

## Ch.2 lecture notes

### Opportunity cost

Opportunity cost is the highest valued alternative that must be given up. Opportunity costs may be monetary or non-monetary, but there can only be one highest valued alternative, although different people may have different highest valued alternatives because value is subjective.

### Transactions costs

Transactions costs reduce our ability to produce potential gains from trade. Transactions costs can include the time, effort and other resources necessary to search out, negotiate, and consummate an exchange.

### Property rights

The right to use, control, gain, and obtain benefits from a good or service.

Private property rights involve 3 things:

1. the right to use the property
2. the right to exclude others from using the property
3. the right to transfer (trade, sell) the property

Private property rights do not allow for people to use their property in ways that infringe on other people's rights

There are incentives to allowing for private property rights

1. Private owners can gain by employing their resources in ways that are beneficial to others
  - a. by doing this they can make a profit
  - b. the profit that they make is the driving force behind the invisible hand principle – that individuals will pursue activities that benefit them the most and thus promote the economic well-being of society
2. The private owner has a strong incentive to care for and properly manage what he or she owns
  - a. this implies that the property will be used efficiently so that it will keep its value
3. The private owner has an incentive to conserve for the future if the property's value is expected to rise.
  - a. if people believe that the property they own will be worth more in the future then they can exclude others from using that property until the property has attained its highest value

4. With private property rights the property owner is accountable for damage to others through misuse of the property

## PRODUCTION POSSIBILITIES CURVE

Definition – A curve that outlines all possible combinations of total output that could be produced assuming

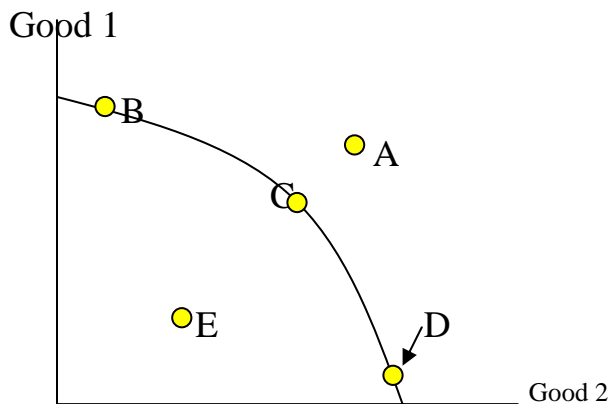
1. The utilization of a fixed amount of productive resources
2. Full and efficient use of those resources
3. A specific state of technical knowledge

The slope of the curve indicates the rate at which one product can be traded off to produce more of the other

There are three places that we can be on the graph (not the curve but the entire graph)

- A. Efficiency – these are points that lie on the curve
- B. Inefficiency – these are points that lie inside the curve
- C. Impossibility – these are points that lie beyond the curve (unless we shift the curve)

### Production Possibilities Curve



This is a production possibilities curve for any two goods.

Point A is beyond the range of this production possibility curve.

Points B, C, and D are all possible and efficient points along the production possibility curve. These three points just represent different amounts of good 1 and good 2, for which the economy is indifferent to.

Point E represents a point inside the production possibility curve. Although this point is attainable using the given resources of the economy, the economy could be better off if it used those resources fully to actually reach the production possibilities curve.

The slope of the production possibilities curve indicates the rate at which one product can be traded off to produce more of the other.

Note that point A can be reached if we shift the production possibilities curve outward

How can we move the production possibilities curve?

Shifting the curve means pushing it outward and expanding the economy

1. An increase in the economy's resource base would expand our ability to produce goods and services
  - A. If we have more resources we can produce more goods to consume
2. Advancements in technology
  - A. Think about the world 100 years ago and how much more free time people have now and how much higher the standard of living is today
3. An improvement in the rules under which the economy can increase output
  - A. The rules that govern the economy can restrict output and decrease utility
    1. The government can set price controls on goods restricting the market from determining prices which could cause a welfare loss for the economy
    2. The government could restrict trade from other countries not allowing for the law comparative advantage to occur
4. By working harder and giving up current leisure we could increase our production of goods and services
  - A. Misleading because leisure is a good
  - B. We can shift away from other goods that we no longer wish to consume to attempt to produce goods that we now want (for example we can shift away from making horse and buggies as people no longer desire them in order to make cars which allow for faster transportation, increasing the amount of time we can spend in other endeavors

## DIVISION OF LABOR / SPECIALIZATION

Definition – a method that breaks down the production of a commodity into a series of specific tasks, each performed by a different worker

1. People can perform better when doing a specialized task
  - a. people can produce more by cooperating than they can by attempting to produce everything they need by themselves
  - b. Again think back in history – people used to have to produce much of their consumption goods by himself/herself – food, clothing, housing, etc. Today people enjoy a higher standard of living by cooperating and specializing in the tasks that they perform at low opportunity cost

## COMPARATIVE ADVANTAGE

A. David Ricardo – economist who developed the principle of comparative advantage

Definition—principle that states that individuals, firms, region, or nations can gain by specializing in the production of goods that they produce at low opportunity cost and exchanging those goods for other desired goods for which they are a high opportunity cost producer

Person A

Lawyer \$50/hr.

Typing skills \$7/hr 120 words per minute

Person B

Typist \$7/hr 60 words per minute

Lawyer – 4 hrs. typing opportunity cost \$200

Typist – 8 hrs typing lawyer only pays \$56

Thus lawyer can make \$744 more by hiring a typist

People gain from specialization and the law of comparative advantage

## GAINS FROM TRADE

1. We trade every day
2. buying is trading – dollars for goods

### Reasons we gain from trade

1. Trade channels goods and services to those who value them the most
2. Exchange permits trading partners to gain from a larger total output as the result of specialization in those areas where they have a comparative advantage
3. Voluntary exchange makes it possible for individuals to produce more goods through division of labor and adoption of mass production methods