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# Chapter 1

## Lecture Notes

### 1.1 Thinking Like an Economist

#### 1.1.1 What is Economics?

**Life** is about making choices.  
Economics is the **science of** choice.  
That means economics is the **science of life**.

by Mr. Alan Duhs (Senior Lecturer, UQ School of Economics)

#### What is Microeconomics?

- How to use what you have (your resources) to get as much as possible of what you want
- It's mostly about how individuals make the most efficient (effective) choices
- The systematic effects these choices have on other individuals

#### Note 1: Scarcity Principle

Our resources are limited, so getting more of one thing means getting less of another.

- Wants exceeds available resources
- Choices between alternatives needed

Something is **scarce** if you:

- have to sacrifice something else to get it (e.g. money, time, effort)
- need to pay a price for it (i.e. not free)

**Consumers** will be forced to decide what to consume

**Producers** will be forced to decide what to produce

**Governments** will be forced to decide how to allocate resources to achieve specified objectives

#### 1.1.2 Opportunity Cost

All about what was **not** chosen. Economic concept to help make a rational choice. What was sacrificed. What is given up once a decision has been made.

#### 1.1.3 Cost Benefit Principle

Chose to do something only if the **extra benefit** (incremental benefit) from doing it is greater than (or equal to) the **extra cost** (incremental cost), assuming the individual is **rational**.

#### 1.1.4 Economic Surplus

Incremental benefits of an action minus the incremental explicit and implicit costs of that action

**Explicit cost** a cost that involves spending money (i.e. a transaction physically occurs)

**Implicit cost** a non-monetary "**opportunity cost**" (no transaction occurs but an alternative is not chosen)

Economic decision strive to maximize economic surplus by:

1. **maximizing** the benefits
2. **minimizing** the costs

Economic surplus can be maximized by making choices that **minimize the opportunity cost**. **Opportunity cost** is economics is about assessing if an **efficient choice** of resources has been made.

#### 1.1.5 Rules for Making Rational Economic Choices

In economics, a rational choice should:

1. **include** opportunity cost
2. **exclude** sunk cost
3. measure cost in **absolute dollar amount**, not percentages
4. be based on **Marginal Analysis**

### Note 2: Sunk Cost

- expenses that have occurred in the past before a decision has been taken
- costs that would have had to occur in order for a choice to be made
- costs that are typically not able to be directly recovered
  1. exploration costs (oil well, mining)
  2. market research costs (focus groups, surveys)
  3. feasibility study costs (before a decision is made)

### 1.1.6 Marginal Benefit

The change in total benefit from doing **one extra unit** of an activity

$$= \frac{\text{change in total benefit}}{\text{one extra unit sold}}$$

### 1.1.7 Marginal Cost

The change in total cost from doing **one extra unit** of an activity

$$= \frac{\text{change in total cost}}{\text{one extra unit produced}}$$

### Note 3: Economic Efficiency

### 1.1.8 Absolute and Comparative Advantage

#### Absolute Advantage

- ability of an individual, firm, or country to **produce more** of a product or service than competitors using the **same amount** of resources.
- alternatively, produce the **same** amount of product or services as competitors with *less resources*.

#### Comparative Advantage

- ability of an individual, firm, or country to produce a product or service at a *lower opportunity cost* than other competitors (relates to who is more efficient at producing something).

Opportunity cost is about assessing if an **efficient choice** of resources has been made. Outcomes are efficient if opportunity cost is minimised. **Comparative advantage** exists with the producer (or service provider) producing the product at the **lowest opportunity cost**. Contrast **absolute advantage** which is *irrelevant* in deciding who is more efficient at producing something.

### 1.1.9 Gains and Specialization

#### Note 4: Principle of Comparative Advantage

- Everyone does best (individuals or countries) when they concentrate on activities for which their opportunity cost is lowest.
- By exchanging goods with others, individuals can more efficiently obtain their preferred mix of goods and services.

### 1.1.10 Production Possibility Curve (PPC)

- The production possibilities curve (PPC) = a graphical representation describing the maximum amount of one good that can be produced for every possible level of production of another good.
- **Assumptions:**
  1. only two goods are able to be produced (for simplification), bananas and blueberries
  2. consider the PPC for a single worker only

**Attainable Point:** Any combination of goods that can be produced using currently available resources. All points on the PPC, as well as below and to the left of the PPC, are attainable.

**Unattainable Point:** Any combination of goods that cannot be produced using currently available resources. All points lying above and to the right of the PPC are unattainable.

**Efficient Point:** Any combination of goods for which currently available resources **do not** allow an increase in the production of one good unless there is a reduction in the production of the other.

**Inefficient Point:** Any combination of goods for which currently available resources **enable** an

increase in the production of one good **without** a reduction in the production of the other.

### Note 6: Supply Definition

Supply in economics is represented as a relationship between **price** and **quantity supplied**.

## 1.2 Demand and Supply

### 1.2.1 Demand

**Demand:** Not stuff, stuff at a price

### 1.2.2 Market System

Individual preferences and purchasing power + costs of production → generate prices → act as signals that coordinate decision making → guide resource allocation in the economy

Decentralized market economies often outperform centrally planned economies in terms of efficiently allocating resources → But, not always → sometimes they fail

### Note 5: Demand Definition

Demand is a mathematical relationship between cost and quantity demanded (stuff)

- **Demand** is a **relationship** between prices and the quantities demanded at those prices, sometimes referred to as a “willingness to pay curve”
- **Demand** is a downward sloping relationship
- As price increases, the **quantity demanded** by consumers decreases
- The area under the demand curve is the amount of money a consumer spends
- The “**Ceteris paribus**” assumption in Latin meaning “all else being equal”
  - needed to develop the demand model
  - when analyzing two variables (such as price and quantity), it is assumed **all other variables are held constant** (not able to be changed).

### 1.2.3 Supply

As the price a product (or service) **increases**, and assuming *ceteris paribus*, producers will supply **more**. **Note:** there is an upward sloping (positive) relationship between price and quantity supplied. A change in price results in a movement **along** the supply curve.

### Market Supply

All individual producers’ quantities supplied add to create a market supply for a product (or service).

### 1.2.4 Interaction of Supply and Demand

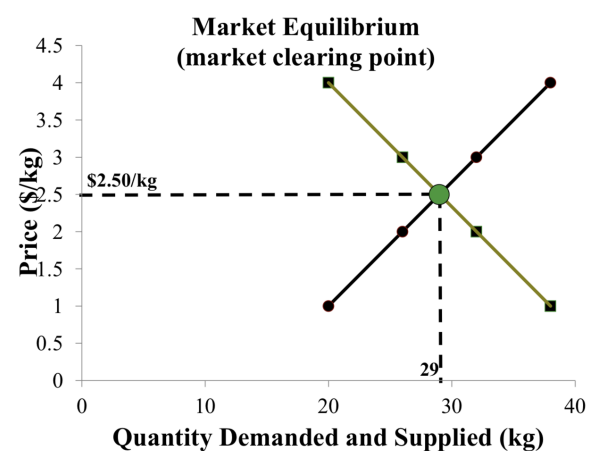


Figure 1.1: Market Equilibrium

- The intersection of the supply and demand curves so → quantity supplied = quantity demanded AND selling price = purchase price
- A point where suppliers are happy to sell a given quantity at a certain price, and this exactly matches the price consumers are willing to pay for this quantity supplied

### 1.2.5 Market Clearing Point

#### Competitive Market

- has many buyers and many sellers
- Prices and quantities continue to adjust until a market clearing point is reached, eliminating shortages and surpluses
- note the market clearing point and the **model suggests** equilibrium is a **static point**. In reality, it can continually move. i.e. the point is **dynamic**

**Price Floor:** Price can be set higher than market clearing

**Price Ceiling:** Price can be set lower than market clearing

### Price Floor

- used by governments to set a legally determined price to protect suppliers
- the price is set **above** the market clearing price, and becomes a minimum price for suppliers
- this minimum price is then guaranteed by the government

### Price Ceiling

- used by governments to set a legally determined price to protect consumers (e.g. tenants who rent, petrol “price caps” when oil prices rising fast)
- the price is set **below** the market clearing price, to help protect consumers from higher prices
- the legal price is a maximum that can be charged by suppliers
- What about **illegally** paying higher prices for the quantity that **is** available? **Black Markets?**

**Market Failure:** an inefficient allocation of goods and services in a market

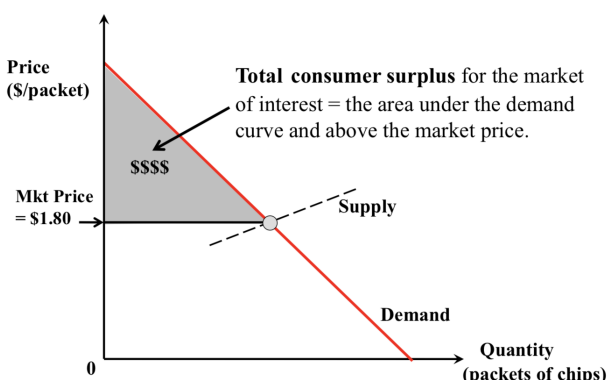


Figure 1.2: Total Consumer Surplus

### Note 7: Consumer Surplus

The maximum price an individual consumer is prepared to pay less the clearing price set by the market = an individual's consumer surplus. See Figure 1.2

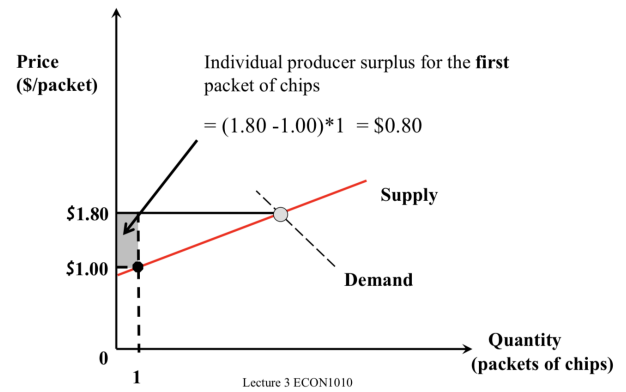


Figure 1.3: Individual Producer Surplus

### Note 8: Producer Surplus

The market clearing price less the minimum price a supplier would have been willing to accept in a sale  
See Figure 1.3

### Note 9: Economic Surplus

Total Economic Surplus = total consumer surplus + total producer surplus (maximised in competitive markets)

### Dead Weight Loss

Economic inefficiency from government intervention. It's the area between the lines that is loss by introducing a Price Floor