Law of demand

Demand: the quantity of a good or service that consumers are willing and able to purchase at a given price in a particular time period

Law of demand: quantity demanded increases when prices decrease and vise versa

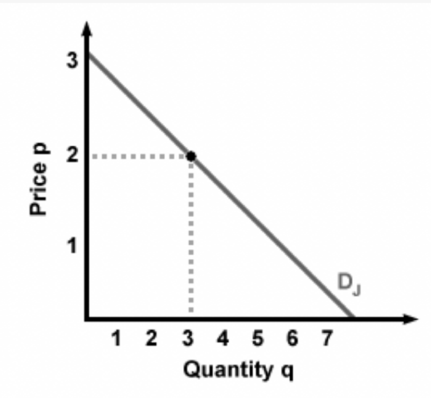
ASSUMPTIONS

Income effect: lower price = higher income = higher demand

Substitution effect: consumers replace higher priced products with lower priced ones.

Diminishing marginal utility: as consumption increases, the satisfaction gained from consuming one additional unit of a product decreases.

Demand curve



The demand curve illustrates an inverse relationship which explores how an increase in price leads to a decrease in the quantity demanded

Non price determinants of demand

Future price expectations

Income

Tastes and preferences

Price of related goods (substitutes)

Price of related goods (complementary)

Number of consumers

Law of supply

Supply: quantity of goods and services that firms are willing and able to sell at any given price

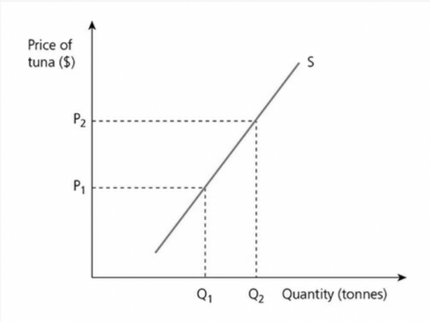
Law of supply: As price increases, supply increases

ASSUMPTIONS

Diminishing marginal returns: after some optimal level of capacity is reached, adding an additional factor of production will actually result in smaller increases in output

Increasing marginal costs: firms are willing and able to increase production only if they receive a higher price for the additional units of output.

Supply curve



An increase in the price of tuna fish provides an incentive on producers to spend more time and effort to catch or farm tuna fish.

Non price determinants of supply

Costs of factors of production

Price of related goods

Indirect taxes

Subsidies

Future price expectations

Changes in technology

Competitive market equilibrium

Market equilibrium: When the quantity demanded for a product is equal to the quantity supplied of the product

Equilibrium price: the point where the demand for the product matches the supply of the product

Market disequilibrium: when the quantity demanded for a product is either higher or lower than the quantity supplied for the product

Excess supply: e price of a product is set above equilibrium price, creating a surplus in the market represented by the higher quantity supplied than demanded

Excess demand: price for a product is set below equilibrium price, resulting in a higher demand and a lower supply

Functions of the price mechanism

The price mechanism: the interactions between buyers and sellers in order to allocate resources, therefore determining production and consumption choices

Signalling function: aspect of the price mechanism that signifies to producers and consumers where resources are required

Incentive function: as price changes, the mechanism provides an incentive for producers and consumers to change their behaviour in order to maximize their benefits

Rationing function: Higher prices, lower the quantity demanded therefore helping to preserve the good or service

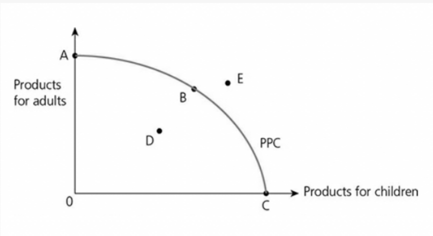
Surpluses

Consumer: Benefit to buyers who can purchase the product at a lower price than they were willing and able to pay

Producer: Benefit to firms who receive a price that is higher than the price at which they were willing to supply at

Social: Sum of consumer and producer surplus at a given market price and output, thereby maximizing economic welfare

Allocative efficiency



Socially optimum situation that occurs when resources are distributed in a way that allows consumers and producers to gain the maximum benefit

Rational consumer choice

decision-making process based on the assumption that people make choices that result in the optimal level of benefits

ASSUMPTIONS

Consumer rationality

Utility maximization

Perfect information

LIMITATIONS

Biases (rule of thumb, anchoring, framing and availability)

Bounded rationality

Bounded self control

Bounded selfishness

Imperfect information

Behavioural economics

Choice architecture: the deliberate design of different ways of presenting choices to members of society, and the impact of these methods on decision-making.

Nudge theory: the practice of influencing the choices that people make. Nudges are created by choice architects using small prompts or tweaks to alter social and economic behaviour, but without taking away the power for people to choose.

Business objectives

profit maximization: Sales level where profits are the highest

CSR: commit ethical objectives to benefit stakeholders

Market share: a firm's portion of the total value of sales revenue

Satisfaction: aim for a satisfactory or adequate level or profit

Growth: increasing the size and scale of operations of a firm

Price elasticity of demand

The responsiveness of quantity demanded for a good in relation to a change in the price for the product

Price elastic: if a slight change in the price or income leads to a large change in the demand for the product.

Price inelastic: if a change in price or income has little impact on the demand for a good or service.

Formula: PED = % change in QD / % change in price

DEGREES OF PED VALUES

PED > 1 → price elastic demand

Price elasticity of demand (cont)

PED < 1 → price inelastic demand

PED = 0 → perfectly price inelastic demand

PED = ∞ → perfectly price elastic demand

PED = 1 → unitary elastic demand

Price elasticity of supply

The degree of responsiveness of quantity supplied of a product due to a change in its price

Formula: PES = % change in quantity supplied / % change in price

DEGREES OF PES VALUES

PES > 1 → price elastic supply

PES < 1 → price inelastic supply

PES = 0 → perfectly price inelastic supply

PES = ∞ → perfectly price elastic supply

PES = 1 → unitary elastic supply

Income elasticity of demand

The degree of responsiveness of demand following a change in income

Formula: YED = % change in QD / % change in income

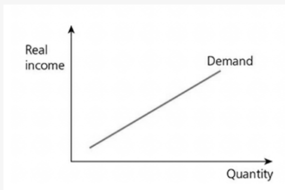
YED SIGNS

YED + < 1 → normal goods

YED + > 1 →Luxury goods

YED - → Inferior goods

YED Engel curve



The engel curve is used to demonstrate the relationship between income and the quantity demanded

Reasons for government intervention

Earn government revenue

Support firms

Support households on low incomes

Influence the level of production

Influence the level of consumption

To correct market failure

Promote equity

Main forms of government intervention

PRICE CONTROLS

Government regulations establishing a maximum or minimum price to be charged for certain goods and services. They consist of price ceilings and price floors.

price ceilings: limits the maximum price in order to encourage output and consumption.

Price floor: binding minimum price in order to encourage production and supply

INDIRECT TAXES

A government levy or charge on the sale of goods and services, rather than on incomes or wealth.

specific: charge a fixed amount of tax per unit sold

Ad valorem: impose a percentage tax on the value of a good or service.

SUBSIDIES

a sum of money granted to help keep the price of a commodity or service low.

DIRECT PROVISION

Government provides certain goods and services deemed to be in the best interest of the public.

Market failure - externalities main terms

Market failure: when the signalling, incentive and rationing functions of the price mechanism fail to operate optimally, which leads to a loss in economic welfare. It is when there is a misallocation of resources

private benefits: advantages or gains of production and consumption enjoyed by an individual firm or person.

Private costs: actual expenses incurred by an individual firm or person

Social benefits: benefits of consumption or production, that is, the sum of private benefits and external benefits

Social costs: costs of consumption or production, that is, the sum of private costs and external costs

MPB: additional value enjoyed by households and firms from the consumption or production of an extra unit of a particular good or service.

MPC additional expense of production for firms or the extra charge paid by customers for the output or consumption of an extra unit of a good or service

MSB: total gains to society from an extra unit of production or consumption of a particular good or service

MSC total expenses to society from an extra unit of production or consumption of a particular product

Externalities

The external costs or benefits of an economic transaction, causing the market to fail to achieve the socially optimal level of consumption and production

Positive consumption: When consuming a good or service, provides a benefit to an unrelated third party

Positive production: the positive effect an activity imposes on an unrelated third party

Negative consumption: when consuming a good causes a harmful effect to a third party

Negative production: the production process results in a harmful effect on a third party.

INTERVENTION TO CORRECT EXTERNALITIES

Indirect taxes, carbon taxes, education, international agreements, subsidies, direct provision

Public goods

Collective consumption goods that have two key characteristics of being non rivalrous and non excludable

Non rivalrous: a person's consumption of a public good does not limit the benefits available to other people.

Non excludable: firms cannot exclude people from the benefits of consumption

FREE RIDER PROBLEM

When people have access to a good or service without having to pay for it. As a result, the good or service will be under provided or not provided at all in the free market

Asymmetric information

A source of market failure that exists when one economic agent (buyer or seller) has more information than the other in an economic transaction. It occurs owing to incomplete information or inaccessibility to information.

Adverse selection: the undesired decisions or outcomes that occur when buyers and sellers have access to imperfect information.

Moral hazard: situation where a party protected from risk behaves differently than if they were fully exposed to the risk.

Responses to asymmetric information

GOVERNMENT RESPONSES
legislation
Provision of information
PRIVATE RESPONSES
Signalling: used by parties with access to more information to maximize their own level of satisfaction
Screening: used by parties with access to less information to maximize their own level of satisfaction