

Microeconomics – F851 OCR.

The Reasons for Individuals, Organisations & Societies having to Make Choices

The economic problem is there are scarce resources in relation to unlimited wants. (2 mark definition)

The four factors of production are; land, labour, capital and enterprise.

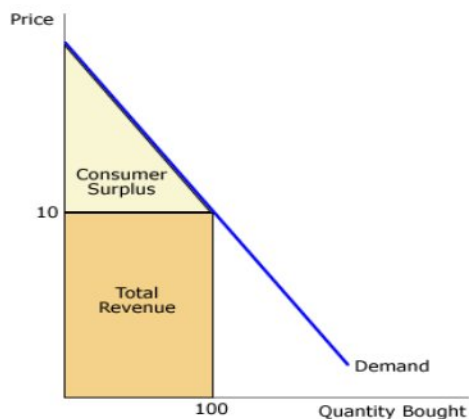
Specialisation can be used to address the problem of scarcity in the sense; as regions specialise, more output can be produced, meeting more wants. Surpluses can be traded (creating dependency).

Opportunity cost is the cost of the next best alternative forgone. (2 mark definition)

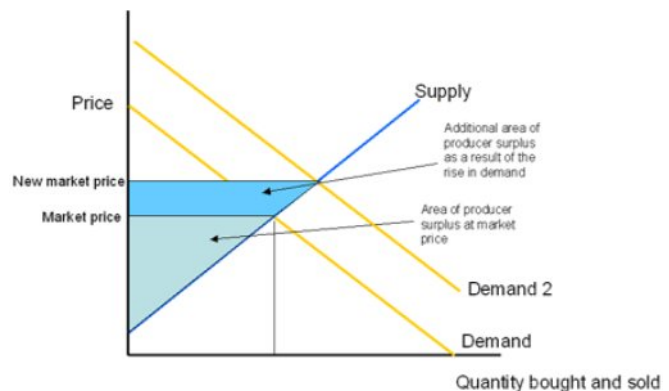
The PPC/PPF/PTC shows the maximum combination of goods. As you produce more of one good, the opportunity cost is the other good. Convex shape. Economic growth will shift curve outwards.

Competitive Markets & How They Work

A competitive market is a market that operates through the laws of supply & demand.



Consumer surplus: the difference between the price that customers are willing to pay, & the price that they actually pay.



Producer surplus: the difference between the price that suppliers are willing to sell at, & the price actually charged.

Factors effecting demand; price, price of substitutes & compliments, income, advertising, tastes/trends, addictiveness

Movement up the curve [expansion of supply] means a higher price, movement down the curve [contraction of supply] means lower price.

Factors effecting supply; changes in costs, legislation

Price elasticity of demand/supply; how responsive demand/supply is to a change in price. $\frac{\% \Delta QD/S}{\% \Delta P}$

Income elasticity of demand; how responsive demand is to a change in income. $YED = \frac{\% \Delta QD}{\% \Delta Y}$

Cross elasticity of demand; how responsive demand for one product is to a change in price of another. $\frac{\% \Delta QD \text{ of GOOD A}}{\% \Delta P \text{ of GOOD B}}$; positive for substitutes, negative for compliments. Higher the number, the stronger the relationship.

Factors effecting PED; addictiveness, proportion of real/disposable income, availability of substitutes

Business relevance of elasticity; set a price, ways to increase revenue (inelastic – lower price and vice versa), luxury/normal good/inferior good (-YED)/necessity, as income rises demand for normal goods increase, set pricing structures (bundling), however only estimates (inaccurate data leads to inaccurate elasticity coefficient)

Market equilibrium = where demand meets supply.

Market Failure & Government Intervention

Markets fail when there is a misallocation of scarce resources in the market. Economic efficiency isn't being met. Due to: +/- externalities, de/merit goods, information failure, public goods

Negative/positive externalities are costs/benefits imposed upon a third party who aren't directly involved in a decision making process

Externalities & market failure: consumers/producers fail to take into account the full social costs of their actions; therefore there will be over/under-production/consumption. This represents a misallocation of scarce resources as too many/too few are being devoted to the production of these goods. Thus, there is allocative efficiency.

Internalising the externalities: making the externality part of the price. Eg. Externalising the externality of petrol.. tax the good (to the level of welfare loss), this will successfully internalise the externality.

Social costs/benefits: the total cost/benefit arising from a particular decision

Private costs/benefits: the costs/benefits that accrue to an individual/firm

External costs/benefits: social costs/benefits exceed private costs/benefits. Costs/benefits upon the third party.

+/- externalities:	Merit/demerit goods:
Divergence between private/social costs/benefits	Due to a lack of information
Not reflected in price	People do not perceive full costs/benefits
Over/under produced and consumed	Over/under produced and consumed
External costs = neg. externality & vice versa	

Both lead to a misallocation of scarce resources. The free market will lead to either too much/too little production. Allocative inefficiency. MARKET FAILURE.

Information failure: lack of how good/bad a product or service is for you, hence insufficient demand will be registered in the free market. Demand is below optimum level – the market has failed.

Merit good: positive externalities. People do not perceive the full benefits. Under-consumed. Eg. Education.

Demerit good: negative externalities. People do not perceive the full costs. Over-consumed. Eg. Cigs.

Public good: non-excludable (cannot stop being provided to everyone). Non-rival (if one person consumes it, it doesn't stop other people). Eg. Streetlighting.

Quasi-public: kinda public, but not fully. Eg. Beach – can get crowded (rival).

Public goods and market failure: not provided at all. Free riding (people want to benefit from other people purchasing the good). There is however demand. Free market doesn't guarantee production.

Why do governments intervene?: to achieve economic efficiency & the achieve a fair or equitable distribution of resources in the economy.

Method of intervention:	Advantages:	Disadvantages:
Indirect taxation – taxing firms who produce demerit goods. De-merit goods are overproduced (imperfect information) so production needs to decrease to social optimum.	<ul style="list-style-type: none"> • Deter demand as price increases • Firms are forced to reduce supply, solving over-production • Costs of production are raised, shifting the supply curve • Reduces firm's profit margin – stop producing the good if it gets too low? • Allocative efficiency • Internalises the externality & thus correct the misallocation of resources 	<ul style="list-style-type: none"> • In order to prevent government failure, the tax must equal external cost • Tax can be inflationary and reduce real GDP • Restricts economics growth – unemployment • Inelastic demand products can increase price to pass the cost onto customers (polluter doesn't pay) • Relocate abroad (tax-less) • Taxes on necessities may be regressive
Subsidies – subsidising production of merit goods. Payment to producers to decrease their costs & increase output	<ul style="list-style-type: none"> • Control inflation rates • Boost living standards of some groups • Encourage consumption of merit goods with positive externalities • Increase social benefits • Improve under-consumption of merit goods to create allocative efficiency 	<ul style="list-style-type: none"> • Opportunity cost of dishing out money to groups • Which groups should receive the subsidy? – fairness + equity • Alternatives – income support through tax system • People may not benefit from subsidy –

	<ul style="list-style-type: none"> • Boost employment of LT unemployed 	yield no satisfaction
Regulation	<ul style="list-style-type: none"> • Restrict amount of ext produced • Fine companies – lots of money 	<ul style="list-style-type: none"> • Not always enforceable • Need evidence to prove breaking of law
Polluter permits	<ul style="list-style-type: none"> • Tradable between firms • Encourages less pollution if firms have an incentive to make money • Limits amount of neg ext (pollution) 	<ul style="list-style-type: none"> • Monopoly can buy them all out • Encourage businesses to travel elsewhere
State provision of public goods	<ul style="list-style-type: none"> • Ensures provision • Meets demand 	<ul style="list-style-type: none"> • Expensive for govt • No profit motive; not as efficient
Provision of information	<ul style="list-style-type: none"> • Correct level of demand would be registered • 	<ul style="list-style-type: none"> • Must ensure information is correct/suitable/cheap or free

Definitions (other):

Allocative efficiency: is achieved when the value consumers place on a good or service (reflected in the price they are willing to pay) equals the cost of the resources used up in production. Condition required is that price = marginal cost. When this condition is satisfied, total economic welfare is maximised. When you get goods that have negative externalities, the market price is not reflective of the true social costs. So if allocative efficiency was truly achieved, the price of the goods with negative externalities would be the private costs + the social costs (ie the damage caused to a third party, e.g. the environment). Things are being produced that people want.

Economies of scale: is when costs fall in the long run due to an increased scale of operation. Examples included; bulk buying materials, division of labour, technological advancements

Pareto efficiency: where it is not possible to make someone in society better off without making someone else worse off

Productive efficiency: where production is at the possible cost. Using the least amount of scarce resources to produce a product.