Basic Uses of Economics

Economics is a broad social science that studies how humans interact and divide resources to meet their needs. Many economic concepts are abstract and cannot be easily applied to real life situations, but some basic economic principles can be employed to help guide simple strategic decisions.

Opportunity Cost

Opportunity cost is one of the most basic concepts in economics. An opportunity cost is the cost associated with not doing an alternative to whatever course you decide to pursue. For instance, you might have a free Friday night and have the option to go out to a movie. If you decide to see the move, your opportunity cost is the lost utility (or happiness) that you could have gained from doing something else, such as performing chores around the house or going to a sporting event. Considering opportunity costs can help people make more informed decisions that lead to greater happiness. Opportunity costs are also important in financial decisions--for example if you decide to buy a new home and have to put down a large down payment, you suffer the opportunity cost of not being able to earn interest on the down payment capital in a savings account or a different investment. A cost benefit analysis is a basic economic tool that involves comparing all the costs--including opportunity costs--of choosing competing actions. Such an analysis can be useful in deciding almost anything from complex things such as buying a house versus renting to simple ones like deciding what to do with free time.

Supply and Demand

Another fundamental concept of economics that can be readily applied to many everyday situations is supply and demand. The basic law of supply and demand states that as the supply of a good increases, the price will fall; as the good becomes more scarce, the price will increase. On the other hand, when demand for a good increases, the price will rise, while lower demand leads to lower prices. Understanding supply and demand can help both consumers and sellers to put a price value on different products. For instance, if you want to sell a video game console on Ebay, it is a good idea to research the demand for the system before setting a price. Brand new consoles tend to have very high demand which can push prices up very high, while older consoles have lower demand so it might not sell if the price you set is too high.

Game Theory

Game theory is a branch of economics that studies strategic interactions between two or more different parties. The purpose of game theory is to determine the best decisions possible based on what other people are likely to do. Failing to consider how the decisions of others might affect you can lead you to poor decisions. For instance, you might decide to see a movie on opening night, but if you don't consider the popularity of the movie and that other people might choose to arrive early, you might not get a ticket. On the other hand, if you arrive too early, you'll end up wasting time waiting for the movie to start. Considering your best options based on the best options of others can lead to better decisions.

Guide to Economics

Understanding basic economic principles can help you understand the ways in which the world works. Money, goods and services are crucial to our everyday lives, and economics helps us understand the distribution of these scarce goods. Studying economics can lead to career options in business, law, government and education. Economics also teaches an analytical way of thinking that can help people weigh costs and benefits in any situation. Some fundamental economic principles include scarcity, opportunity cost, supply and demand, comparative advantage, trade and trade barriers.

Scarcity And Opportunity Cost

Scarcity is a fundamental concept underlying economic thought. According to the idea of scarcity, resources are scarce. People do not have as much money or time as they would like, and there are not enough goods, services and natural resources for everyone to have as much as they would like. This scarcity forces choices and trade-offs, which leads to the notion of opportunity cost. Opportunity cost is the cost of what must be given up to make a decision. For example, the opportunity cost of going to the movies is not only the price of your ticket, but also the value of what you could have been doing, such as spending the afternoon with friends, reading a book or working.

Supply And Demand

The price of a good or service in a market is influenced by supply and demand for that good. This can be represented on a graph in which the Y-axis represents price and the X-axis represents quantity of goods. The

intersection of the supply and demand curves represents the equilibrium price, or the market price. Shifts in demand or supply--for example, if consumer preferences change, technology increases the amount produced or goods become scarcer--shift the equilibrium price. These shifts are intuitive. For example, if a good becomes abundant (an increase in supply) the price falls, and if it becomes more rare (decrease in supply) the price rises.

Comparative Advantage And Trade

According to the principle of comparative advantage, people and nations will gain if they specialize in producing their comparative advantage and then trade. Comparative advantage is less intuitive than many economic principles, but it is essential to understanding economics. Even if one person or group has an absolute advantage in producing two goods--they can produce both at a lower cost--they can gain by producing what they produce most efficiently, and then trading that good for the other good. Comparative advantage relies on the notion of opportunity cost: the cost of producing a good is lower for different people or nations.

Trade Barriers: Tariffs And Quotas

According to comparative advantage, trade benefits everyone. However, trade does not benefit everyone equally, which is part of the reason why countries often distort free trade with trade barriers, which include tariffs and quotas. Tariffs are essentially taxes on imported goods, which raises their market price and decreases demand, increasing demand for domestically produced goods.

Quotas are limits on the number of a good that a country can import. Since demand generally outstrips quotas, domestic firms benefit. Although tariffs and quotas can help domestic firms, they ultimately cause greater harm to consumers through increased prices.