CHAPTER 1: THE ECONOMIC PROBLEM

1.1 SCARCITY, CHOICE, AND OPPORTUNITY COST

- Economics defined:
  - Economics is the study of how to distribute scarce resources among competing ends.
  - Microeconomics focuses on individual consumers and businesses.
  - Macroeconomics takes a broad view of the economy.

- Economy defined:
  - A self-sustaining system in which many independent transactions (often triggered by self-interest) create distinct flows of money and products.
  - Economics distinguishes between the effective and efficient use of resources.
    - Effective: use of resources achieves desired end
    - Efficient: Use of bare minimum resources to achieve desired end

- Economists deal with the economic problem.
  - Economic agents must continually make choices.
  - Our needs wants are unlimited, while we face a limited supply of economic resources.
  - We must economize, or use these resources wisely.

- Economic models:
  - Simplify economic reality
  - Show how dependent variables are affected by independent variables
  - Include inverse and/or direct relationships
  - Incorporate a variety of assumptions such as ceteris paribus
  - Are classified as part of either positive economics or normative economics
1.1 SCARCITY, CHOICE, AND OPPORTUNITY COST

Analytical (or positive) economics:
- Deals with facts and direct observations
- Descriptive statements: portray things as they really are in the present or have been in the past
- Conditional statements: forecasts based on careful analysis of economic behaviour

Normative (or policy) economics:
- Deals with statements that contain value judgments
- Express what a particular group of economists thinks should be the case

1.1 SCARCITY, CHOICE, AND OPPORTUNITY COST

Economic choice:
- Economists assume that economic decision-makers maximize their own utility.
- Decision-makers must keep in mind the opportunity cost of each alternative.
- Opportunity cost: the utility of the best forgone alternative.
  - Explicit costs: out of pocket costs (dollar value)
  - Implicit cost: value of resources that could be used elsewhere

1.1 SCARCITY, CHOICE, AND OPPORTUNITY COST

Founder of modern economics: Adam Smith
- Explained how the division of labour increases production
- Argued that self interest is transformed by the invisible hand of competition so that it creates significant economic benefits
- Stressed the principle of laissez faire, which means that governments should not intervene in economic activity

CONSIDER THE FOLLOWING:

Analyze the following statement: “The economic welfare of a country’s citizens falls if there is a reduction in the quantity of the country’s economic resources.”
- To what two variables does the statement refer?
- Which variable is independent and which is dependent?
- Is the relationship between these variables direct or inverse?
- Is the statement positive or normative?
- How is the statement related to the economic problem?

1.2 THREE FUNDAMENTAL QUESTIONS & TYPES OF ECONOMIES

Three production questions:
1. What to produce?
   - Type of product or service, quantity, level of quality, consume or save natural resources, etc.
2. How to produce?
   - Labour-intensive methods, capital intensive methods, knowledge of how to best combine the factors of production
3. For whom to produce?
   - Equal share for all, distributed based on needs, distributed based on individual contribution, etc.
1.2 THREE FUNDAMENTAL QUESTIONS & TYPES OF ECONOMIES

Factors of production:
- Land: includes all natural resources (soil, mineral deposits, fossil fuels, forest reserves and other raw materials used in production)
- Labour: includes physical labour, mental effort, knowledge (also includes volunteer work)
- Capital: goods that aid in the production of other goods
  - Real capital: factories, machinery, equipment
  - Money capital: funds used to acquire the real capital

1.2 THREE FUNDAMENTAL QUESTIONS & TYPES OF ECONOMIES

Factors of production (continued):
- Entrepreneurship: ability to organize economic activity, assume risk, and achieve effective results (directs the other factors of production)
- Environment for enterprise: social and cultural values, political and economic stability, and work ethic that are conducive to doing business
- Knowledge: science, applied technology, education, and other features that are important as Canada moves from a manufacturing economy to an information economy

1.2 THREE FUNDAMENTAL QUESTIONS & TYPES OF ECONOMIES

Economic systems
- Set of laws, institutions, and common practices that help a nation determine how to use its scarce resources to satisfy as many people’s needs and wants as possible
- Three distinct ways of answering the production questions: by tradition, by command, or by market forces

1.2 THREE FUNDAMENTAL QUESTIONS & TYPES OF ECONOMIES

Traditional economy:
- Practices of past determine how to answer the three production questions
- Goods and services, practices and skills, output levels and manners of production resemble the past
- Often seen in society’s that struggle to meet daily needs and engage in little long-term planning
- Families aim to be as self-sufficient as possible
- Engage in bartering

1.2 THREE FUNDAMENTAL QUESTIONS & TYPES OF ECONOMIES

Command economy:
- Production decisions are made by a small group of political leaders (economy is centrally planned)
- Productive resources are owned by the state, who determines their allocation
- Individual person has the obligation to serve the state
- Rely on a system of reward and punishment to motivate productivity
- Emphasis on the production of capital goods over consumer goods

1.2 THREE FUNDAMENTAL QUESTIONS & TYPES OF ECONOMIES

Market economy:
- Economic activity is coordinated by many individuals who make independent decisions (often out of self-interest)
- Sometimes called free enterprise or private enterprise (since resources are privately owned)
- Demand influences what to produce, profit affects how to produce, and income levels determine for whom to produce
- Few “pure” economies exist today
Canada = mixed economy (modified market):
- Includes private enterprise and state-owned enterprise (examples?)
- Allows for crown land (state owned, like a command economy) or private ownership
- Extensive free enterprise, but also many government regulations
- Many social programs (which would be ignored in a pure market economy)

Canada (continued):
- Some examples of a return to bartering (culturally influenced)
- Consequences?
- Evidence of a hidden economy
- Citizens trade services to avoid taxation
- Illegal transactions are not recorded in GDP calculations (e.g. paying employees 'off the books' or 'under the table')

Connection to political systems

Law of diminishing returns:
- Concerns the relationship between an input and the resulting output
- Outputs will increase when an input is increased, but only to a certain extent, after which increasing inputs will not have an appreciable effect on outputs
- Also holds true if one input is held constant while others increase

Law of increasing returns to scale:
- When all productive inputs are increased simultaneously, output also will increase (since the scale of operations has increased)

Competitive advantage:
- Achieved when companies /countries outperform their competitors by offering improved or superior products, better pricing, higher quality, better services, greater profit margins, or easier access to markets and distribution channels
- Can be measured by: market share, customer demand, basic resources, or financial indicators
- The Global Competitiveness Report released by the World Economic Forum in 2002 ranked Canada eighth among 80 countries measured in their competitive growth. (The U.S. was ranked first.)
1.5 PRODUCTION POSSIBILITIES

- Achieving competitive advantage:
  - Economic utility: a product’s ability to satisfy the needs and wants of the customers
  - Different types of utility:
    - Form utility: achieved when raw materials are converted in a finished product
    - Place utility: suggests that product is more useful at a certain place

- Calculating comparative advantage:
  - A country can either produce 10 computers or 50 kg of rice.
  - The opportunity cost of producing 1 computer:
    \[ OC_c = \frac{R}{C} = \frac{50}{10} = 5 \text{ kg rice} \]
  - The opportunity cost of producing 1 kg of rice:
    \[ OC_r = \frac{C}{R} = \frac{10}{50} = 0.2 \text{ computers} \]
  - Which has a lower opportunity cost?
    - The country should produce rice. (Note that this is a consumer good, however.)

1.5 PRODUCTION POSSIBILITIES

CONSIDER THE FOLLOWING

1.7 ECONOMIC GOALS

- Political stability:
  - Consistent policy making promotes investor confidence and provides a climate for economic growth
- Reduced public debt:
  - Public debt accumulates interest and can lead to higher interest rates and prices for consumer goods
- Increased productivity and efficiency:
  - Result of healthy competition
- Equitable distribution of income:
  - Value-laden, controversial goal as some argue it rewards inefficiency
    - Governments also use transfer payments to redistribute national wealth by taking revenues from one province to make social program payments in another
- Price stability:
  - Mitigate inflation (general rise in prices) and deflation (general fall in prices)
- Full employment:
  - Defined as between 6-7% of the labour force being out of work
- Viable balance of payments:
  - Concerns all currency transactions between Canadian and foreign economies
- Economic freedom:
  - Freedom of choice available to workers, consumers, and investors in the economy
  - Consumer sovereignty: production choices of the economy are ultimately made by the buying decisions of consumers
1.6 ECONOMIC GOALS

- Economic goals may be complementary.
  - An example is the relationship between full employment and economic growth.

- Economic goals may be conflicting.
  - An example is the relationship between price stability and full employment.