

AAE101: Intro to Ag. & Applied Econ.

Discussion Section 2

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Today's goal

1. Review last part of chapter 1: The individual's economizing problem; the production possibilities model.
2. Review chapter 2: Economic systems.

Individual's Economizing Problem

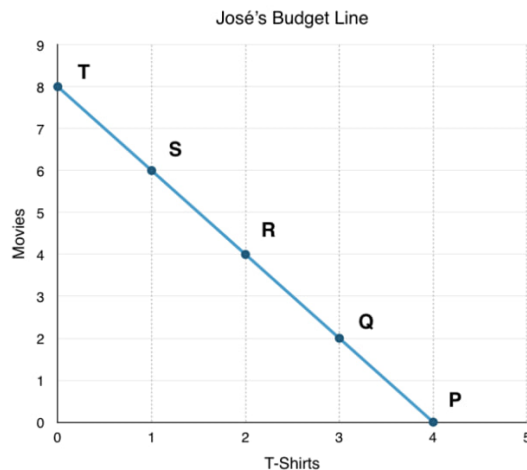
Budget line: It is a schedule or curve that shows various combinations of *two* products a consumer can purchase with a specific money income.

Opportunity costs and the budget line: The budget line illustrates the idea of trade-offs arising from limited income. In order to obtain more of one good, you have to give up some quantity of the other good.

*This handout is based on the corresponding handouts from previous years by Felipe Parra Escobar, Matt McKetty & Talita Silva. Modifications and additions in this version by Erick.

Attainable and unattainable combinations, opportunity costs, choice and income changes.

Let's assume that Jose has a budget of \$56. T-shirts cost \$14, and movies cost \$7. Then, the opportunity cost of an additional t-shirt is 2 movies. The linearity of the budget line reveals to us that there is a constant opportunity cost.



Source: *Principles of Microeconomics*

In the figure, we can see that all the combinations to the left (or below) the line are attainable and those to the right (or above) are unattainable. Note that if Jose's budget increased, he would be able to buy more goods.

Production Possibilities Model

Production Possibilities Curve: Displays the different combinations of goods and services that a society can produce in a fully employed economy, assuming a fixed availability of supplies of resources and fixed technology.

Law of increasing opportunity costs: As the production of a particular good increases, the opportunity cost of producing an additional unit rises.

Here is a production possibilities curve.

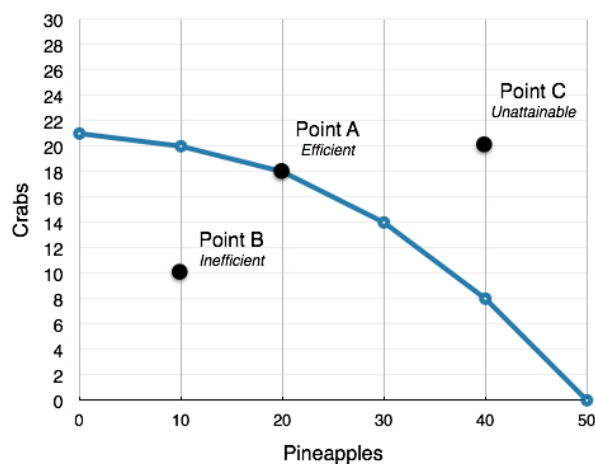


Figure 2.2b

Source: *Principles of Microeconomics*

Economic Systems

Laissez-Faire (or pure) Capitalism: The government's role is limited to protecting private property and establishing a legal environment in which contracts can be enforced and people can interact in markets to buy and sell goods.

Command System: In this system, the government owns most property resources and economic decision making is set by a central economic plan created and enforced by the government.

Market System: It is a mixture of central government economic initiatives and decentralized actions taken by individuals and firms. In the market system, self-interest is the driving force of such an economy and competition functions as a regulatory or control mechanism. Specialization, use of advanced technology, and the extensive use of capital goods are common features of the market system. Money works as a medium of exchange and eliminates the problems of bartering and permits easy trade.

Practice Questions

1. Suppose that you are on a desert island and possess exactly 20 coconuts. Your neighbor, Friday, is a fisherman, and he is willing to trade 2 fish for every 1 coconut that you are willing to give him. Another neighbor, Kwame, is also a fisherman, and he is willing to trade 3 fish for every 1 coconut.
 - (a) On a single figure, draw budget lines for trading with Friday and for trading with Kwame. (Put coconuts on the vertical axis.)
 - (b) What is the slope of the budget line from trading with Friday?
 - (c) What is the slope of the budget line from trading with Kwame?
 - (d) Which budget line features a larger set of attainable combinations of coconuts and fish?
 - (e) If you are going to trade coconuts for fish, would you rather trade with Friday or Kwame? Why?
2. Contrast how a market system and a command economy try to cope with economic scarcity.
3. Write the concept that corresponds to each definition.
 - (a) An institution that brings buyers and sellers together.
 - (b) The right of private persons and firms to obtain, control, employ, dispose of, and bequeath land, capital, and other property.
 - (c) The presence in a market of independent buyers and sellers who compete with one another and who are free to enter and exit the market as they each see fit.
 - (d) The freedom of firms to obtain economic resources, decide what products to produce with those resources, and sell those products in markets of their choice.
 - (e) What each individual or firm believes is best for itself and seeks to obtain.
 - (f) Economic transactions willingly undertaken by both the buyer and the seller because each feels that the transaction will make him or her better off.
 - (g) The freedom of resource owners to dispose of their resources as they think best; of workers to enter any line of work for which they are qualified; and of consumers to spend their incomes in whatever way they feel is most appropriate.

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