

Basic Economic Concepts — Free Preview Key Concept Sheet

Economics examines how scarce resources are allocated and used efficiently to satisfy unlimited wants. **Microeconomics** focuses on the behavior of individual consumers, firms, and markets, while **Macroeconomics** studies the economy as a whole, like national output, inflation, and unemployment.

Because resources are limited, every choice involves a trade-off. The need to sacrifice one option in order to pursue another is captured by the concepts of **opportunity cost** and the production possibilities frontier (PPF/PPC). The **law of increasing costs** states that as more of one good is produced, the opportunity cost of producing additional units increases because resources are not equally efficient in all uses.

Positive economics describes and explains economic behavior using facts and data, while **normative economics** involves opinions and value judgments about what the economy should be like.

Factors of production are the resources used to produce goods and services. Because these resources are limited, scarcity exists and choices must be made.

There are four factors of production:

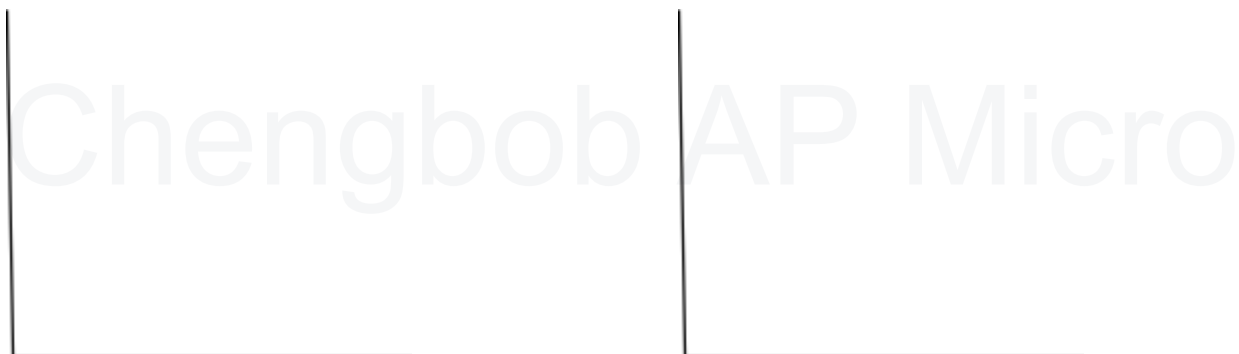
- **Land:** all natural resources used in production, such as land, water, minerals, forests, and energy resources.
- **Labor:** the physical and mental effort provided by workers in the production process.
- **Capital:** man-made goods used to produce other goods and services, such as machines, tools, factories, and equipment. (note: capital does not include money)
- **Entrepreneurship:** the ability to organize the other factors of production, take risks, and innovate in order to create new goods and services.

Production Possibilities Frontier

The **Production Possibilities Frontier / Curve (PPF/PPC)** is a graphical model that shows the maximum combinations of two goods an economy can produce given its available resources and technology. Due to the law of increasing costs, the PPC is bowed outward and concave to the origin rather than a straight line, reflecting rising opportunity costs.

- Points on the PPC represent productive efficiency
- Points inside the PPC indicate inefficiency or underutilized resources
- Points outside the PPC are unattainable with current resources
- Shifts of the PPC occur due to changes in resources or technology

Draw two PPF, label x-axis + y-axis, the first one is a realistic market where opportunity costs exist (concave outward), the second one is where resources are used to a fullest potential:



Comparative advantage exists when an individual or country can produce a good at a lower opportunity cost than another. Even if one producer has an **absolute advantage** in producing all goods, specialization based on comparative advantage allows all parties to gain from trade.

Productive efficiency occurs when an economy produces goods and services at the lowest possible cost, which happens when price equals minimum average total cost ($P = \min ATC$).

Allocative efficiency occurs when the mix of goods and services matches what society wants most, which happens when price equals marginal cost ($P = MC$).

Productive efficiency focuses on how goods are produced efficiently, while allocative efficiency focuses on what mix of goods best satisfies society.