the production of clothing, then it can produce at point *S*.
- If it allocates all of its resources toward the production of food, then it can produce at point *T*.
- Mapping out all the possibilities of how an economy can divide the use its resources gives us the economy's **Production Possibilities Curve**.
- Output combinations *A*, *B*, & *C* are all on the **PPC** and are, therefore, **efficient** allocations of resources.
- D* is within the **PPC** and represents an **inefficient** resource allocation. Combination *B* delivers more food with the same output of clothing.

Output of clothing

Production Possibilities Curve (PPC)

Output of food

- Inefficiency -

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### Shifting the Production Possibilities Curve Outward

- An **increase** in the economy's **resource base** would expand our ability to produce goods and services.
- Advancements in technology** can expand the economy's production possibilities.
- An **improvement in the rules** (laws, institutions, and policies) of the economy can increase output.
- By working harder and **giving up current leisure**, we could also increase our production of goods and services.
  - This requires us to give up something else we value: leisure.

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### Investment and Production Possibilities in the Future

- The long-term benefits of investment include greater output in the future. Thus, decisions we make today regarding how much to save (*investment*) and consume determine the shape of the *PPC* 10 years from now.
- If we choose to produce a mixture of consumption and investment goods which corresponds to bundle *A* ... then the future *PPC* might move out to *PPC 2015 with A* – due to the new buildings, equipment, training, and other forms of investment goods that  $I_A$  represents.

Investment goods

Consumption goods

PPC 2005

PPC 2015 with A

$I_A$

$C_A$

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### Investment and Production Possibilities in the Future

- If we choose to produce a mixture of consumption and investment goods which corresponds to bundle *B*, with fewer consumption goods ( $C_B < C_A$ ) and more investment ( $I_B > I_A$ ) ... then the future *PPC* might move out to *PPC 2015 with B* instead.
- The level of investment (*savings*) in an economy is only one determinant of the movement outward (or inward) of the *production possibilities curve*.

Investment goods

Consumption goods

PPC 2005

PPC 2015 with A

PPC 2015 with B

$I_B$

$I_A$

$C_B$

$C_A$

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### Trade, Output, and Living Standards

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### Division of Labor

- **Division of labor:** breaks down the production of a commodity into a series of tasks performed by different workers.
- Specialization and division of labor increase output for three reasons:
  - Specialization permits individuals to take advantage of their existing skills.
  - Specialized workers become more skilled with time.
  - Division of labor allows for the adoption of mass-production technology.

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### Law of Comparative Advantage

- **Law of comparative advantage:** The proposition that the joint output of trading partners will be greatest when each good is produced by the low opportunity cost producer.
- Implies that trading partners can gain by specializing in the production of goods they can produce at a relatively low opportunity cost and trade for goods they could only produce at a relatively high opportunity cost.
- The principle of comparative advantage is universal as it applies across individuals, firms, regions and countries.

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### Sources of Gains from Trade

- Trade is a key to prosperity because it:
  - channels goods toward those who value them the most, and,
  - makes it possible for people to produce more as the result of specialization and division of labor, large-scale production processes, and the dissemination of improved products and lower cost production methods.
    - **Economies of Scale:** often, large scale production leads to lower per unit costs.
    - **Innovation:** technological change is about figuring out how to get more from existing resources.
- Gains from trade underlie modern living standards.

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## Is the Size of the Economic Pie Fixed or Variable?

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## Economic Pie

- At any point in time, output is limited by the resource base. The production possibilities curve highlights this point.
- Over time, investment and improvements in technology permit us to increase output. *Shifts in the production possibilities curve* highlight this point.
- Economic goods are the result of human ingenuity and action. Through time, the size of the "economic pie" is variable, not fixed.

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## Economic Organization: Markets vs. Political Planning

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### Market Organization

- **Market organization:**  
A method or organization that allows for unregulated prices and the decentralized decisions of private property owners to resolve the basic economic problems.
  - Sometimes called *capitalism*.

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### Political Planning

- **Political organization** is the major alternative to the use of markets.
- Political organization involves the use of **collective decision making** (government) to decide what, how, and for whom goods and services will be produced.
  - An economic system in which the government owns the income-producing assets and directly determines what goods they produce is called *socialism*.
  - In a *democracy*, political decision makers have to consider how their actions will influence their election prospects.

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### Questions for Thought:

1. Suppose Amy is a doctor who has records that need to be entered. Doing this work herself would take 10 hours per week. She is thinking about hiring an assistant who could do the same work in 40 hours. If Amy can make \$80 per hour seeing patients, should she hire the assistant at \$10 an hour?
2. Do you make the food that you consume and clothing you wear for yourself? What are the sources of gains from trade? Would modern living standards be possible without trade?

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**Questions for Thought:**

3. What does a production-possibilities curve demonstrate? Can the production possibilities of an economy be increased? If so, how?
4. "Modern living standards are primarily the result of brain power, capital formation, and the quality of institutions." What is the meaning of this statement? Is it true?

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**End  
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