


Third Canadian Edition
MACROECONOMICS



**Chapter 2:
 The Economic
 Organization of
 Society**

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Introduction

- An economic system has to solve three coordination problems:
 - What, and how much, to produce.
 - How to produce it.
 - For whom to produce it.
- Every economy faces these problems.

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Introduction

- Sometimes the goals of society and individuals conflict.
 - An example is the NIMBY (Not In My Back Yard) phenomenon.
 - **NIMBY** is a mindset in which individuals approve of a project so long as it is placed somewhere else.

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Introduction

- An economic system must provide the incentives to do those things that alleviate scarcity—produce more and consume less.
- The two main economic systems of the past 50 years, capitalism and socialism, answer these immense coordination problems differently.

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Capitalism

- **Capitalism** is an economic system based upon private property and the market in which, in principle, individuals decide how, what, and for whom to produce.

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Under Capitalism:

- Individuals are encouraged to follow their own self-interest, while market forces of supply and demand are relied upon to coordinate those individual pursuits.
- Distribution of goods is to each according to his or her ability, effort, or inherited property.

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Under Capitalism:

- Government must allocate and defend private property rights.
- **Private property rights** – the control a private individual or firm has over an asset or a right.

Reliance on the Market

- Markets work through a system of rewards and payments.
- In capitalism individuals are encouraged to follow their own self-interest.
- Prices coordinate individuals' wants.

What's Good About the Market?

- Most economists believe the market is a good way to coordinate individuals' needs.
- The market is, however, not fair nor is it always efficient.

What's Good About the Market?

- The primary debate among economists is about how markets should be structured, and whether they should be modified and adjusted by government regulation.

Socialism in Theory

- Socialism is, in theory, an economic system based on individuals' good will toward others, not on their own self-interest.
- In principle, society decides what, how, and for whom to produce.
- Everyone contributes what they can and get what they need, provided it is available.

Socialism in Theory

- If individuals' inherent goodness will not make them consider the general good, government will force them.

Socialism in Practice

- Socialism in practice is often called Soviet-style socialism.
- **Soviet-style socialism** is an economic system that uses administrative control or central planning to solve the coordination problems what, how, and for whom.

Production Possibilities Model

- The production possibilities curve shows the trade-offs among choices we make.

Production Possibility Table

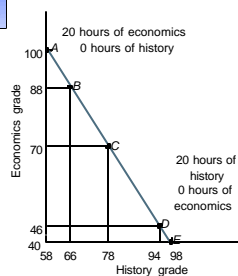
- A **production possibility table** lists the combinations of outputs (products) that can be obtained from a given number of inputs (resources).
- **Output** – simply a result of an activity.
- **Input** – an what you what you put into a production process to achieve an output.

Production Possibility Curve

- A **production possibility curve** shows the maximum combination of outputs that can be achieved from a given number of inputs.
- It slopes downward from left to right.

Production Possibility Curve

Hours of study in history	Grade in history	Hours of study in economics	Grade in economics
20	98	0	40
19	96	1	43
18	94	2	46
17	92	3	49
16	90	4	52
15	88	5	55
14	86	6	58
13	84	7	61
12	82	8	64
11	80	9	67
10	78	10	70
9	76	11	73
8	74	12	76
7	72	13	79
6	70	14	82
5	68	15	85
4	66	16	88
3	64	17	91
2	62	18	94
1	60	19	97
0	58	20	100



Production Possibility Curve

- The production possibility curve not only represents the opportunity cost concept, it also measures the opportunity cost.

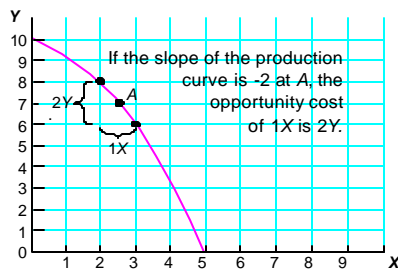
Production Possibility Curve

- The production possibility curve demonstrates that:
 - There is a limit to what you can achieve, given the existing institutions, resources, and technology.
 - Every choice made has an opportunity cost—you can get more of something only by giving up something else.

Increasing Marginal Opportunity Cost

- The production possibility curve is generally bowed outward since some resources are better suited for the production of some goods.

Increasing Marginal Opportunity Cost



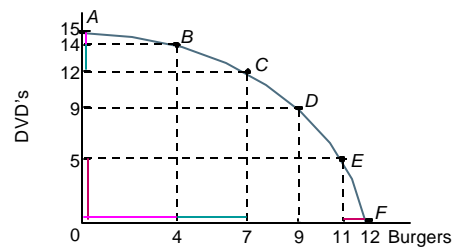
Increasing Marginal Opportunity Cost

- **Comparative advantage** explains why opportunity costs increase as the consumption of a good increases.
 - Some resources are better suited for the production of some goods than to the production of other goods.

Production Possibilities Table

% of resources devoted to production of burgers	Number of burgers	% of resources devoted to production of DVD's	Numbers of DVD's	Row
0	0	100	15	A
20	4	80	14	B
40	7	60	12	C
60	9	40	9	D
80	11	20	5	E
100	12	0	0	F

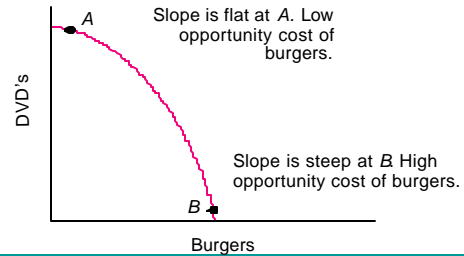
Production Possibilities Curve



Increasing Marginal Opportunity Cost

- The **principle of increasing marginal opportunity cost** states that opportunity costs increase the more you concentrate on an activity.
- In order to get more of something, one must give up ever-increasing quantities of something else.

Increasing Marginal Opportunity Cost



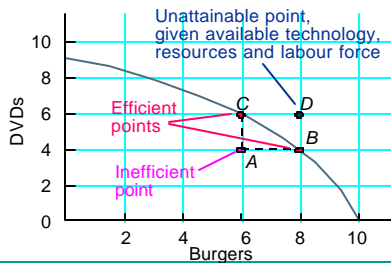
Efficiency

- In production, we'd like to have **productive efficiency**— achieving as much output as possible from a given amount of inputs or resources.
- Any point within the PPC represents **inefficiency**— getting less output from inputs which, if devoted to some other activity, would produce more output.

Efficiency

- Any point outside the production possibility curve represents something unattainable, given present resources and technology.

Efficiency and Inefficiency



Shifts in the Production Possibility Curve

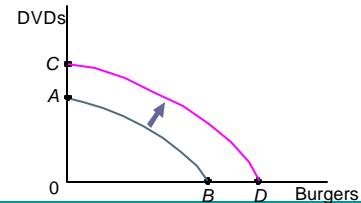
- Society can produce more output if:
 - Technology is improved.
 - More resources are discovered.
 - Economic institutions get better at fulfilling our wants.

Shifts in the Production Possibility Curve

- More output is represented by an outward shift in the production possibility curve.

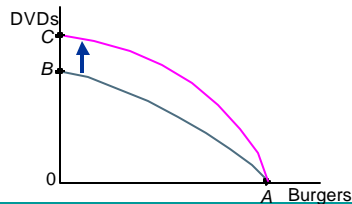
Shifts in the Production Possibility Curve

Neutral Technological Change



Shifts in the Production Possibility Curve

Biased Technological Change



Distribution and Production Efficiency

- The production possibilities curve focuses on productive efficiency and ignores distribution.
- In our society, more is generally preferred to less and many policies have relatively small distributional effects.

Production Possibility Curve and Economic Systems

- The production possibility curve presents choices in a timeless fashion but most choices are dependent on previous choices.

Production Possibility Curve and Tough Choices

- Politicians make promises as though the production possibility curve did not exist or that the economy can operate outside the economy's production possibility curve.
- Economists continually point out that seemingly free lunches often involve significant costs thus earning for themselves the nickname, the dismal science.

Comparative Advantage, Specialization, and Trade

- The production possibility curve is bowed because individuals specialize in the production of goods for which they have a comparative advantage and trade with others.

Comparative Advantage, Specialization, and Trade

- The comparative advantage argument used to explain the bowed-out shape of the production possibilities curve can be used to show how trade makes society better off.
- Collaboration and specialization can make society better off.
- Total production can rise.

Gains From Trade

- Sunder can either write one economics paper or four creative writing papers in a day.
- Ti can either write one creative writing paper or four economics papers in a day.
- Sunder has a comparative advantage in creating writing and Ti has a comparative advantage in economics.

Gains From Trade

- The following table and production possibility curves demonstrate how output increases when two individuals collaborate and specialize in the activity for which each has a comparative advantage.

Gains From Trade

Sunder's and Ti's Individual Possibilities		
	Economics papers per day	Creative writing papers per day
Sunder	1	4
Ti	4	1

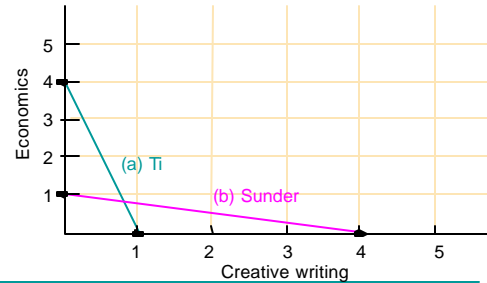
Gains From Trade

Sunder's and Ti's Joint Possibilities		
	Economics papers per day	Creative writing papers per day
A	5	0
B	4	4
C	0	5

Gains From Trade

- Each individual's PPC is drawn by connecting the number of papers each can write in a day on a graph.

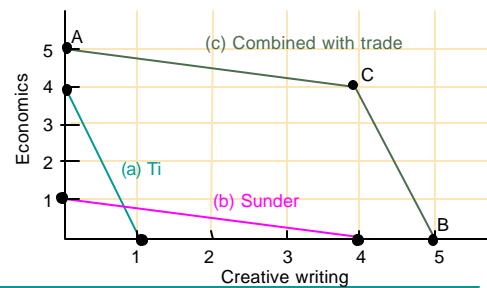
Gains From Trade



Gains From Trade

- The combined PPC curve is drawn by finding three points and connecting them.

Gains From Trade



Gains From Trade

- Point A:** This is the combined number of economics papers they both can write in a day.
- If economics papers are on the Y axis, it is point 0,5.

Gains From Trade

- Point B:** This is the combined number of creative papers they both can write in a day.
- If economics papers are on the Y axis, it is point 5,0.

Gains From Trade

- **Point C:** This is where each is focusing on that activity for which he or she has a comparative advantage.
- Sunder writes four creative papers and Ti writes four economics papers.
- This is the coordinate 4,4.

Division of Labour

- Markets allow specialization and the division of labour.
- They allow individuals to develop their comparative advantages, thereby increasing the production possibilities of society.

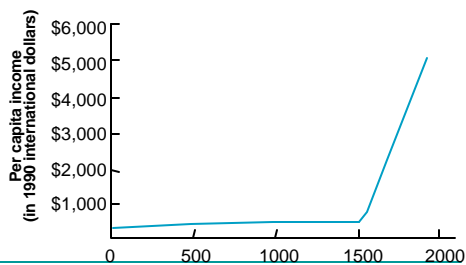
Markets, Specialization, and Growth

- Markets and specialization have led to growth.

Markets, Specialization, and Growth

- The growth in per capita income (constant 1990 dollars) in the past 2 millennia has been astonishing.
- As people are allowed to compete and specialize, they get better at what they do, develop new technologies and the market grows ever larger.

Growth in the Past Two Millennia



The Economic Organization Of Society

End of Chapter 2