

Chapter 2

SCARCITY, TRADE-OFFS, AND PRODUCTION POSSIBILITIES

Chapter 2: Learning Outcomes

Scarcity, Trade-Offs and Production Possibilities

2.1 THE THREE ECONOMIC QUESTIONS EVERY SOCIETY FACES

- What is to be produced?
- How are the goods and services to be produced?
- Who will get the goods and services? ♦

2.2 THE CIRCULAR FLOW MODEL

- What are product markets?
- What are factor markets?
- What is the goods and services flow?
- What is the income flow?
- What is the circular flow model? ♦

Chapter 2: Learning Outcomes

Scarcity, Trade-Offs and Production Possibilities

2.3 THE PRODUCTION POSSIBILITIES CURVE

- What is a production possibilities curve?
- What is efficiency?
- How is opportunity cost measured?
- What is the law of increasing opportunity costs? ♦

2.4 ECONOMIC GROWTH AND THE PRODUCTION POSSIBILITIES CURVE

- How do we show economic growth on the production possibilities curve?
- How can we summarize the production possibilities curve model? ♦

Chapter 2

2.1 The Three Economic Questions Every Society Faces

2.2 The Circular Flow Model

2.3 The Production Possibilities Curve

2.4 Economic Growth and the Production Possibilities Curve

2.1 The Three Economic Questions Every Society Faces

- Our *wants* far outstrip what can be produced from nature's scarce resources.
- Because of scarcity, certain economic questions must be answered...

2.1 The Three Economic Questions Every Society Faces

- What is to be produced?
- How are these goods and services to be produced?
- Who will get the goods and services?

2.1 The Three Economic Questions Every Society Faces

1. What is to be produced?

- In **market economies**, consumers decided what is produced by voting with their dollars (or pounds or yen etc.). This is called **Consumer sovereignty**
- Decentralized decision-making process
- Millions of individual producers and consumers determine what goods will be produced.

2.1 The Three Economic Questions Every Society Faces

1. What is to be produced?
 - most countries have mixed economies - the government and private sector determine the allocation of resources together

2.1 The Three Economic Questions Every Society Faces

2. How are the Goods and Services to be Produced?
 - Goods and services can generally be produced in several ways. For example, a ditch can be dug by many workers using their hands, by a few workers with shovels, or by one person with a backhoe.

2.1 The Three Economic Questions Every Society Faces

2. How are the Goods and Services to be Produced?
 - the best method is the *least-cost* method.
 - each nation tends to:
 - *conserve its relatively scarce (more expensive) resources;*
 - *use more of its relatively abundant (cheaper) resources.*

2.1 The Three Economic Questions Every Society Faces

2. How are the Goods and Services to be Produced?
 - ***labour intensive*** methods will be used where capital is relatively scarce.
 - ***capital intensive*** methods will be used where labour is relatively scarce.

2.1 The Three Economic Questions Every Society Faces

3. Who will get the Goods and Services

- a question of distribution of income.
- in a market economy, the output one can get depends on one's income.
- income depends on the quantity and quality of scarce resources that an individual controls.

2.1 The Three Economic Questions Every Society Faces

Why Do Celebrities Make So Much Money?

- Because they control scarce resources: in this case, Avril's talent and name recognition.
- Talents and other goods and services in limited supply relative to demand will command higher prices.

Avril Lavigne



2.1 The Three Economic Questions

Section Check

- Every economy has to decide **What to Produce?**
 - In a decentralized market economy, millions of buyers and sellers determine what and how much to produce.
 - In a mixed economy, the government and the private sector determine the allocation of resources.

2.1 The Three Economic Questions

Section Check

- Every economy has to decide: *How to Produce the Goods and Services?*
 - The best form of production is the one that conserves the relatively scarce (more costly) resources and uses more of the abundant (less costly) resources.
 - When capital is relatively scarce and **labour is plentiful**, production tends to be **labour-intensive**.
 - When labour is scarce and **capital is relatively abundant**, production tends to be **capital-intensive**.

2.1 The Three Economic Questions

Section Check

- Finally, every economy has to determine: ***Who Will Get the Goods and Services?***
 - In a market economy, the amount of goods and services one is able to obtain depends on one's income.
 - The amount of one's income depends on the quantity and the quality of the scarce resources that the individual controls.

2.2 The Circular Flow Model

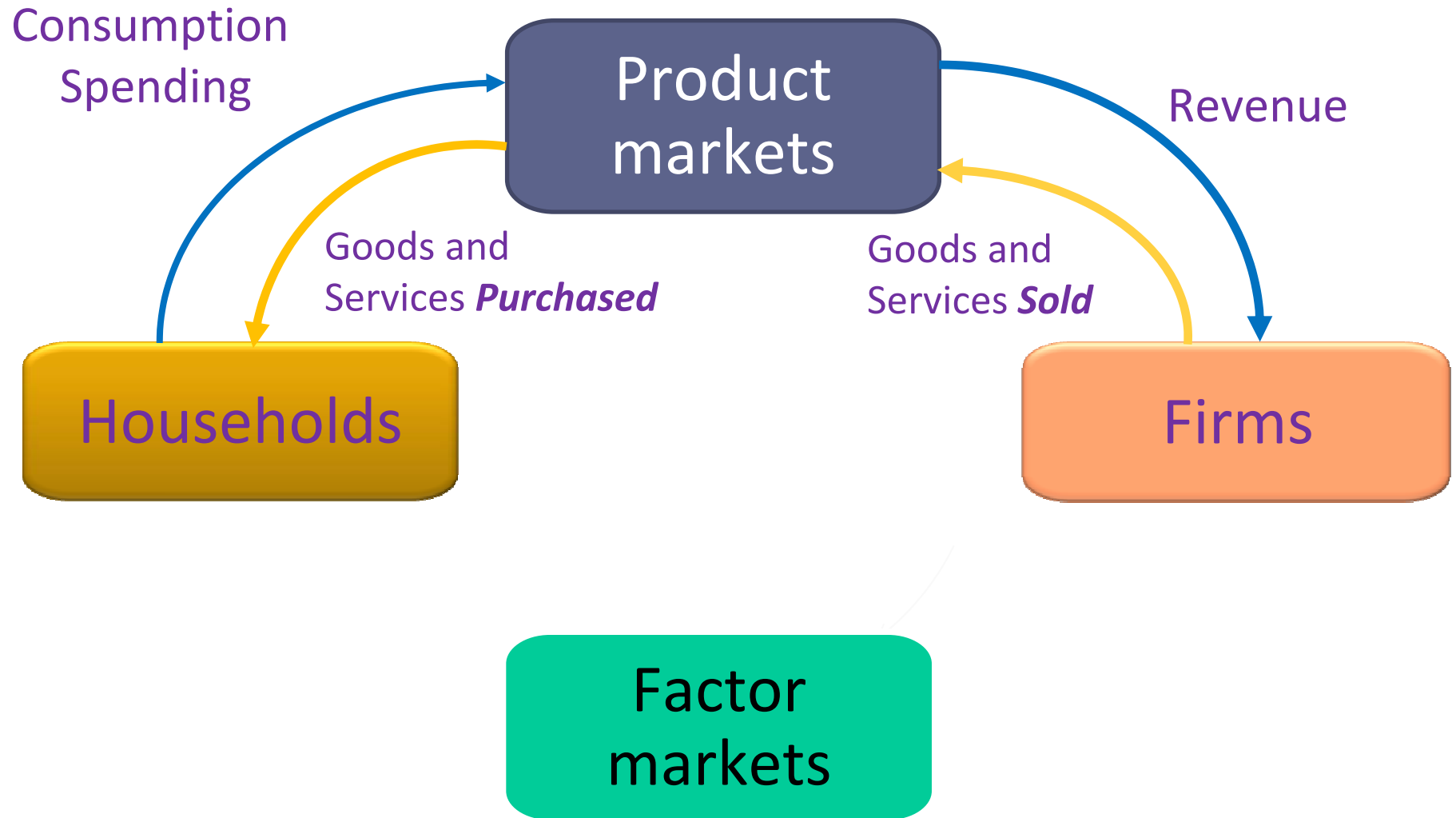
- What are product markets?
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- What is the income flow?
- What is the circular flow model?

2.2 The Circular Flow Model

What are Product Markets?

- the markets for consumer goods and services
- households are buyers, firms are sellers.
- payments flow to firms at the same time goods and services flow to households.

2.2 The Circular Flow Model

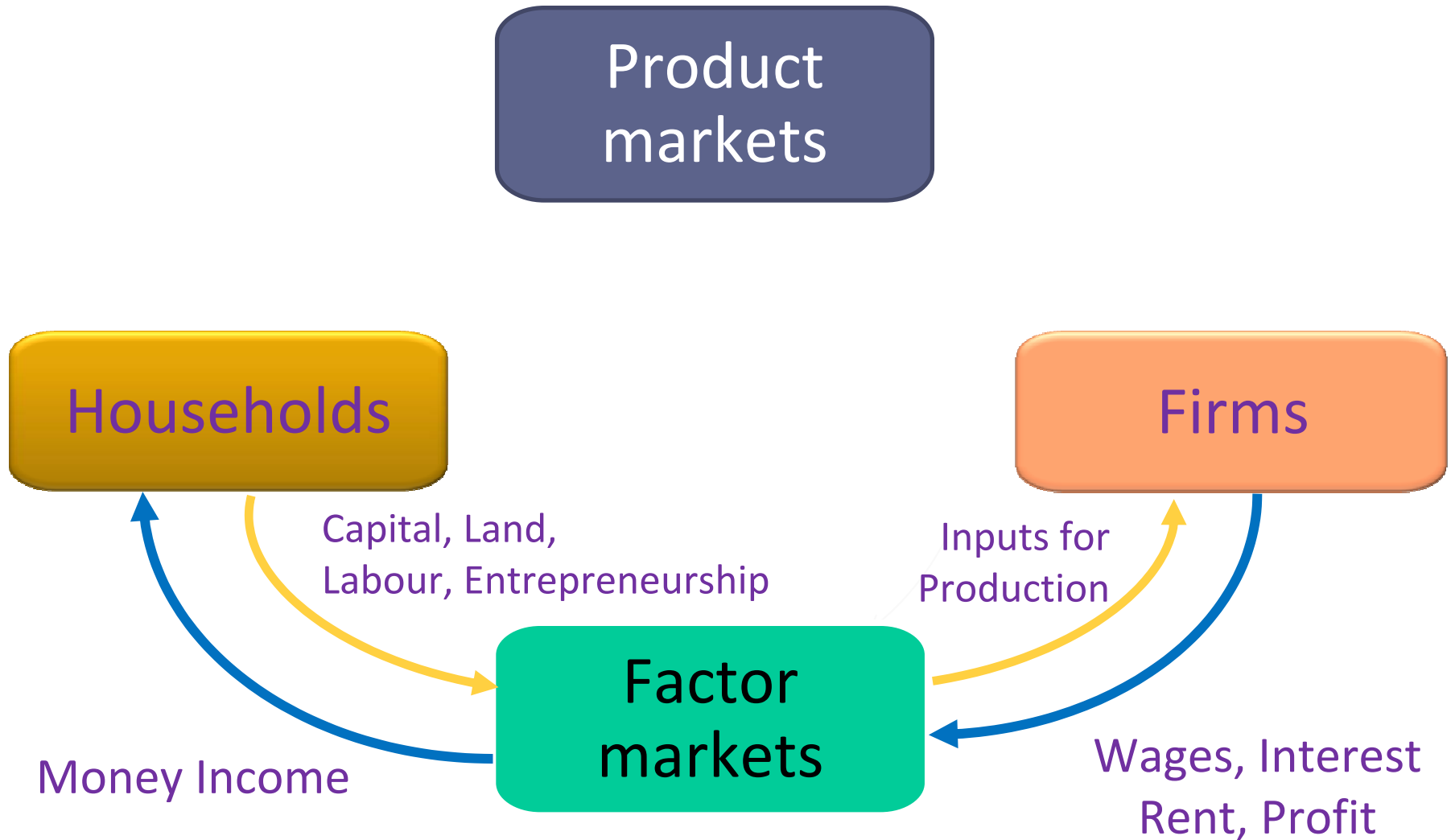


2.2 The Circular Flow Model

What are Factor (input) markets

- the markets where households sell their factors of production to firms:
capital, land, labour, entrepreneurship
- households receive money payments from firms as compensation.

2.2 The Circular Flow Model

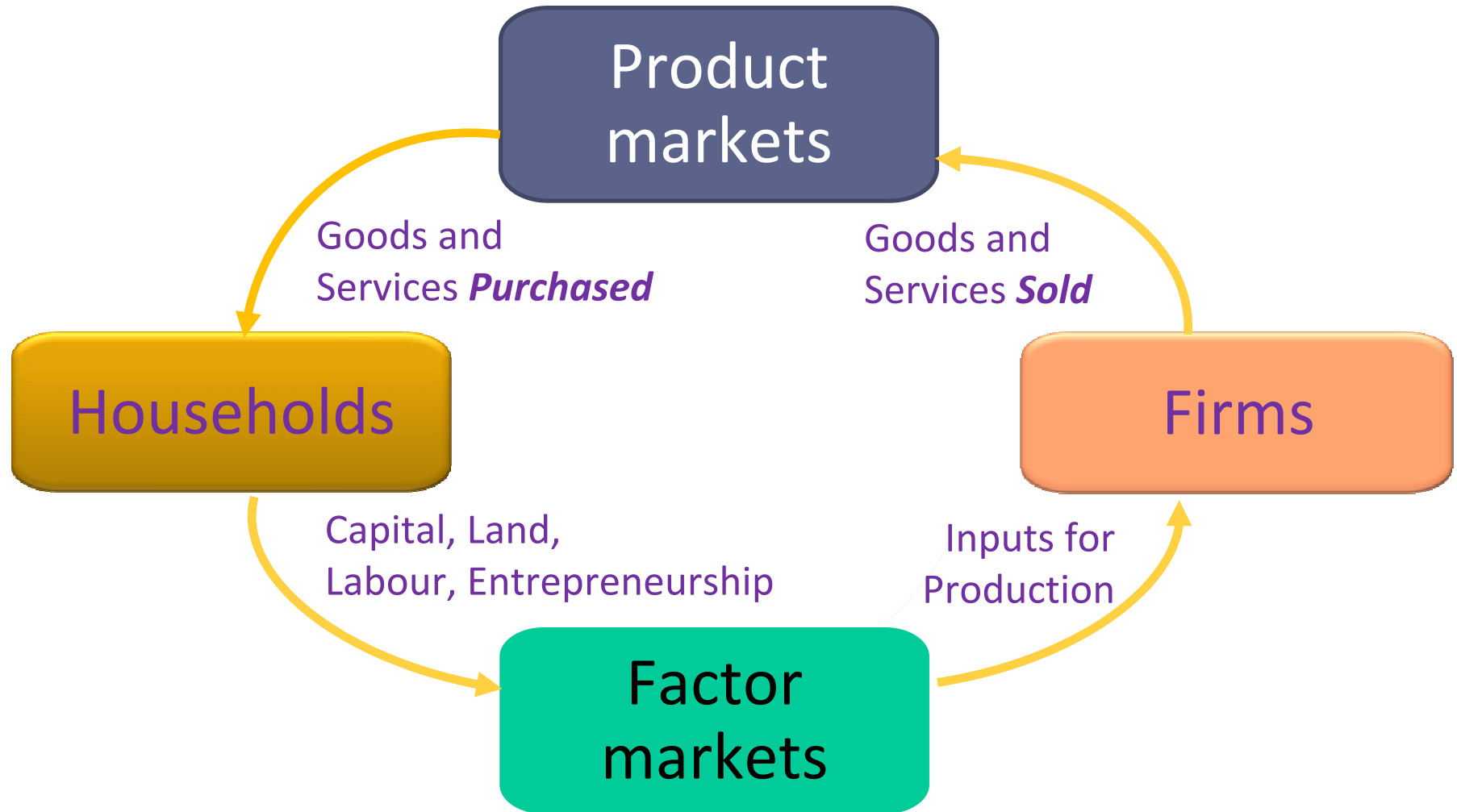


2.2 The Circular Flow Model

What is the Goods and Services Flow

- Continuous flow of inputs and outputs in an economy

2.2 The Circular Flow Model

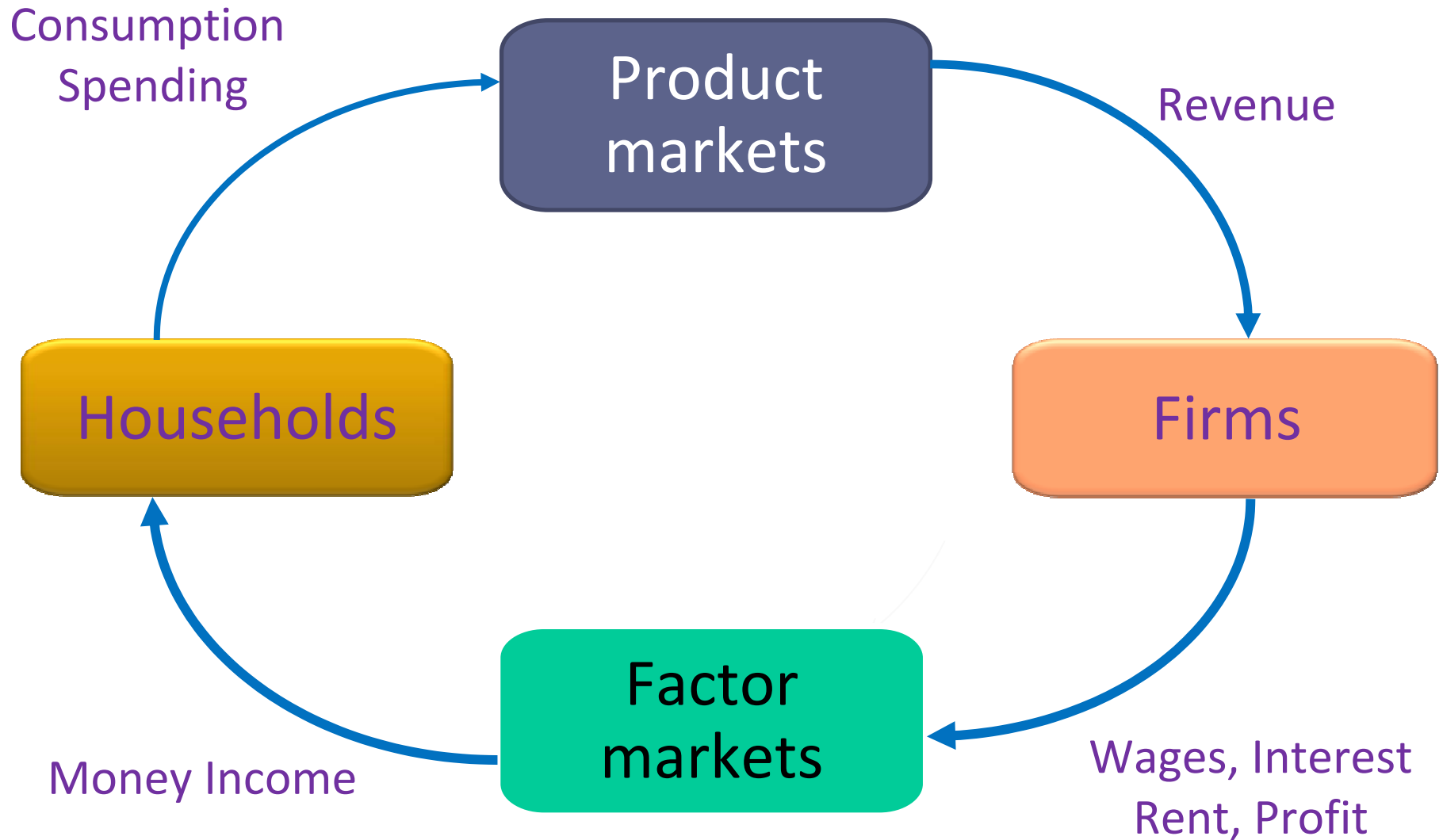


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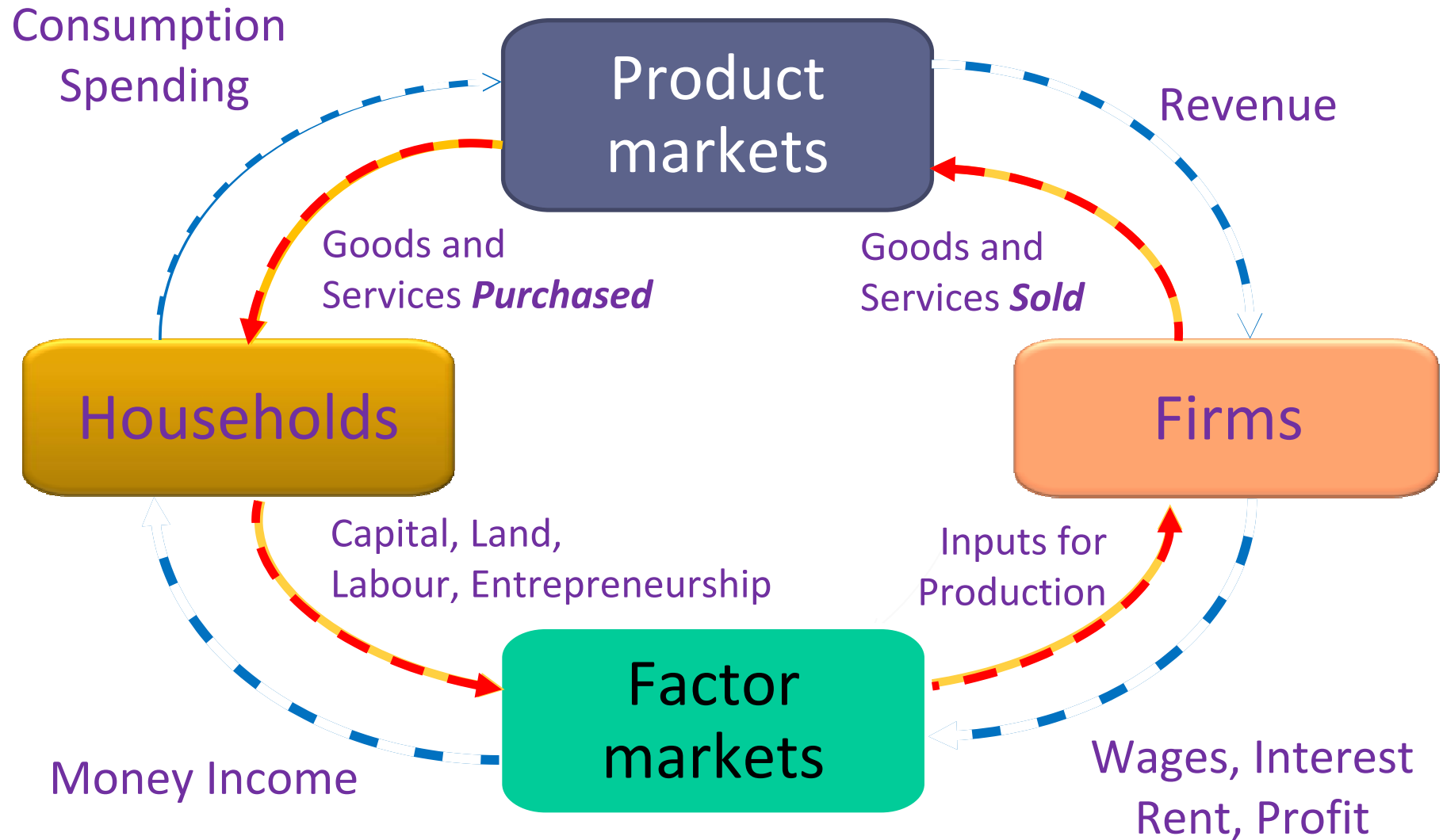
What is the Income Flow?

- Continuous flow of income and spending in an economy.

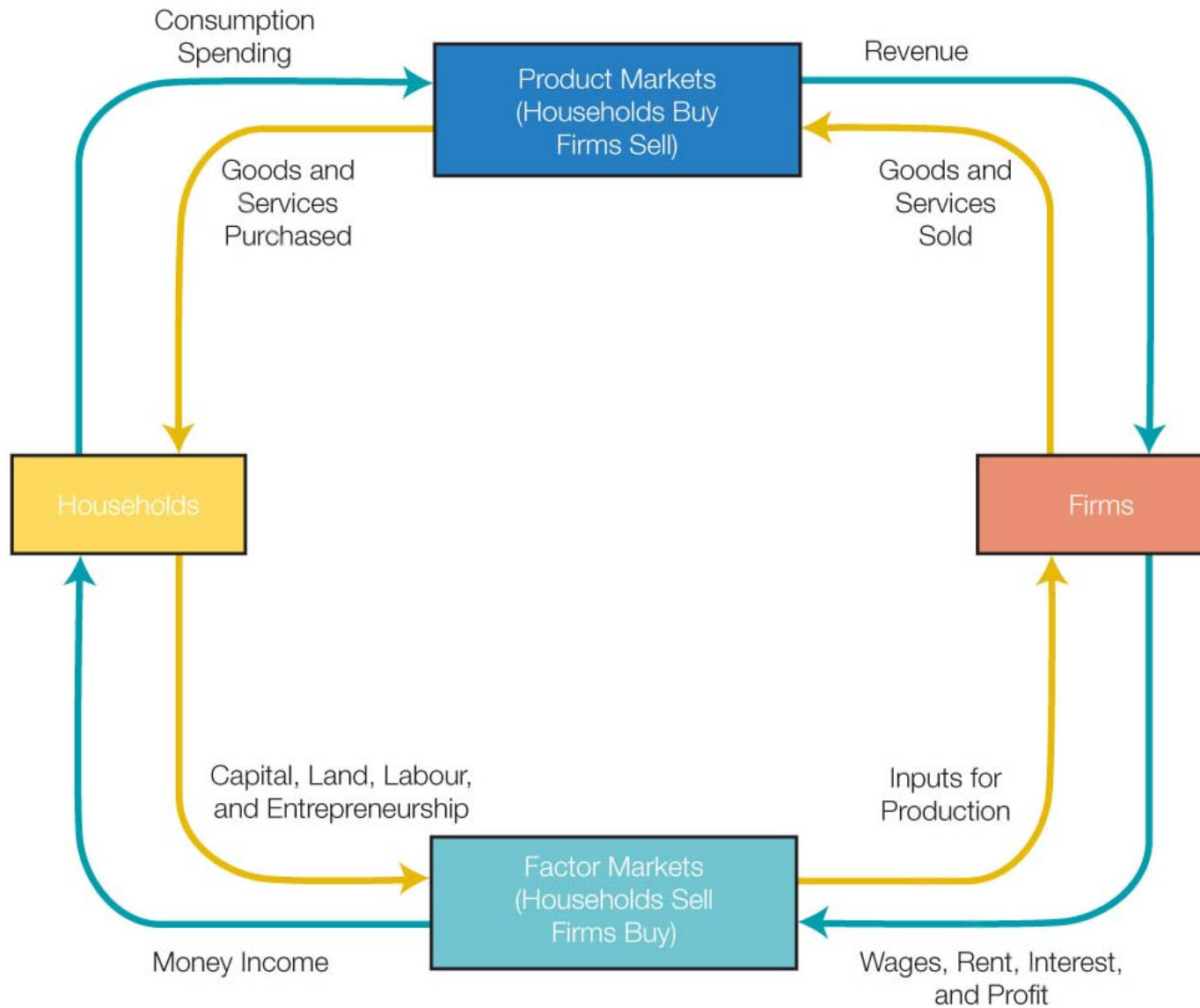
2.2 The Circular Flow Model



2.2 The Circular Flow Model



2.2 The Circular Flow Model



2.2 The Circular Flow Model

Section Check

- In the **product** market, households are buyers and firms are sellers.
- In the **factor** markets, households are the sellers and firms are the buyers.
- The *goods and services flow* represents the continuous flow of inputs and outputs in an economy.

2.2 The Circular Flow Model

Section Check

- The *income flow* represents the continuous flow of income and expenditure in an economy.
- The **circular flow** model illustrates the flow of goods, services, and payments among firms and households

2.3 The Production Possibilities Curve

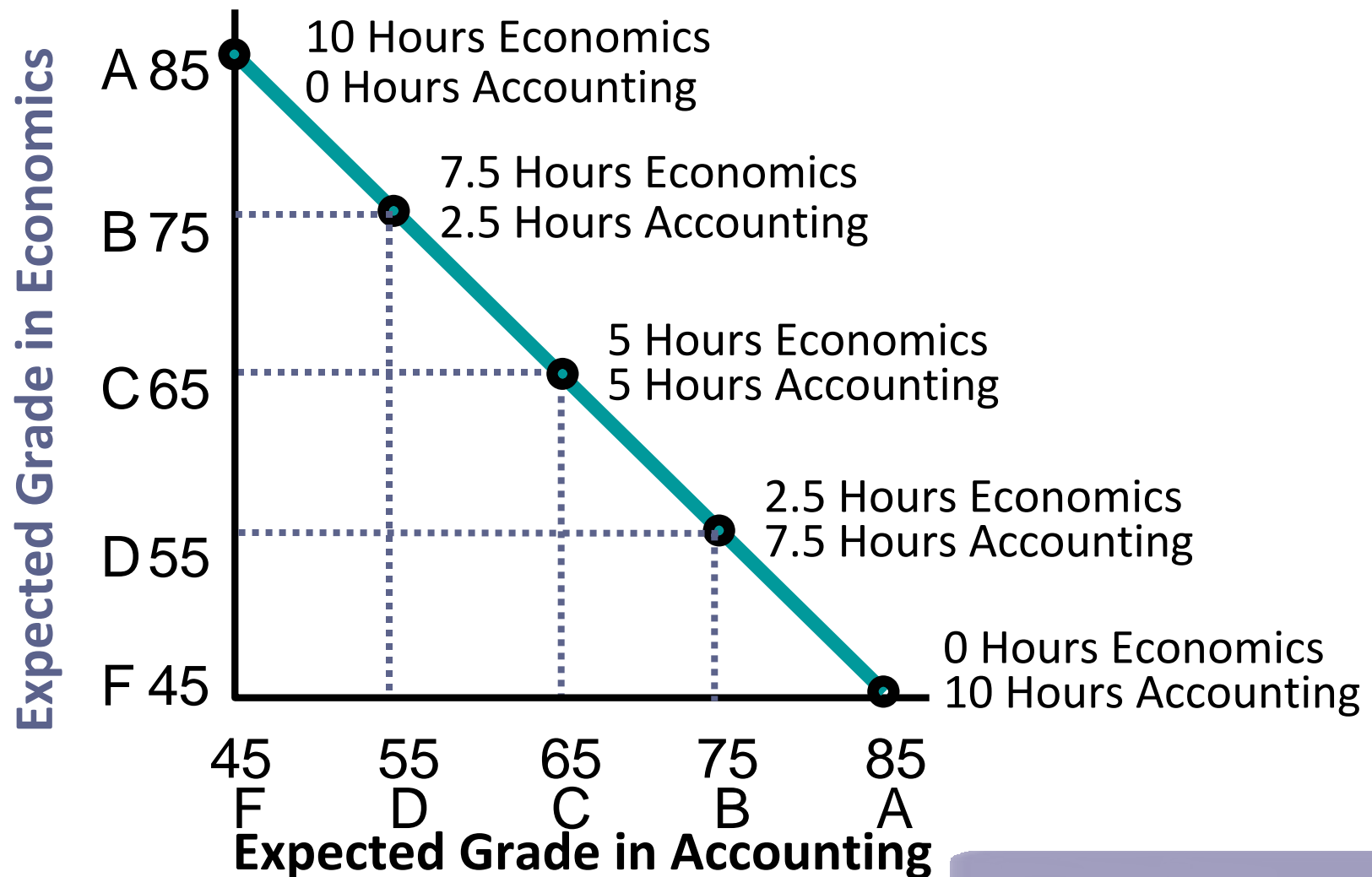
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- What is efficiency?
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- How is opportunity cost measured?
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2.3 The Production Possibilities Curve

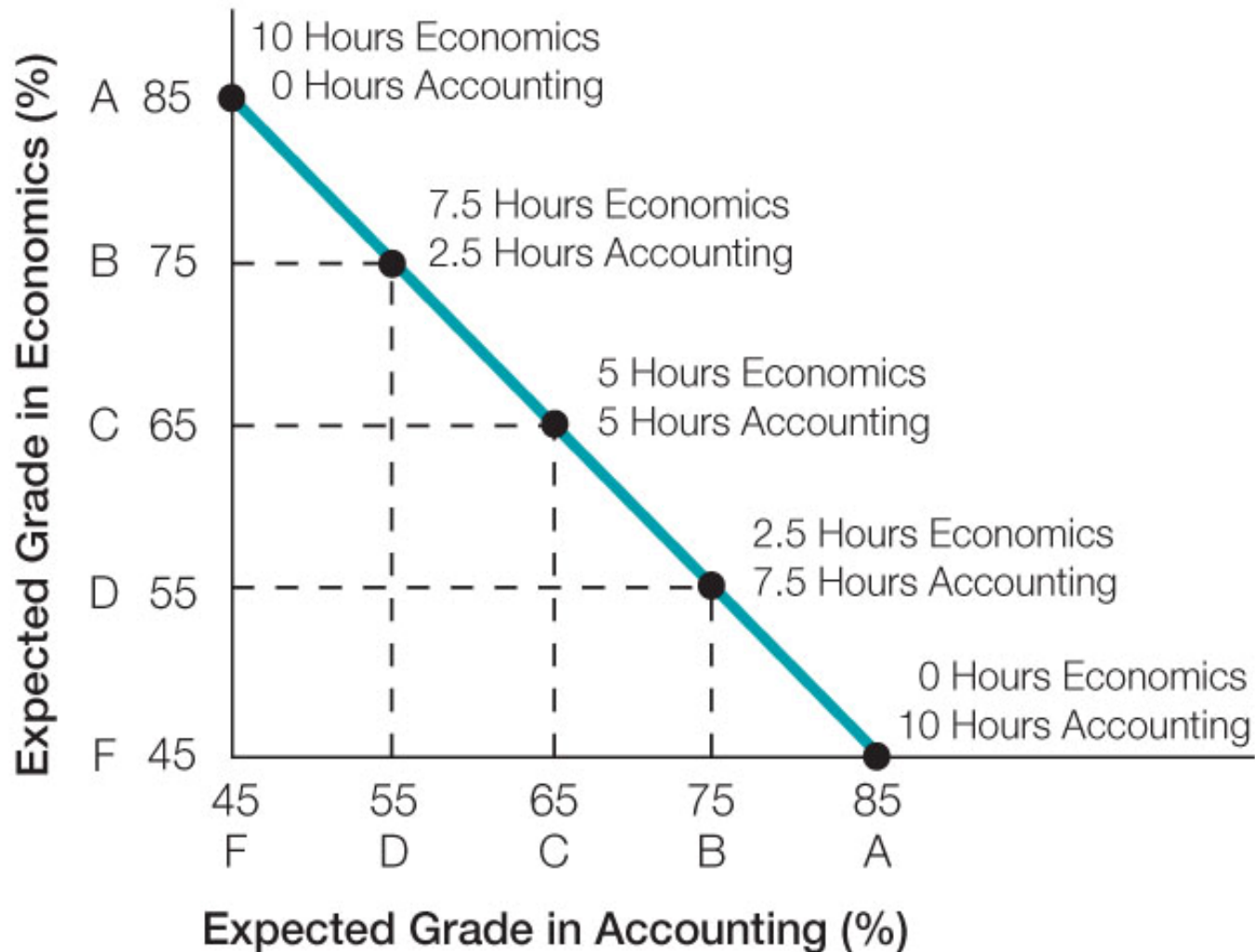
Production Possibilities Curve

- shows potential total output combinations of any two goods for an economy
- given existing levels of resources and technology
- illustrates the economic concepts of scarcity, choice and trade-offs

Exhibit 1: Production Possibilities Curve: "Producing" Grades in Economics and Accounting



2.3 The Production Possibilities Curve



2.3 The Production Possibilities Curve

Efficiency:

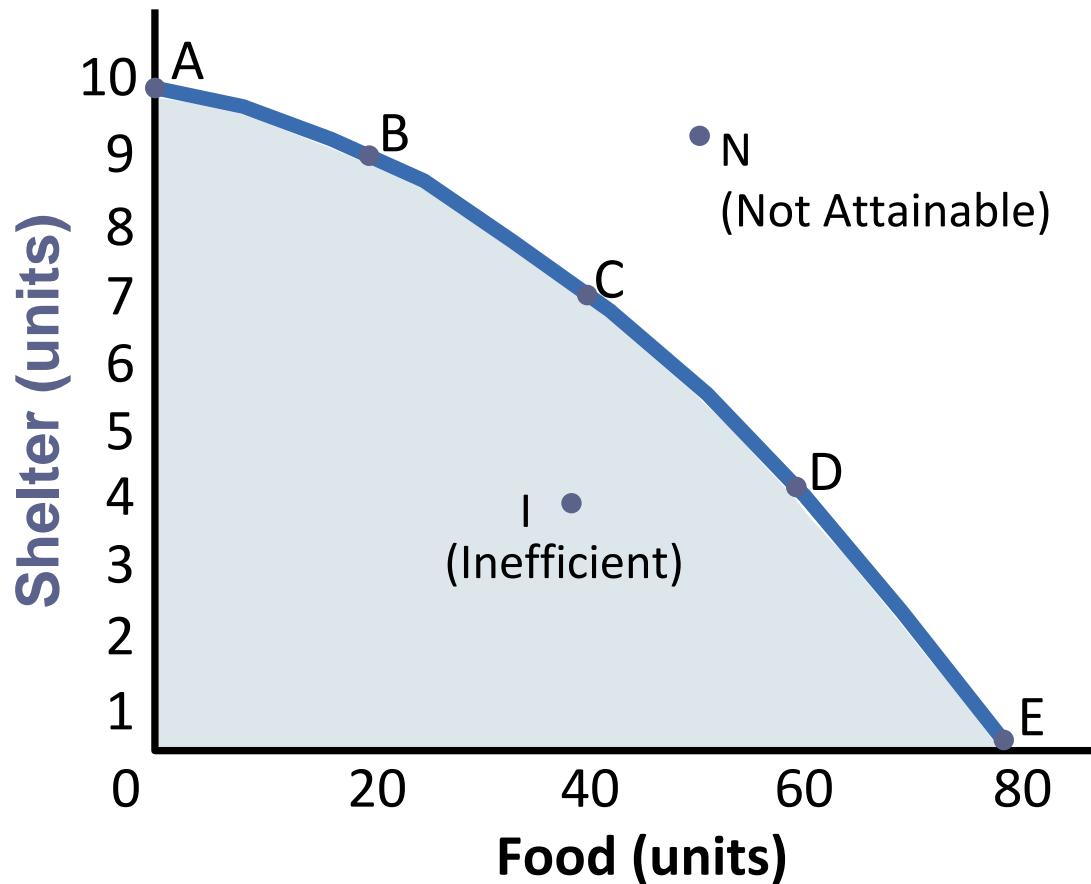
- getting the most from society's scarce resources.
- resources are used efficiently at all points along a production possibilities curve
- more of one product requires the sacrifice of another product

2.3 The Production Possibilities Curve

Efficiency:

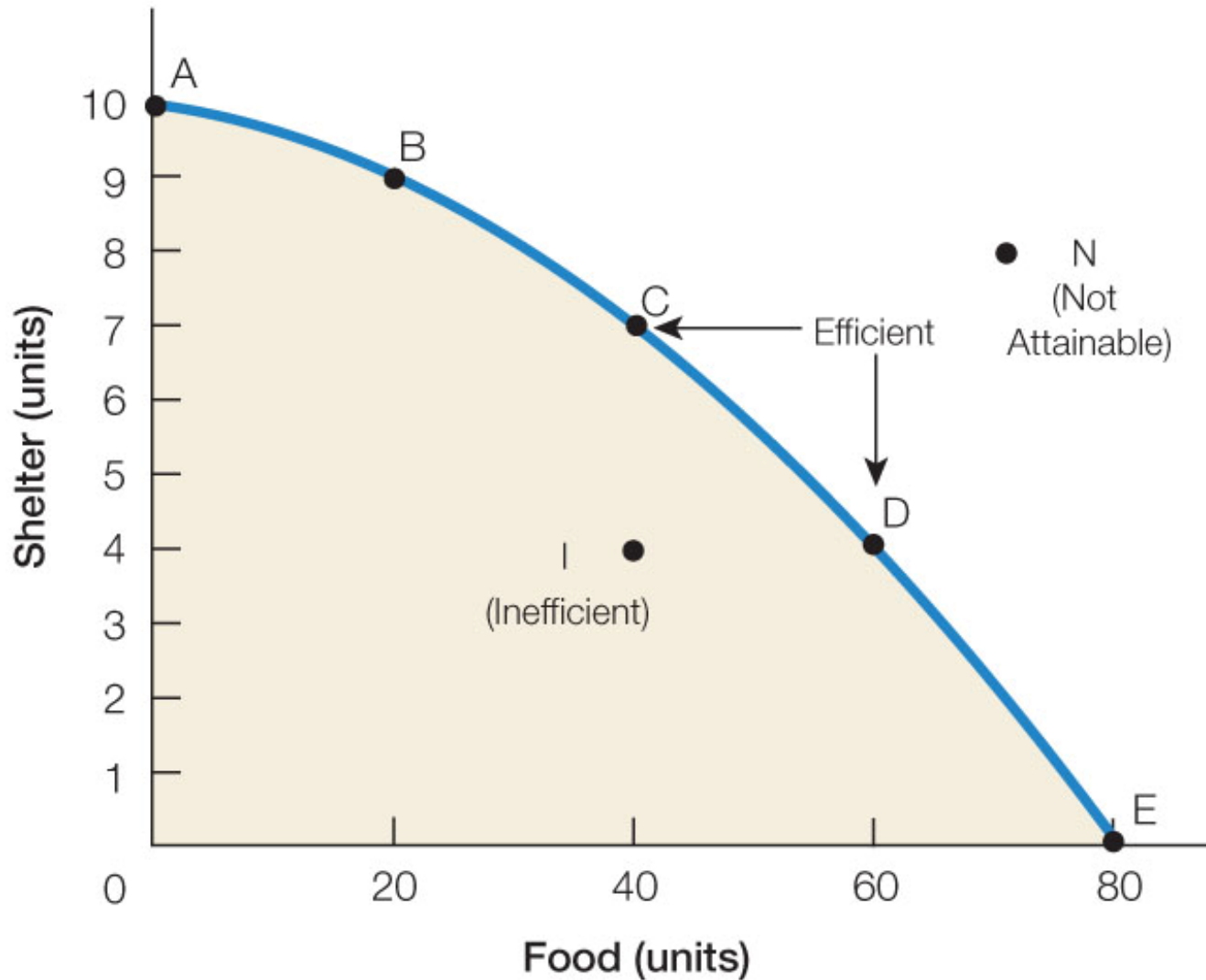
- if resources are not fully used, an economy is operating within the curve.
- actual output is less than potential output.
- a point outside the curve is not attainable with existing resources and technology

Exhibit 2: Production Possibilities Curve: The Trade-Off Between Shelter and Food



- all points on the curve are efficient (A,B,C,D,E)
- all points in the shaded area are inefficient (I).
- any points outside of the curve are not attainable with current resources and technology (N).

2.3 The Production Possibilities Curve



2.3 The Production Possibilities Curve

Increasing Opportunity Cost:

- production possibilities curve is bowed outwards from the origin.
- reflects **increasing opportunity costs**: *opportunity cost of producing a product increases as more of that product is produced.*

2.3 The Production Possibilities Curve

Increasing Opportunity Cost:

- some resources are less adaptable to alternative uses.
- as more of a product is produced, less adaptable resources are used
- the production of additional units becomes increasingly more costly

2.3 The Production Possibilities Curve

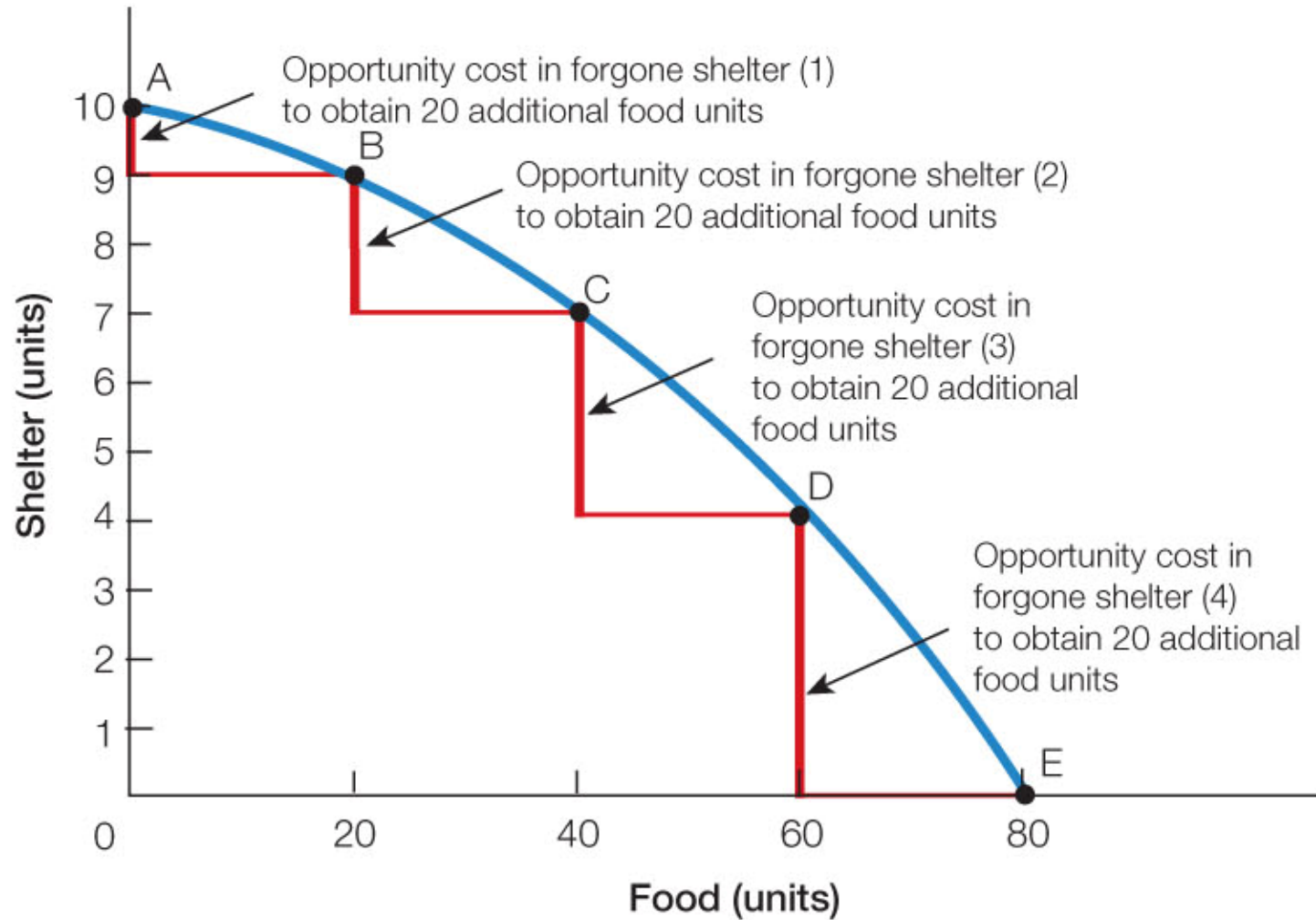
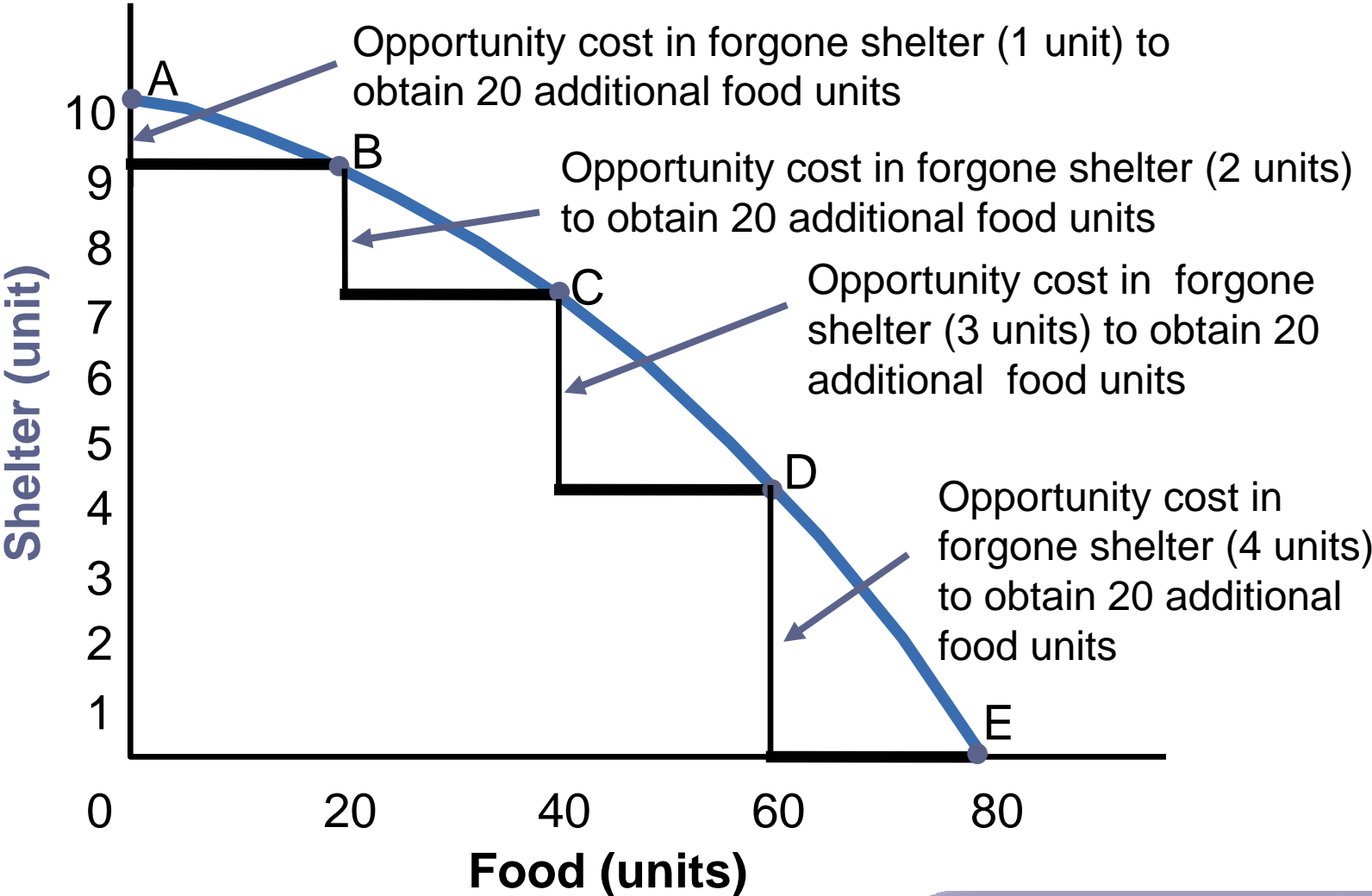


Exhibit 3: Increasing Opportunity Cost and the Production Possibilities Curve



2.3 The Production Possibilities Curve

Section Check

- The production possibilities curve represents the potential total output combinations of two goods available to a society given its resources and existing technology.
- Efficiency requires society to use its resources to the fullest extent—no wasted resources. If the economy is operating within (under) the production possibilities curve, the economy is operating inefficiently.

2.3 The Production Possibilities Curve

Section Check

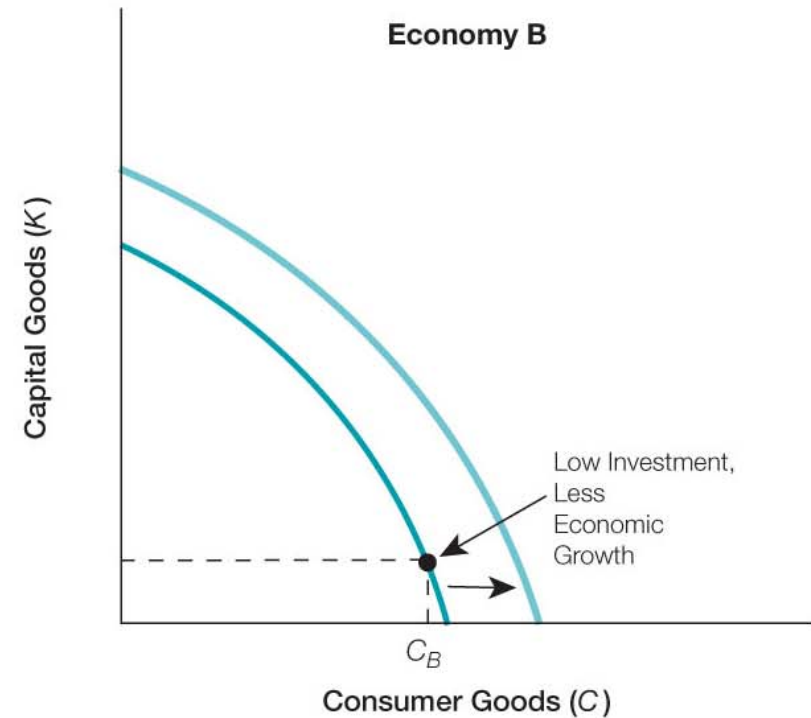
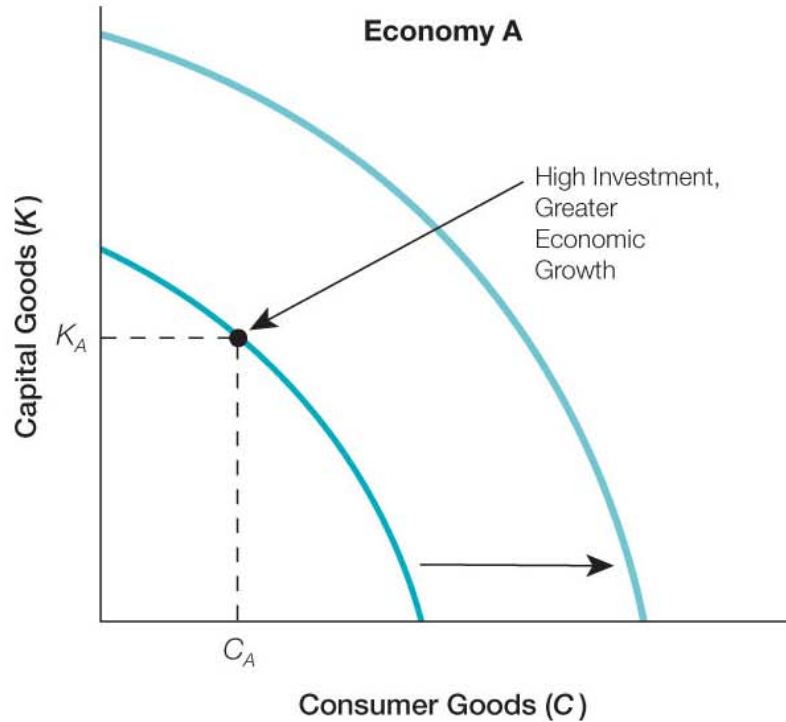
- The cost of altering production within the production possibilities curve framework, at efficiency, is measured in forgone units of the sole alternative.
- A bowed production possibilities curve means that the opportunity costs of producing additional units of a good rise as society produces more of that good (invoking the law of increasing opportunity costs).

2.4 Economic Growth and Production Possibilities

Economic Growth:

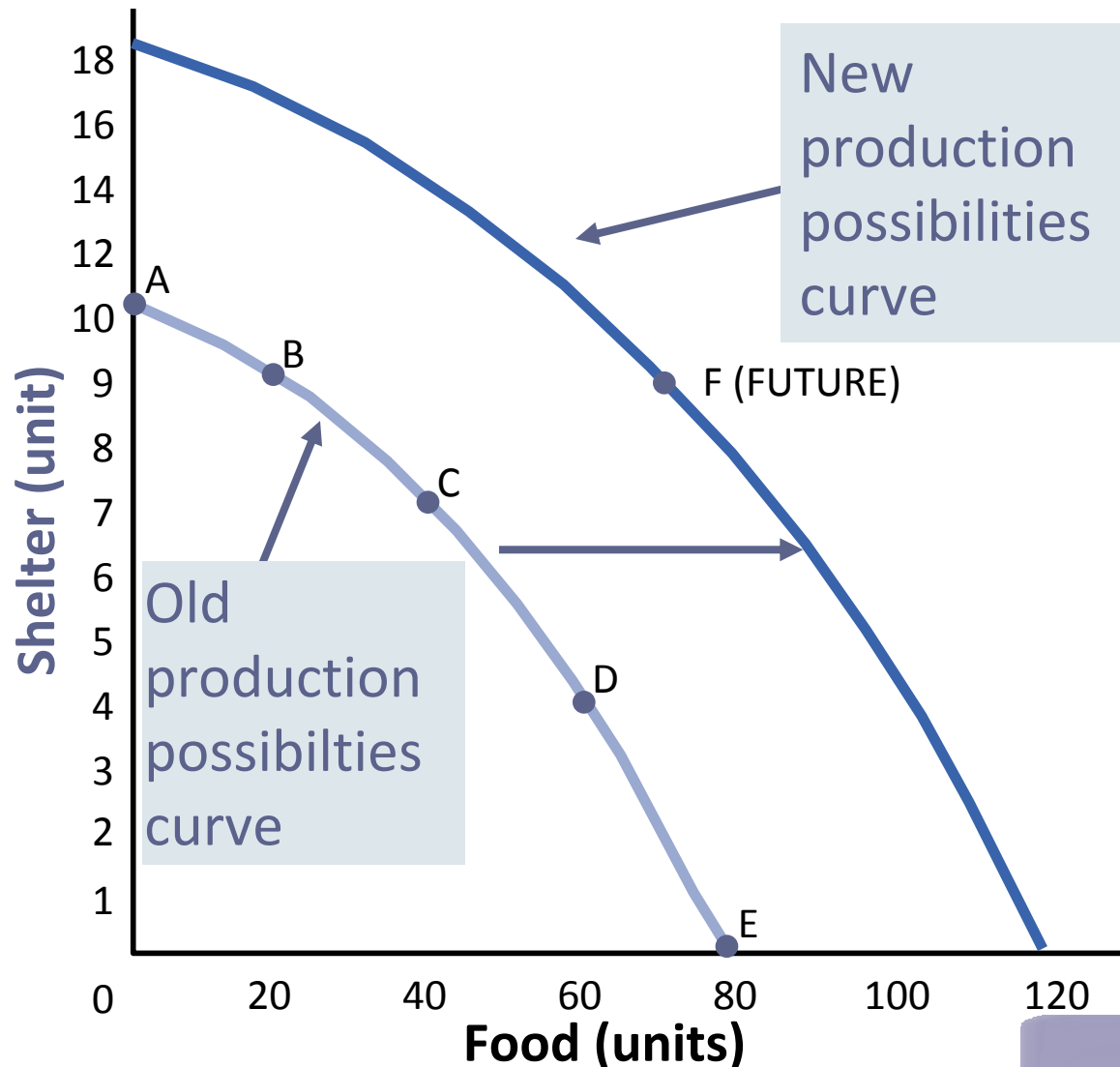
- results from qualitative or quantitative changes in the factors of production (resources).
 - *advancements in technology*
 - *improvements in productivity*
 - *new sources of natural resources*
- causes an outward shift in the possible combinations of goods and services.

2.4 Economic Growth and Production Possibilities



Because Economy A invests relatively more in capital goods than Economy B, it will experience greater economic growth.

Exhibit 1: Economic Growth and Production Possibilities

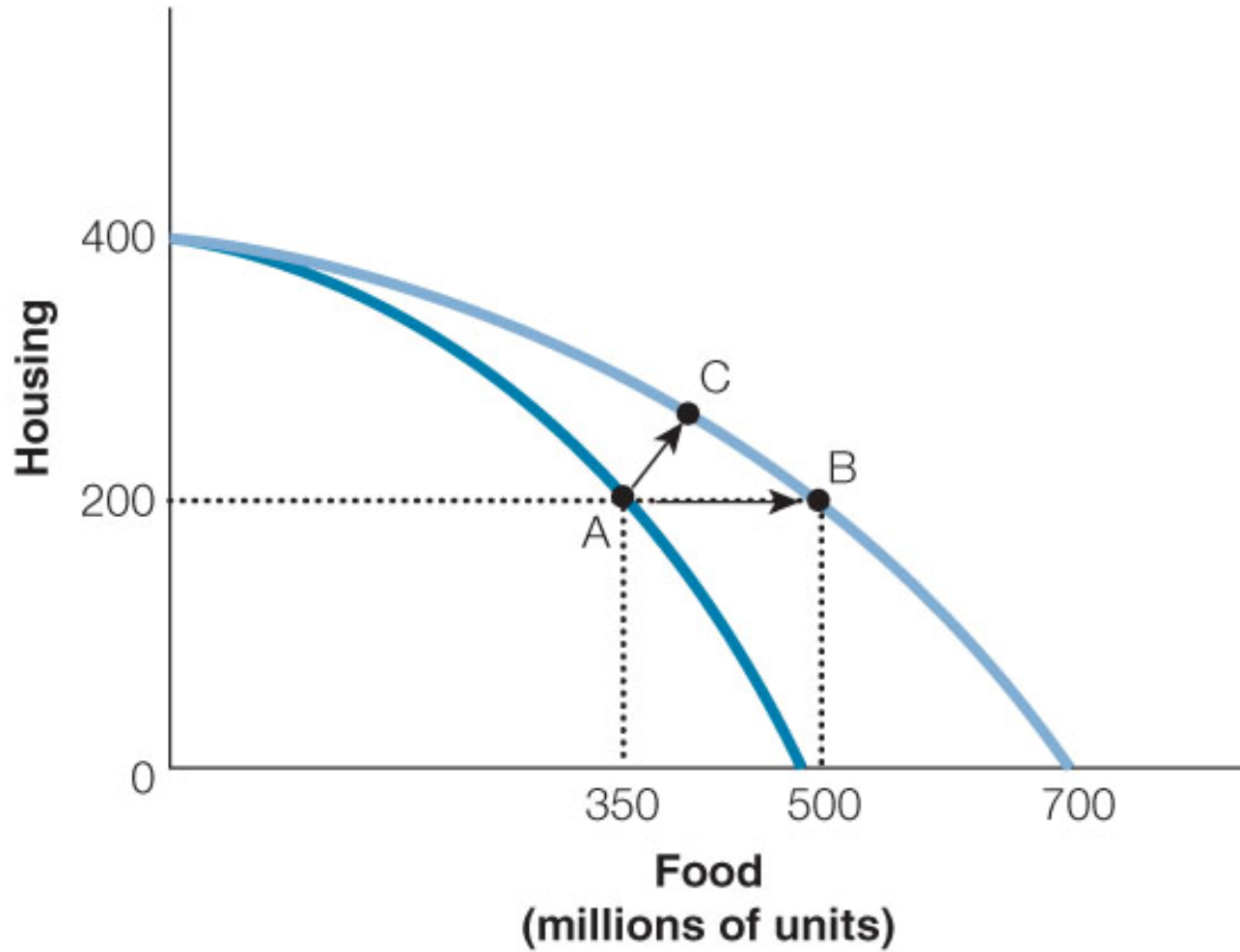


2.4 Economic Growth and Production Possibilities

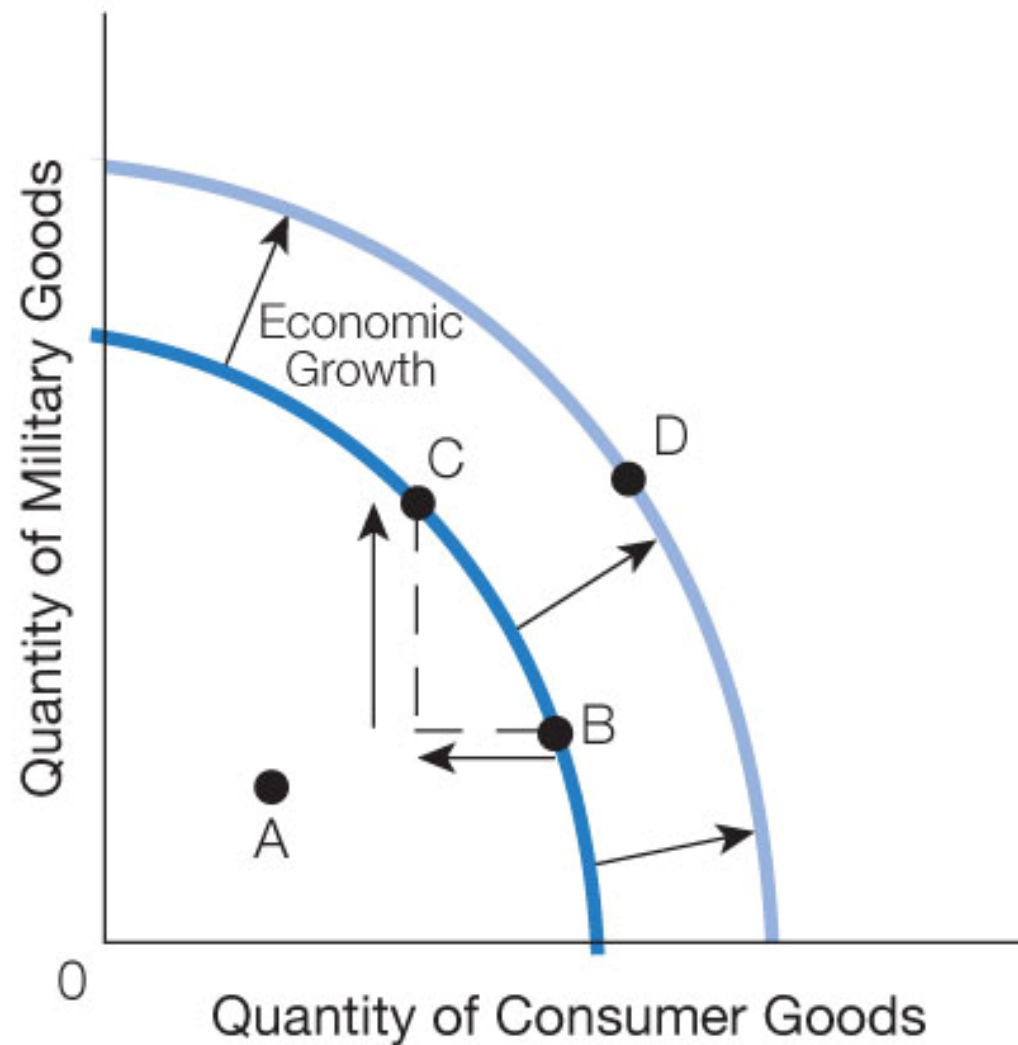
Generating Economic Growth:

- must invest more resources for the future.
- capital goods expand the ability to produce in the future
- to grow, must produce fewer consumer goods, more capital goods.
- sacrifice some current consumption to increase future consumption

2.4 Economic Growth and Production Possibilities



2.4 Economic Growth and Production Possibilities



2.4 Economic Growth and Production Possibilities

Section Check

- Economic growth is represented by an outward shift of the production possibilities curve, indicating an increase in the possibility of producing more of all goods. Despite this, scarcity inevitably remains a fact of life.
- The production possibilities model is an effective way of illustrating the economic concepts of scarcity, choice, opportunity costs, efficiency, and economic growth.

Reviewing the Learning Outcomes

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Reviewing the Learning Outcomes

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