

Econ-Hub **Rapid Revision** Classes

Intro to Econ & Basic Economic Concepts

BOOK [1]

Theory Recap Material [TRM]

2027 A/L Edition



Coverage

- ✓ Introductory Concepts
- ✓ Human Needs, Wants and Utility
- ✓ Intro to Types of Goods in economics

- ✓ Basic Economics Concepts
- ✓ Relative Scarcity of Resources
- ✓ Alternative Uses of Resources
- ✓ The Problem of Choice
- ✓ Opportunity Cost



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Introduction:

- Economics as a subject relates to the study of wealth, human behavior and dealing with the central problem of scarcity of resources.
- Economics is the science that deals with the key activities of production, exchange and consumption of various commodities and services within an economic system.
- The central focus of economics is on scarcity of resources and choices among their alternative uses, leading to the creation of opportunity cost.

Defining Economics [Scarcity based Definition]:

According to Prof. Lionel Robbins; **“Economics is the science that studies human behavior as a relationship between ends and scarce means which have alternative uses.”**

Economics in simple terms is a study of the ways in which people provide for their welfare or satisfaction.

‘Positive’ and ‘Normative’ Statements

- **Positive** economic statements are highly ‘objective’ nature statement, which can be tested: proven, corrected, or disproven, using the available actual evidence and logical thinking (i.e., using the scientific method).
- Positive economics or statements focus on explaining or answering questions such as ‘what was’ (the past), ‘what is’ (the present) or ‘what might be’ (the future).
- All the main **theories** and **laws** in economics are **based on positive economic statements**. They are used in economic to point out the relationship between variables and to explain certain events, based on **empirical evidence** (observation of actual evidence)
- **Normative** economic statements are highly ‘subjective’ nature statements, which are based on an opinion and generally have value judgements.
- Normative statements involve the opinions: ethics, believes, values and norms of the person or institution making the statement.
- These statements tend to suggest what ‘should’ be done or how the economy should be. Normative statements always have a personal value judgement or opinion (such as the word ‘should’) and will be more focused on economic policies.

In **application** [MCQ]:

<u>Positive [Common Words]</u>	Vs.	<u>Normative [Common Words]</u>
▪ Was or wasn't ▪ Has or Hasn't ▪ May or May not ▪ Shall or shall not		▪ Should or Shouldn't ▪ Good or Bad ▪ Right or Wrong ▪ Fair or Unfair

Examples:

Positive	Normative
High interest rates may encourage people to save more	People should save more OR Interest rate should be increased
A high tax on tobacco has discourage smoking	Smoking or tobacco should banned
Color coding of soft drinks based on sugar level has no impact on the demand for soft drinks	Government should introduce a system of color coding
Capital Punishment may help reduce drug related major crimes	Capital punishment should be introduced

‘Microeconomics’ and ‘Macroeconomics’

- **‘MICRO’ economics** is the branch of economics which studies the economic behavior of ‘individual decision-making units in an economic system such as consumers, labourers, resource or factor owners, business firms and government
- In microeconomics we study the inter-relationship between these units and determine the patterns of production and distribution of goods and services.
- **‘MACRO’ economics** is the branch of economics which studies the behaviour of the economy. Simply ‘big picture economics’
- In macroeconomics we very closely observe an economy’s structure, performance, and behavior of an ‘aggregate’ basis.
- This branch of economics focuses on concepts such as circular flow model, business cycle, national income, unemployment, inflation, and exchange rates

Also Noteworthy:

The branch of economics, level of analysis or point of view known as macroeconomics is a relatively new branch of economics, which became popular when an economist by the name of John Maynard Keynes published a book titled 'General Theory of Employment, Interest and Money'. Accordingly, J.M. Keynes is commonly known as the Father of Macroeconomics'.

Defining 'Human Needs'

In economics, human needs are defined as essential or necessary requirements to live one's life in a socially acceptable manner, as a human being.

Needs tend to be indispensable (cannot do without) and unless certain basic human needs are satisfied, humans cannot live or survive in society.

Salient features of human needs:

- (1) **Basic in nature**
 - Easy to identify (biological)
 - Can not be artificially created.
 - Common to all individuals and societies (universal in nature)
- (2) **Relatively limited in nature**
 - Limited to a small number of basic and other needs
 - Sufficient if fulfilled at a minimum level (socially acceptable level)

Types of Needs [Classifying Needs]:

[A] **Basic Needs and Other Needs**

Basic needs refer to the requirements which are essential to be fulfilled for the purpose of subsistence or survival. Examples may include food, clothes, shelter, and health.

Other needs refer to the psychological and social requirements, other than the basic needs. Examples may include needs such as communication, transportation, safety and security, self-esteem, respect, achieving life goals

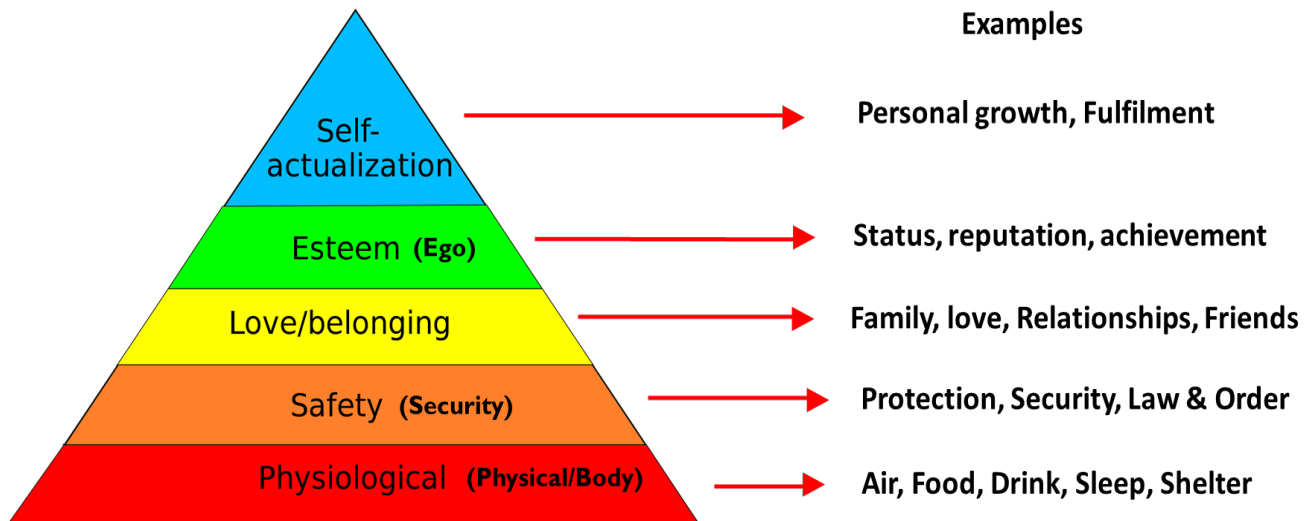
[B] **Material Needs and Psychological Needs**

Material Needs: Needs which are fulfilled using goods (and services)
E.g. Food, water, clothes, transport, education, shelter

Psychological Needs: Needs which cannot be effectively fulfilled using goods, and only through human relationships.
E.g. Security, respect, family, love and sex

[C] Maslow's Hierarchical Needs Model

Fulfilling human needs is a continuous process, since when one need is fulfilled, another need shall arise. This is because humans continuously look to improve our physical and social standard of life. These needs we attempt to satisfy one after the other, is outlined through the 'Maslow's Hierarchy of Needs Model', presented by Abraham Maslow



'Maslow's Hierarchy of Needs Model'

Defining 'Human Want'

In the study of economics, wants are defined as various or different means that people choose to fulfil their needs. Wants are considered as ways of expressing the needs.

[Source: P. Perera, 2020; p19]

The fulfillment of wants is optional. Human wants are derived (resulting) from human needs.

Also important: Needs are essential and wants are luxuries.

Salient features of human wants

[1] Unlimited in nature

- At a given point of time, there are many unattained (unsatisfied) human wants, when considering the society of any country as whole.
- When one want is fulfilled, immediately another want(s) is created, generally related to the formerly fulfilled want.

The main factors which influence wants to be unlimited:

- Inherent properties (birth, religious beliefs, family background)
- Physical and material needs.
- Social environment
- Advertising, new technologies and innovations

[2] Diversity of wants (Complexity of wants)

- Human wants tend to change from person to person, as well as society to society, with respect to the same need.
- Such complicating, diversity of wants is influenced by disparities: geographic, demographic (personal), cultural values, religion, political ideologies, and personal preferences.

[3] Wants can be created through advertising (wants are impulsive)

[4] Wants are competitive and have alternatives.

[5] Wants are inherent (non-biological) and become habits.

[6] Present wants are more important than future wants.

Human Needs Vs. Wants [Difference & Link]:

- Human needs are limited but human wants are unlimited.
- Human needs are basic, while human wants are diverse and complex.
- In economics needs are essentials, while human wants tend to be luxuries (optional)
- Unlimited human wants to reflect different means of satisfying limited human needs (Human needs derive wants).



Also Relevant [1]:

- Human needs derive wants and wants can only be satisfied through the consumption of goods and services. The process of satisfying human wants by using or consuming goods and services, derives utility.
 - **Law of Diminishing Marginal Utility:** where the additional or marginal utility received by consuming an increased number of the same product by one unit at a time on continuous basis tends to gradually decrease or diminish.
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Basic types of Goods in Economics:

Distinguishing between a 'good' and a 'bad'

A good is anything which can directly or indirectly provide satisfaction of a human want. Essentially, goods create utility or positive utility to its user.

A bad is a commodity or product (or anything) which creates a disutility (negative utility) or dissatisfaction for its consumer. Accordingly, a bad has a negative demand at zero price.

Examples: garbage, snow, pollution, wild weeds, passive smoking

Goods (and commodities) are tangible, services are intangible, and goods are used in providing a service. The word good or product is most of the time used as a common word which included services as well. In economics goods are categorized into two main types namely, Economic and Non-economic (Free) goods.

Distinguishing between Economic Goods & Free Goods

An economic good is a good (or service) with the ability fulfil a human want, which is a direct outcome of a production process, which uses 'limited resources' with alternative uses.

Due to the use of scarce resources the supply (or availability) of economic goods is limited, and the production of economic goods shall result in creating an 'Opportunity Cost'.

Main Properties of Economic Goods:

- Production of economic goods use limited resources
- Supply of economic goods are limited
- There is an opportunity cost, a price and a positive marginal cost
- There is ownership

Free Goods [Non-economic Goods]:

Free or non-economic goods are goods which are unlimited in supply at zero price, with the ability to fulfil a human want. Since the creation of free goods does not involve the use of scarce resources, the use of free goods has zero opportunity cost.

Non-economic goods are known as free goods because they are freely available in nature when the supply is present. The consumption of a free good by one person, will not reduce the amount of the good available for others.

Examples: Air (fresh air or oxygen), rainwater and sunlight

Main Properties of Free Goods:

- There is zero opportunity cost, no price and a marginal cost is zero
- Supply of free goods are unlimited, and is determined by nature
- Free goods use abundant (limitless) factors and there is no commercial value
- There is no ownership

[Source: P. Perera, 2020; p26]

Also Noteworthy:

Economic goods will not become non-economic goods under any circumstance, but free or non-economic goods can become economic goods in certain situations [bottled **water**, **oxygen** used by diver or provided to a patient...]

Also, Relevant [2]:



Types of Economic Goods

[A] Gross Domestic Product (GDP) Composition

[A1] Based on Output Source [Industry Origin]:

- **Agricultural** (Agro) Sector Output/Product
[Agriculture, forestry and fishing]
- **Industrial** Sector Output/Product
[Mining, Manufacturing, Electricity, Water, Construction...]
- **Service** Sector Output/Product
[Trade, Banking, Finance, Insurance, Communication, Tourism, Transportation.....]

[A2] Based on Usage:

- **Consumer Goods**
[Goods used for final personal consumption]
- **Capital Goods**
[Goods used to produce other goods]
 - Fixed Capital [e.g. buildings, machinery, equipment, vehicles ...]
 - Circulation Capital [e.g., raw materials, work in progress, inventory.]

[B] Based on Social Cost and Benefits

[B1] Merit Goods:

An economic good, which tends to create an external benefit or positive externality of consumption [benefits the broader society, in addition to the consumer of the product]. **E.g. Health, Education...**

[B2] Demerit Goods:

An economic good which tends to create an external cost or negative externality of consumption [Burdens the broader society, beyond the benefit to the consumer of the product]. **E.g., Alcohol, Tobacco, Gambling....**

[C] Based on Excludability and Rivalry in Consumption

[C1] Private Goods:

Goods which are 'Rival in Consumption' and 'Excludable'. E.g., Mobile phones, pens, computers, education, medicine....

[C2] Public Goods:

Goods which are 'Non rival in Consumption' and 'Non-excludable'. E.g., Streetlights, National defence, flood protection etc.

Distinguishing 'Capital Goods' & 'Consumer Goods'

Capital goods refer to goods used to produce other goods and services. Consumer goods refers to goods which are not used to produce other goods and services instead for final use of consumption.

Capital goods are produced and are used in the process of producing consumer goods. Capital goods tend to be durable assets, while consumer goods can be both durable and nondurable.

The capital or consumer nature of a good essentially depends on the usage of the good, thus a certain good can be both a capital and consumer good.

Pure Public Goods & Free (Non-economic) goods:

Non-economic or free goods are created without any human effort or not because of a production process, while produced, public goods are a result of a production process which uses limited resources (economic resources).

The production of a public good involves an opportunity cost, while both a free good and a public good have zero marginal opportunity cost. There is no cost incurred to provide an additional unit of a non-economic good a public good.



The Problem of 'Relative Scarcity'

Scarcity in economics is the limitedness or insufficiency of the available stock of productive resources in comparison or relative to the unlimited human wants of a given society.

Relative scarcity is a central or fundamental problem in economics, and it is a universal economic problem or concept.

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- ✓ The key term in defining scarcity in economics is 'Wants' (unlimited wants), i.e. whether or not a given endowment of resources creates scarcity, depends on the level of wants, we attempt to fulfil (by producing goods and services), using such resources. Therefore, scarcity is a relative concept.
 - ✓ Scarcity is a problem common to all societies (scarcity is universal). Scarcity is a result of two characteristics, which essentially exist with in all human societies:
 - The human wants within a given society being unlimited at a given point of time.
 - The stock of productive resources held by a society, which can be used to produce goods and services to satisfy said wants to be limited or inadequate, at a given point of time.
-

The Principal Features of Scarcity

- Scarcity is a relative concept (i.e., relative scarcity)
- Scarcity is a problem (or phenomenon) common all societies and individuals' (i.e., universal concept)
- All individuals do not face the problem of scarcity in the same degree or intensity.
- Different economic agents, face different types of economic problems which are created due to relative scarcity.

Key 'Conceptual' Differences

[Let's avoid some common confusions about scarcity]

- **Scarcity and Shortage:**

Scarcity is not a situation of a temporary market shortage (i.e. scarcity is not a temporary shortage or disequilibrium in a market, created by quantity demanded for a product being above available quantity supplied).

- **Scarcity and Poverty:**

Scarcity is conceptually different from poverty (i.e. being poor: inability satisfy basic human needs). Relative scarcity is a problem faced by the rich and the poor at different degrees.

- **Scarcity and Inefficiency (Efficiency):**

Scarcity and efficiency are also conceptually different. Scarcity is a problem connected with unlimited human wants compared to limited stock of resources, while it is not a problem created due to inefficiency. It is important that all economies' make efficient use of its scarce resources.



Also Relevant [4]:

‘Alternative Uses of Resources’

- ✓ A given factor of production or a combination of resources (land, labour, capital, and entrepreneurship efforts), can be used to produce multiple or a range of different goods and services (can be used for more than one purpose).
- ✓ This is a characteristic common to many factors of production.
- ✓ It is noteworthy; the problem of unavoidable choice arises not just because of the scarceness resources, but also since such scarce resources have alternative uses.

The ‘Problem of Choice’

A choice in economics broadly refers to a decision every society has to make, in the process of satisfying unlimited human wants using relatively limited resources with alternative uses.

Economics is known as a ‘Science of Choice’, since choice is unavoidable for all individuals and societies. A problem of choice is created due to two main reasons (i.e., why choice becomes unavoidable).

- Relative scarcity resources held by a society at a given point of time.
- The alternative uses presented by such resources

All economic systems in the world are designed to make choices (decisions) and find solutions to three basic problems

- 1) What to produce? in what quantity? [Allocation Problem]
- 2) How to produce ? [Production Problem]
- 3) Whom to produce? [Distribution Problem]

The Problem of ‘Opportunity Cost’

The opportunity cost is the value of the next best alternative sacrificed when a choice must be made among alternative choices, in terms of a production or consumption activity.

Opportunity cost is a highly subjective and real concept. Cost in economics is opportunity cost and, in some situations, may include external cost.

Alternatively:

- Opportunity cost is the value of the next best alternative choice that could have been made instead of the actual choice made.
- Opportunity cost is the value of the next best alternative foregone when an item or alternative is chosen.

Principal Features of Opportunity Cost:

- Opportunity cost is Subjective [i.e., only the individual making the decision can estimate the expected value of the next best alternative forgone by him or her].
- Opportunity cost in economics is a Real Concept
 - ✓ Opportunity cost is measured and expressed in goods or materials, and not in monetary terms. Therefore, it is called real cost to distinguish it from money cost.
 - ✓ Real cost in terms of goods or materials foregone and known as economic or actual cost.
- Opportunity cost is not only limited to the person who makes decisions (instigators), in some situations the decision made by one person has an impact (for better or worse) on others (persons external to the decision maker). These impacts are known as externalities, especially external costs.

Further Features

- Opportunity cost normally involves giving up some positive amount of one commodity to get more of another. Therefore, we describe this cost as being positive.
- Cost in economics is opportunity cost. Cost in economics should always include both monetary cost and foregone income.
- Goods that generate an opportunity cost are known as “Economic goods”.
- There are few specific and exceptions where the opportunity cost becomes zero.

Situations of ‘Zero Opportunity Cost’

- 1) Use of free or Noneconomic Goods or Resources
- 2) Use of Single use factors or capital goods
- 3) Use of unemployed resources within the production (the presence of General Unemployment)

- 1) Opportunity cost is zero when making a choice with regards to **free goods** or **non-economic resources**. The process of using free goods shall result in zero opportunity cost, since the use of a free good doesn't represent a foregone benefit.
- 2) In the use of '**single use factors** or **capital goods**. Such factors do not represent any other practical alternative use. Therefore, a choice is not required and opportunity cost will not be created.

Ex: A bridge, power station, a ship anchor

- 3) In situations where all resources used to produce a certain product was unemployed (such a situation is known as '**General unemployment**'). The use of unemployed resources will not create opportunity cost, since there will not be any foregone benefit.



Also, Relevant [5]:

Principal Economic Agents

[A] Household Units [HH]

- Small family units, making collective consumption decisions
- Economic role: Factor Owners, Consumers and generating household or personal savings.
- Principal objective: Maximizing Satisfaction (maximizing self-interest/high quality of life)

[B] Business Units or Production Firms [F]

- Individuals and collectives, producing goods and services targeting the market.
- Economic role: Investing/provide entrepreneurship, produce goods and services, generates business savings.
- Principal objective: Maximizing Profits

[C] General Government [GG]

- The legislative, judiciary and executive branches, working together in governing the Sri Lanka economy or society.
- Economic role: allocative, regulative, stabilizing and redistribution.
- Principal objective: Maximizing Social Welfare/Benefit

[D] International Trade Sector or Rest of the World [ROW]

- Consists of trade flows, foreign investments, foreign loans, grants
- Trade flows: Exports [Money inflow, real outflow] and Imports [Money outflow, real inflow]
- Essentially uses a Foreign Exchange Rate

Key Economic Activities

[A] Production

- The process of converting inputs to output (product), using a specific technical methodology.
- Production results in a 'Value Addition'
- Alternatively: Production is the process of extracting /deriving the productivity within production factors and generating a product.

[B] Exchange

- The process of transacting; buying and selling goods, services, and factors of production, within different markets.
- Market: an institutional mechanism which creates a relationship between buyers and sellers for the purpose of exchange.
- Monetary system/transactions: using money as a medium of exchange

[C] Consumption

- The process of using goods and services to fulfil human wants, in turn human needs
- Alternatively: consumption is the process of extracting/deriving the utility within products and generating satisfaction
- The amount of money allocated /spent on consumption by an individual depends on his or her income and general price of goods and services

Making Rational Choices [Trade-offs]

The concept of rational choice refers to a process of making economic decisions which **maximize** a given **decision maker's benefits** or **returns** and **minimize** the **opportunity cost** with regards to the decision.

The concept of rational choice becomes highly important in the process of consumption or production decision making, mainly because each unavoidable economic choice involves relatively scarce resources with alternative uses. Therefore, making rational choices shall **optimize the benefits (welfare)** of a given **society's limited economic resources**.

Also relevant: '**Cost Benefit Analysis**', a fundamental approach used in economic decision making, to ensure rationality in resource allocation.

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