

UNIT 2: FUNDAMENTALS

SSEF1; SSEF2; SSEF3; SSEF4; SSEF6

In this unit, you will build a basic foundation in economics. You will have opportunities to connect basic economic fundamentals to past, present, and future life choices. You will identify the benefits enjoyed and the costs incurred from past decisions. You will describe the limited nature of your own productive resources. You will analyze how your own choices reflect allocation of scarce resources.

KEY IDEAS

- Scarcity, tradeoffs and opportunity cost (SSEF1a, c)
- Response to incentives (SSEF2c)
- Examples of productive resources (SSEF1b)
- Choices made with resources (SSEF1b)
- Resource allocation (SSEF4c)
- Rational decision making—cost/benefit analysis (SSEF2b)
- Economic systems—command, market, traditional, mixed (SSEF4a)
- Ways the various economic systems answer the 3 basic economic questions about the use of productive resources (SSEF4b)
- Role of government (SSEF5a)
- Production possibilities curve—tradeoffs, opportunity cost and economic growth (SSEF6d)
- Division of labor and specialization (SSEF3a)

KEY TERMS

The term *economics* is flexible. It can be used when a bank decides to raise its prime lending rate or when a wheat farmer decides to plant one more bushel of wheat this year than he did last year. However, if you had to boil down economics to one definition, you would have something like:

Economics: a social science studying the allocation of scarce resources and goods.

Allocate: to distribute according to some plan or system. (SSEF4c)

Scarce: limited productive resources. (SSEF1a, SSEF4c)

Productive resources: the inputs—land (natural), labor (human), capital (physical and human), and entrepreneurship—used by a society to produce outputs. **Natural resources**, also known as **land resources**, are the gifts of nature we use to produce goods and services. **Human resources** are the people involved in the production of goods and services. People offer their time to production as well as their physical abilities, knowledge, and skills. The abilities each person brings to the production process is known as their **human capital**. **Physical capital** refers to tools, machines, and structures used over and over again in the production of goods and services. **Entrepreneurs** take risks by using their own financial resources to create new products or start new businesses. (SSEF1b)

Those outputs, which are often finished products such as hamburgers and cars, are called **goods**.

The decision to produce one good instead of another often relates to **choice** and **opportunity cost**. (SSEF1d)

Incentives: In economics, an **incentive** motivates individuals, businesses, and/or governments to undertake an action or avoid an action. Incentives are positive when individuals, businesses, and/or governments choose an option associated with a perceived benefit or gain. For example, an income tax credit for purchasing a home will most likely lead to more people buying homes so they can take advantage of the tax credit. Incentives are negative, sometimes called disincentives, when individuals, businesses, and/or governments avoid a particular option because they associate it with a cost that is too high. Fines and penalties for breaking laws are negative incentives or disincentives. People are less likely to break a law if they know it might cost them financially. Traditionally, economists believe individuals, businesses, and governments will respond predictably to positive and negative incentives. (SSEF2c)

Most economic situations can be discussed using the concepts of scarcity and opportunity costs. It doesn't matter if the subject is a nation or a person. Basic economic decision-making processes center on deciding how best to allocate the scarce resources at hand.

Every day, consumers and producers everywhere compare marginal benefits to marginal costs in order to make economic decisions.

Marginal cost: the cost of procuring one more item. (SSEF2a)

Marginal benefit: the benefit associated with that one additional item. (SSEF2a)

Productivity looks at the relationship between inputs and outputs. An input is something that goes into making a good. An output is the amount of a good or service produced. (SSEF6a)

Investment in human capital, physical capital, and new technology are ways to increase economic growth.

Human capital is the economic value of an employee's skill set. Investing in human capital can be done through education, training, and enhanced benefits. Investing in human capital by companies or by governments can lead to a higher standard of living. **Physical capital** is one of the factors of production. It includes man-made goods that assist in the production process, such as machinery or buildings. Investments in physical capital as well as technology can lead to economic growth. (SSEF1b, SSEF6b, SSEF6c)

A **production possibilities curve** is used to show the maximum combination of goods and services that can be produced from a fixed amount of resources. The production possibilities curve can show **trade-offs**. Trade-offs are what was exchanged for the use of something else. The production possibilities curve shows the opportunity cost of any trade-offs made. (SSEF6d)

Economic growth is increasing production of goods and services over time. Economic growth can be shown by an outward shift of the production possibilities curve. **Economic efficiency** has to do with how well factors of production are allocated to uses desired by consumers and how they are used in production to keep costs low. (SSEF6)

A **rational decision making model** is a multistep process for choosing between two or more alternatives. Some steps of the rational decision making model include: identifying the decision, establishing criteria for making the decision, identifying and evaluating alternatives, predicting outcomes, and concluding with implementation and evaluation of the option selected. (SSEPF1a)

Specialization allows people to concentrate on a single activity or area of expertise. For an entire society, specialization helps boost overall productivity and leads to an efficient use of resources. People gain knowledge and skills in a certain area, which allows them to do that job better than other non-specialists. This specialized knowledge might allow them to build a product faster, increasing output. It could also allow them to complete something that others could not even attempt. Either way, specialization expands the efficiency of a society and usually helps boost overall production ability. Furthermore, this "skilled labor" can charge more for their services, which allows individual wealth to increase. An assembly line utilizes the benefits of specialization by allowing individual workers to concentrate on a certain task. As each of these workers gains experience in one particular part of the production process, the entire factory

is able to produce more without increasing the number of workers it employs or the time each employee spends on the job. This is also known as **division of labor**. (SSEF3a)

The United States is primarily a **market-based system**, but this is not the only economic system being used in the world today. All economies must answer three questions: what to produce, how to produce, and for whom to produce. The following provides a brief description of four major economic systems.

Major Economic Systems (SSEF4a, b)

1. Market: This is also called a **capitalistic** or **free-market** system. In a market system, private individuals and firms control all resources, and the price and quantity of all goods are determined by the interaction of demand and supply in unrestricted, open markets. Ownership of property and goods is determined in the private sector, and the government does nothing to interfere with any market. Instead, this system relies on the belief that a market system naturally leads to efficient results (called the “invisible hand”) that theoretically correct any inequalities in resource allocation. The United States is very market oriented, but it is not a purely capitalistic system. In a market system, it is easy to open a new business. Customer tastes drive which goods and services will be produced. There is a high level of competition in a market system. Competition incentivizes firms to lower prices, increase quality, and/or use resources more efficiently.

2. Command: A command economy is the opposite of a market economy. In this case, the government commands all markets, determining what to produce, how to produce, and for whom to produce. Centralized planning committees take into account all the resources a nation has to offer (labor, land, and capital) and then set up an economic system to produce this predetermined mixture of goods and services. Since the government is in charge of everything, citizens should all receive equal amounts of basic goods and services. In theory, this means that there should be no problems with high unemployment or poverty. In a command economy, the government is meant to provide for the welfare of its citizens. Because the government makes all economic decisions, there is little opportunity or reward to pursue individual economic success. There is little to no competition among individual firms so there is little incentive to innovate, increase quality, or lower prices.

3. Mixed: While the command and market economy describe theoretical concepts of how an economy might function, in the real world most economies blend two or more systems together. For instance, while China is considered a command economy, it has rapidly begun to incorporate many aspects of a market structure into its economy. Likewise, while the United States is considered to have one of the most capitalistic economies in the world, the government still intervenes in some markets. Therefore, there is a third economic system known as a mixed economy. Individuals, firms, and the government all have the right to own property. Laws determine how disputes about property are resolved. Entrepreneurs can freely start businesses. Businesses produce goods that consumers want. Competition is encouraged in a mixed economy, unless there is a compelling reason to allow a monopoly. Businesses have to follow laws set by the government and may be required to acquire licenses and to complete other government paperwork before opening.

4. Traditional: In a traditional economy, economic decisions are made based on history and tradition. The goods and services provided by people are most likely the same goods and services their ancestors provided to people. Production and distribution of goods and services are based on how past generations made and distributed goods. The consumer will have little control in what is produced. Even as consumer preferences change or as new producers enter the market, the economy will continue to operate in the same manner as it has in the past. Traditional leaders, like councils of elders or tribal chiefs, will most likely resolve business disputes between members of the community. Their decisions will be based on how these disputes were solved in the past.

There are many different ways economic systems can allocate scarce resources. The following describes some ways to allocate these resources:

- **Price:** allows the forces of supply and demand to determine market price of goods, services, and factors of production.
- **Majority rule:** occurs when a group of people who have control over a good, service, or factor of production vote to decide how the good, service, or factor of production will be distributed.
- **Contests:** an allocation strategy where the “winner” gets the good, service, or factor of production.
- **Force:** giving or taking away productive resources by using threats.
- **Sharing:** the owner of the good, service, or factor of production determines who and how to distribute them.
- **Lottery:** also known as random selection. A lottery gives everyone who wants a good, service, or factor of production equal odds of achieving it.
- **Authority:** when the decisions about who gets to obtain a good, a service, or a factor of production are made by the person or group in power.
- **First-come-first-served:** an allocation strategy that allows people to receive a good, service, or factor of production if they get there first or are one of the people close enough to the front of the line to receive the good, service, or factor of production before they are all gone.
- **Personal characteristics:** an allocation strategy that allows resources to be distributed based on a need or merit. Ideally the person who gets the good, service, or factor of production will be the one who puts it to the best use. (SSEF4c)