Chapter 2
Economic Tools and Economic Systems

These slides supplement the textbook, but should not replace reading the textbook
What is opportunity cost?

The value of the best alternative forgone when an item or activity is chosen.
How is opportunity cost estimated?

Opportunity cost is *subjectively* estimated by the individual decision maker.
What is the opportunity cost of a city to use local taxes to pay for a park?

The best alternative foregone by not building the park
What is your opportunity cost of attending college?

If you make $300 a week, but you expect you could make $500 without school - your opportunity cost is $200.
What is the opportunity cost of cleaning your room?

It’s greater on sunny days than on rainy days.
Why is opportunity cost subjective?

- calculation requires time and information
- time is the ultimate restraint
- may vary with circumstances
What is a sunk cost?

A cost that is irrelevant when an economic choice is being made
What is an example of a sunk cost?

The $6.75 you pay to watch a boring movie is irrelevant to whether or not you watch it to the end.
What is absolute advantage?
The ability to produce something with fewer resources than other producers use
You can paint a room in 2 hrs, a high school student in 3 hrs, who has absolute advantage?

You do because you can do it faster
What is comparative advantage?
The ability to produce something at a lower opportunity cost than other producers face.
You can make $50 an hr, the high school student makes minimum wage, who should paint?

The high school student because of a lower opportunity cost
What is barter?

The direct exchange of one good for another without using money.
What is a division of labor?

The production of a single good into separate tasks in which people specialize.
What is a specialization of labor?

Focusing an individual’s efforts on a particular product or a single task
How does the specialization of labor increase productivity?
- Takes advantage of individual natural abilities
- Allows workers to develop more experience at a particular task
- Permits the introduction of labor-saving machinery
- Reduces time required to shift between tasks
What is the production possibilities frontier?

A curve showing all combinations of goods that can be produced when resources are used most efficiently.
What is efficiency?
The condition that exists when there is no way resources can be reallocated to increase the production of one good without decreasing the production of another.
What assumptions do we make with the production possibilities model?
- Output is limited to two classes of products
- Focus is on production during a given time period
- Available supplies of resources are fixed
- Technology is constant
What is the law of increasing opportunity?
As more of a good is produced, larger quantities of another good must be sacrificed if resources are already used efficiently
What shifts the production possibilities frontier?

- Changes in resources
- Increase in the capital stock
- Technological change
Shifts in the Economy’s PPF
Panel A: Increase in available resources
Shifts in the Economy’s PPF
Panel B: Decrease in available resources

Consumer goods

Capital goods

A
A''

F''F
Shifts in the Economy’s PPF

Panel C: Increase in resources or technology that benefits consumer goods
Shifts in the Economy’s PPF

Panel D: Increase in resources or technology that benefits capital goods
What is true along the production possibilities curve?

- resources are used fully
- maximized division of labor
- most efficient combination of resources
What choices are made along the production possibilities curve?

To have more of one product units of the other have to be given up
Production Possibilities Curve analysis includes?

- opportunity cost
- scarcity
- maximum choices
- efficiency
- increasing opportunity costs
- economic growth
What is an economic system?

A set of social institutions and mechanisms organized to answer the three economic questions.
What are the three questions?

Who gets what and how much?
What is pure capitalism?
An economic system characterized by private ownership of resources and the use of prices to coordinate economic activity in unregulated markets.
What is a command economy?

An economic system characterized by public ownership of resources and centralized economic planning.
What is a mixed capitalist economy?

An economic system characterized by private ownership of some resources and public ownership of others; some markets are regulated, others are not.
What kind of economic system do we have?

A mixed capitalist economy
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