BUSS1040 Notes

Week 1

Foundations of economic reasoning

- **Three key economic ideas**
  1. **People are rational** → consumers and firms use as much of the available information as they can to achieve their goals (weigh up the benefits and costs of each action, and only choose an action if the benefits outweigh the costs).
  2. **People respond to economic incentives**
  3. **Optimal decisions are made at the margin** → instead of deciding all or nothing; it is deciding to do a little more, or a little less.
     - **Marginal analysis**: involves comparing marginal benefits and marginal costs.
     - Economists reason that the optimal decision is to continue any activity up to the point where the MB (marginal benefit) = MC (marginal cost).

- **Scarcity and trade-offs**
  - **Scarcity** is where unlimited wants exceed the limited resources available to fulfill those wants.
  - **Trade-offs,** caused by scarcity, force society to make choices (production of one good, means less production of another good), about the following:
    - *What goods and services will be produced?*
      - Determined by the choices made by consumers, firms and governments. → opportunity cost helps decide between alternatives.
    - *How will the goods and services be produced?*
      - Trade-offs between what resources are used to produce G/S. Eg using more workers vs more machines.
    - *Who will receive the goods and services produced?*
      - Individuals with the highest income have the ability to buy the most G/S.
  - In a **market economy** most economic decisions are made by consumers and firms. In a **centrally planned** economy, most economic decisions are made by the government. However, most economies (inc. Aus) are **mixed economies**, whereby most economic decisions are made by consumers and firms, but in which the gov has a significant role.
  - **Voluntary exchange** occurs in markets when both the buyer and seller of a product are made better off by the transaction.
  - **Efficiency** (achieving maximum productivity with minimum wasted effort or expense):

    - **Productive efficiency:** Producing a G/S with the least amount of resources. → achieved when competition between firms in markets forces the firms to produce G/S using the least amount of resources and therefore at the lowest cost.
    - **Allocative efficiency:** Production reflects consumer preferences and resources are allocated throughout the economy to produce what consumers demand. → Producing G/S to the point where the last unit provides a marginal benefit to the consumers equal to the marginal cost of producing it (MB=MC)
    - **Dynamic efficiency:** Adopting new technology & innovative process. → can be achieved by competition, as firms seek to adapt their product and use new tech over time to secure their market share.
    - **Equity:** Fair distribution of economic benefits. → efficient outcome does not necessarily mean that society finds it desirable.

Role of models in economic analysis

- An **economic model** is a simplified version of reality to analyse effects on real-world economic situations.
- **Economic models** should have a hypothesis (statement that is correct or incorrect about an economic variable). *Correlation does not imply causation* (eg it's raining because it's Wednesday → cannot imply the reason for rain is because it's Wednesday).
- **Positive analysis:** Analysis concerned with WHAT IS → can be checked through facts.
- **Normative analysis:** Analysis concerned with WHAT OUGHT TO BE → judgements which cannot be tested.

Production possibility frontier

- **Production possibility frontier** is a curve that shows the maximum attainable combinations of two products that can be produced with available resources.
    - Anything inside the curve is an inefficient combination.
    - Anything outside the curve is an unattainable combination (with available resources).
    - Combinations on the frontier are efficient because all available resources are being fully utilized.
- **Opportunity cost:** the highest-valued alternative that must be given up to engage in that activity.
    - Includes explicit and implicit (lost opportunity, eg time and effort, non-cash) costs. Eg, the time and effort that an owner puts into the maintenance of the company, rather than working on expansion, can be viewed as an implicit cost of running the business.
- As the economy moves down the PPF, it experiences **increasing marginal opportunity cost** as increasing production of good1 (x-axis) by a given quantity requires larger and larger decreases in the production of good2 (y-axis). The increase in good1 becomes increasingly smaller, while the decrease in good2 becomes

increasingly larger → occurs because some resources are better suited to one use than another.
    - This illustrates *the more resources already devoted to an activity, the smaller the payoff to devoting additional resources to that activity.*
- The total resources available to an economy are fixed, therefore to produce more of something, less of another is produced. If there is an increase in the available labour force and the capital stock, the PPF will shift outwards, making it possible to produce more of both goods → illustrates **economic growth**. Can also shift inward, illustrating the economy shrinking, possibly due to natural disasters or war.
- Technological advance makes it possible to produce more goods with the same amount of works and machinery, which shifts PPF outwards. However, tech advances may not affect all sectors equally, thus one good can increase in production, whilst leaving an unchanged quantity of the other good.

Comparative advantage & basis of trade

- **Trade** is the act of buying/selling G/S in a market.
- **Absolute advantage:** The ability to produce more of a G/S than competitors using the same amount of resources. → it is possible to have an absolute advantage, without having a comparative advantage.
- **Comparative advantage:** The ability to produce a G/S at a lower opportunity cost than other producers. → it is possible to have a comparative advantage without having an absolute advantage.
- **Gains from trade:**
    - **Comparative advantage** is the basis for trade, not absolute advantage. → Individuals, firms or countries are better off if they **specialise** in production where they have a comparative advantage and obtain other desired G/S by trading.