Econ 101 – Section 5

Lecture 2
Opportunity Cost, Scarcity, Production Possibilities, Trade, Specialization, and Economic Systems

January 15, 2004

The Concept of Opportunity Cost

• Opportunity Cost for Individuals
• Opportunity Cost and Society
• Production Possibilities Frontiers
• The Search for a Free Lunch

Opportunity Cost for Individuals

The *opportunity cost* of any choice is all that we forego when we make that choice.

(This is not just the monetary costs)

Opportunity Cost and Society

All production carries an opportunity cost: to produce more of one thing, society must shift resources away from producing something else.

Production Possibilities Frontier

*Production Possibilities Frontier (PPF)*

A curve showing all combinations of two goods that can be produced with the resources and technology available.
The Concept of Opportunity Cost

Law of increasing opportunity cost: the more of something we produce, the greater the opportunity cost of producing even more of it.

Production Possibilities Frontier

- PPF curves are concave because the law of increasing opportunity cost holds.
  - If this law did not hold then the PPF would just be a straight line.
  - Consider the PPF of an economy which is only interested in producing right shoes and left shoe.
    - The PPF will be a 45 degree line.
    - If the right shoe was an ankle high then we would still have a straight line but it would no longer be 45 degree.

The Search for a Free Lunch

Productive Inefficiency
A situation in which more of at least one good can be produced without pulling resources from the production of any other good.

The Search for a Free Lunch

Recessions
A slowdown in overall economic activity when resources are idle:
- there is widespread unemployment
- factories shut down, so land and capital are not being used
- Resources are idle

Figure 2 Production and Unemployment
Economic Systems

• Specialization and Exchange
• Resource Allocation
• Resource Ownership
• Types of Economic Systems

Specialization and Exchange

Specialization
A method of production in which each person concentrates on a limited number of activities.

Specialization and Exchange

Exchange
Trading with others to obtain what we want.

Gains to Specialization

Absolute Advantage
The ability to produce a good or service using fewer resources than other producers use.

<table>
<thead>
<tr>
<th></th>
<th>1 Quart of Berries</th>
<th>1 Fish</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maryanne</td>
<td>1 hour</td>
<td>1 hour</td>
</tr>
<tr>
<td>Gilligan</td>
<td>1 1/2 hours</td>
<td>2 hours</td>
</tr>
</tbody>
</table>

• It takes Maryanne less time to gather 1 quart of berries or catch 1 fish than Gilligan
• Does than mean everyone on the Island would be better off if Maryanne did all the food gathering?
  • NO!

Comparative Advantage
The ability to produce a good or service at a lower opportunity cost than other producers.
What is the opportunity cost?

### Table 2: Opportunity Costs

<table>
<thead>
<tr>
<th>Opportunity Cost of:</th>
<th>1 Quart of Berries</th>
<th>1 Fish</th>
</tr>
</thead>
<tbody>
<tr>
<td>For Maryanne</td>
<td>1 fish</td>
<td>1 quart of berries</td>
</tr>
<tr>
<td>For Olaf</td>
<td>1/2 fish</td>
<td>2 quarts of berries</td>
</tr>
</tbody>
</table>

**Comparative Advantage**

- Total production of every good or service will be greatest when individuals specialize according to their comparative advantage.
- This is another reason why specialization and exchange lead to higher living standards than does self-sufficiency.

**Resource Allocation**

*Three Methods of Resource Allocation*
- Traditional Economy
- Command (Centrally-Planned) Economy
- Market Economy

**Resource Ownership**

*Types of Resource Ownership*
- Communism - economic system in which most resources are owned in common
  - This just does not work since we all have different preferences and ideas how we should use scarce resources
- "Marge, I agree with you -- in theory. In theory, communism works. In theory." - Homer Simpson
- Socialism - economic system in which most resources are owned by the state
- Capitalism - economic system in which most resources are owned privately
Economic Systems

Economic System
Composed of two features:
• resource allocation
• resource ownership

Figure 3  Types of Economic Systems

Resource Allocation
Market
Capitalism
Command

Resource Ownership
Private

State
Market
Socialism
Centrally Planned
Socialism

Centrally Planned
Capitalism