

Economics ClassNotes

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Key Terms

1. **Goods:** Materials that satisfy human wants or needs
2. **Services:** Non-material goods
3. **Needs:** [Goods and services \(G&S\)](#) that all humans must have for survival
4. **Wants:** Desires that people have for a good or service - not needed for survival
5. **Limited:** A certain amount of something available
6. **Unlimited:** Never ending amounts

7. Renewable: Resources that can be replaced as they are used to produce G&S
8. Non-renewable: Resources that cannot be replaced by natural means quick enough
9. * **Economic goods**: Goods that are scarce relative to the demand for the good
10. * **Free good**: Resources supplied at zero cost - more than enough for everything
11. **Public Sector**: All levels of government and government-controlled enterprises
12. **Private Sector**: Run by individuals and companies for profit and is not state controlled

The Basic Economic Problem

- **Limited resources to satisfy unlimited wants and needs**
- The problem of **SCARCITY**
- Can **NEVER** be solved
- Countries' questions because of scarcity
 - How
 - What
 - For Whom

Resource Allocation

- Involves deciding how best to use scarce resources to satisfy as many needs and wants as possible

Opportunity Cost

- Opportunity cost is the **cost of choice**, the cost of something is what you must give up to get the alternative.
- It is the benefit we could have enjoyed from the next best alternative we choose to go without.

Production Possibilities Curve (PPC)

A model that shows the maximum possible output for two goods or services with a given amount of resources

PPC demonstrates:

1. Opportunity cost
2. Unattainable
3. Inefficiency

- **Productive Efficiency:** anywhere on the PPC
- **Allocative Efficiency:** movement through the line

PPC changes in resource quality and quantity.

Demand and Unemployment does not shift the PPC !

Economic System

Market system: refers to the method of **allocating scarce resources** through the market forces of **supply and demand**

1. * Market Economy

- Private sector: firms and consumers make all decisions
- Price decided by **price mechanism**
 - Freedom to set up business anywhere
 - No Government intervention
 - Little or no taxation or public spending
 - **Advantages**
 - Wide variety of G & S
 - Firms respond quickly to changes in consumer wants and spending patterns
 - Profit motive encourages firms to develop new products
 - No taxes
 - **Disadvantages**
 - **Market Failure:** when free markets fail to produce worthy G & S or decisions have external costs to someone
 - When a free market allocates resources inefficiently and inadequately
 - Firms only produce profitable G & S
 - Ignore external costs (Harmful effects)
 - Income and wealth inequalities
 - Production is geared to meet the needs and wants of the wealthy
 - Wasteful competition
 - Competitive pressures can mean that firms use up unnecessary resources

2. Mixed Economy

- Private sector firms and consumers, and a government
 - Ownership of scarce resources are shared by both
- The price mechanism and government planning decide what to produce
- **Advantages**
 - Can provide essential G & S in the greatest need
 - Can reduce the production of harmful goods and dangerous activities
 - Can employ people in public sector organizations and provide financial support to private

sector firms to boost output and employment

- Can reduce business practices that restrict competition or mislead consumers
- Best of both the planned and market economic systems
- Disadvantages
 - Consumers still pay higher prices due to the profit motive of private sector businesses
 - Public sector activities must also be funded by taxes and other government fees

3. Plan Economy

- Public sector: Government
 - Few private businesses & choices
 - Government decides what people want
 - No competition = poor quality
- Government decides the allocation of resources
- Disadvantages of government intervention
 - High taxes can distort market price signals and reduce work incentives
 - Increase production costs
 - May produce poor-quality G & S
 - Spending may be political or even personal gain

- **Production Inefficiency**
- **Allocative Inefficiency**

These two inefficiencies lead to the proposal of the mixed economy system.

The Three Questions

1. **What to produce**
2. **For whom to produce**
3. **How to produce**

Demand

Prices do not shift the demand line !

- **Effective Demand** is the different quantities of goods that consumers are **willing** and **able** to buy **at a given price in a given period of time**
 - **Demand Schedule** is a table that shows how much of a good to service consumers are **willing** and **able** to buy at different prices
 - A **demand curve** is a graphical representation of the demand schedule, it shows the relationship between quantity demanded and price
- **Law of Demand:** There is an **INVERSE** relationship between price and quantity demanded
 - The higher the price, the smaller the quantity demanded
 - The demand curve is downward sloping
- **Market demand** is the total demand for a product, which is the aggregate (sum) of individual demand to arrive at a total amount

Movement along the demand curve (Price)

- **Extension in demand & Contraction in demand**
 - Extension - Increase in quantity demanded
 - Contraction - Decrease in quantity demanded
- Movement along the line
- Quantity demanded & Price
- Ceteris Paribus

Determinants of the demand curve (Non - price / Shifters)

Prices do not shift the demand line !

- A shift means that at the same prices, more people are willing and able to purchase that good.
- A change in demand, not a change in quantity demanded !
- **6 determinants of demand**
 1. Tastes and Preferences
 2. Number of Consumers
 3. Price of Related Goods
 1. Substitutes
 - The demand of its substituents increase as the price of the good increases
 2. Complements
 - A higher price in complements led to a decrease in demand for the good
 4. Income
 5. Future Expectation
 - Expectation in the future that the price will increase/decrease
 6. Advertising
- Types of goods
 - Normal goods: As income rises the demand for this good rises
 - Inferior goods: As income rises the demand for this good decreases
 - Canned food -> Fresh food
 - 2nd hand clothing -> new clothing

Supply

- Different quantities of good that sellers are willing and able to sell (produce) at different prices

Law of Supply

- **DIRECT** (or positive) relationship between **price** and **quantity supplied**.
 - As price increases, the quantity producers make increases - UPWARD SLOPING
- Reasons

- Existing firms can earn higher profits if they supply more
- New firms are able to join the market if the higher price allows them to cover their production costs

Extension and Contraction of supply

- Movement along the line
- Extension occurs when the price increases, as the quantity increases
- Contraction occurs when the price decreases, as the quantity decreases

Determinants of supply

- Number of suppliers
- Improvement in technology (right)
- Cost of production (left)
 - Price of complements
- Government action
 - Taxes or subsidies
- Future expectations
- Weather

Price Determination

- Market Equilibrium
 - The position where the demand for a product is equal to the supply of the product
 - An **equilibrium price** (Market clearing price) is established in this point
 - The free market system automatically put the price to equilibrium
 - A state of balance is created - there are no incentives to change the price
- Market disequilibrium
 - Occurs when the QD is unequal to QS
 - Shortages & Surpluses happen
 - Excess demand / excess supply
 - Surplus is created when supply exceeds demand because the price is higher than the equilibrium price
 - Fixed by changing price!
 - Inefficient

Price Changes

- Caused by **changes in demand and supply**
- Demand increases, so at the previous price, a shortage may occur, stimulating the producer to produce more, which increases the quantity supply, as well as rises the equilibrium price and quantity.
- Supply increases, which stimulate a surplus at the original price, leading to a lower equilibrium price and quantity, which rises the quantity demand as the price falls down.

Elasticity

- Refers to the responsiveness of one economic variable, such as quantity demanded, to a change in another variable, such as a price.

Price elasticity of demand (PED)

- Measures the responsiveness of the quantity demanded of a product to a change in the price of that product
- **Determinants** (SPLAT)
 - S - Substitutes
 - P - Proportion of income
 - L - Luxury or necessity
 - A - Addictive or not
 - T - Time to respond

Types of elasticity (elasticity coefficient)

- Perfectly inelastic: 0
- Relatively inelastic: <1
 - Insensitive to a change in price
 - Most goods have inelastic supply in the short-run
- Unit elastic: 1
- Relatively elastic: >1
- Perfectly elastic: ∞

Calculation

PED = Percentage change in quantity demanded / Percentage change in price

$$= \frac{\% \Delta Q_d}{\% \Delta P}$$

Price and Total Revenue

- **Inelastic**
 - Price increase causes TR to increase
 - Price decreases causes TR to decrease
- **Elastic**
 - Price increase causes TR to decrease
 - Price increase causes TR to increase

Price elasticity of supply (PES)

- Shows how sensitive producers are to a change in price

PES = Percentage change in quantity supplied / Percentage change in price

$$= \frac{\% \Delta Q_s}{\% \Delta P}$$

- **Determinants**

- Manufactured or service vs. Primary products
- Time Frame
 - Elastic in long run
- Excess Capacity
- Substitutes
- Ease of storage

Market failure

Merit & demerit goods and services

- Merit: Education and Vaccination
 - Consumers may undervalue these goods, but the government considers it "good"
 - Underproduced in pure market economy due to information failure
 - Information costs
 - Information costs are **expenditures of time and money that are required to obtain information.**
 - Information failure
 - Information failure is **a type of market failure where individuals or firms have a lack of information about economic decisions.**
 - Deemed to have social benefits yet are under-provided and under-consumed without government intervention or provision.
 - Social benefits of producing and consuming merit goods outweigh the private benefits.
 - Both the public and private sectors provide merit G & S.
 - e.g. independent schools
- Demerit: Tobacco, Alcohol and Gambling (Junk food as well!)
 - Overproduced
 - Cause negative spillover effects in an economy

Concepts

- Excludability: The ability to keep people who don't pay for a good from consuming the good.
- Non-excludability: When the public good is provided to one person, it is not possible to prevent others from enjoying its consumption.
 - Provided by the government -> no incentive to make profits
- Rivalry in consumption: The property of a good whereby one person's use diminishes other people's use.
- Non-rivalry: One person's use of the public good does not deprive any other person of such use or does not diminish the amount available to others.
- Free-riders: Someone who consumes a product without paying for it.

- **Public Goods:** non-excludable and non-rivalrous in consumption, those who do not pay can still enjoy access to the product and there is no competition to purchase or use the product. Private sector firms have little or no incentive to produce them, since they would be impossible to sell.
- **Private Goods:** A good that is easy to keep non payers from consuming (excludability), and use of the good by one person prevents use by others (rival consumption). They are be sold to others for a price (profit incentive)

Type	Properties
Private Goods	Excludable, Rival in consumption (food)
Public Goods	Not excludable, Not rival (national defense)
Common Resources	Rival but not excludable (fish in the ocean)
Natural Monopolies	Excludable but not rival (cable TV)

Leading causes of market failure

1. Externalities
 - Third-party: the group of people than consumers and producers that are affected by the production or consumption
 - Some-one else
2. Monopoly
 - Private firms without government control could grow to become monopolies and exploit their market power by charging higher prices and supplying less.
3. Factor Immobility

Private and social costs

1. Private costs
 - Actual cause of an individual firm, household or government
2. Social costs
 - True costs of an economic activity
 - Sum of private and external costs
 - External cost
 - The negative spillover effects of production and consumption incurred by 3rd party for which no compensation is paid.
3. Socially optimal
 - Optimal distribution of resources
 - Social cost = Social Benefit
 - Demand = Supply
 - No overproduction, underproduction or overconsumption, underconsumption

Max and Min Price

Minimum price (price floor)

- The imposition of a price guarantee set **above the market** price to encourage supply of a certain good or service
- Also applies in the labor market, where more workers supply their labour services if there is a minimum wage.
 - Results in the supply of labour exceeding the demand for labour
 - Stimulating a higher costs of labour, which causes **unemployment**

Government Intervention

- Reasons
 - Combat market inequality (not in free markets)
 - Promote general economic fairness
 - Maximizing social welfare
 - Promote their goals, e.g. national unity
- Indirect taxation
- subsidies
- regulation
- privatisation
- nationalisation
- Direct provision of goods and services

Tax

- When a tax is imposed on a good or service, it increases the price paid by the consumers.
- It lowers the prices for the producer and reduces the overall quantity
- Tax incidence
 - The burden of a tax
 - Elasticity influence:

	Demand	Supply
Inelastic	Consumers pay more	Suppliers pay more
Elastic	Suppliers pay more	Consumers pay more

