ECON1001 INTRODUCTION TO MICROECONOMICS
THE UNIVERSITY OF SYDNEY

CHAPTER SUMMARIES AND KEY CONCEPTS

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1. Key Economic Concepts

Scarcity & Opportunity Cost

- **Scarcity**
  - Resources are limited, so not all wants can be met
- **Opportunity Cost**
  - The value of the next best alternative forgone
  - Includes explicit + implicit costs
  - Excludes sunk costs
- **Explicit Costs**
  - Costs that involve direct payment
- **Implicit Costs**
  - Opportunities that are forgone that do not involve an explicit cost
- **Sunk Costs**
  - Costs that have been incurred and cannot be recovered

Marginal Analysis

- **Marginal Analysis**
  - Consumers seek to maximise benefits
  - Firms seek to maximise profits
  - Analysis considering the additional benefit or cost of any action
- **Marginal Benefit**
  - Additional benefit derived from consuming an extra unit of a good
- **Marginal Cost**
  - Additional cost incurred from purchasing an extra unit of a good

Ceteris Paribus

- **Ceteris Paribus**
  - 'other things equal'
  - Examining the impact of one change at a time, holding everything else constant

Correlation & Causation

- **Correlation**
  - A situation in which 2 or more factors are observed to move together
- **Causation**
  - A situation where a change in one factor brings about, or causes, a change in something else

4. Trade and the PPF

Gains from Exchange	The PPF	Absolute Advantage & Comparative Advantage	Gains from Specialisation
• **Gains from Exchange** - Trade makes people better off - Trade helps allocate goods and services to those who value them the most - Trade can only occur if the seller's valuation of the item (Vs) does not exceed the buyer's valuation (Vb) - For trade to take place: $Vs \leq p \leq Vb$	• **PPF** - Traces out combinations of the quantity of 2 goods that an individual/country can produce if it uses all of its resources • **Points on the PPF** - Efficient in the sense that it makes full use of the available resources • **Points inside the PPF** - Inefficient because it does not make full use of the available resources • **Points outside the PPF** - Not feasible, because production of those levels of X and Y would require more resources	• **Absolute Advantage** - A has absolute advantage over B in the production of a good if, for a given amount of resources, A can produce a greater number of that good than B • **Comparative Advantage** - A has a comparative advantage over B in the production of a good if A's opportunity cost of producing that good is lower than B's	• **Gains from Specialisation** - When parties specialise in producing the good they have comparative advantage in, total production increases - With more output, both trading parties can potentially be made better off

14. Monopolistic Competition

Characteristics	The Short Run	The Long Run	Welfare under Monopolistic Competition
• **Many buyers and sellers** - No producer has complete control over the price, because buyers can always switch to other sellers • **Production differentiation** - Each firm sells a slightly differentiated product • **Free entry and exit** - No barriers to entry in the long run	• **Short Run** - If firms raise their prices slightly, there will be drop off in quantity demanded, but not necessarily falling to 0 - Firms set profit-maximising prices like monopolists - Number of firms in market fixed in the short run - Each firm faces fixed cost of production, which constraints the ability of firms to enter and exit market in short run - Firms can make profits/losses, depending on whether the price charged is higher/lower than average total cost	• **Effect of entry and exit on demand curves** - If a new firm enters the market, it will affect the demand curves of all incumbent firms - Decrease in demand for products of incumbent firms - Demand curve for products of incumbent firms becomes more elastic - If a firm leaves the market, there will be an increase in demand for incumbent firms and their demand curves become less elastic • **Elimination of profits and losses** - Entry of firms decreases demand for other firms, lowering the price those firms can charge and lowering their profits - Exit of firms increases demand for other firms, increasing the price those firms can charge and increasing their profits	• **Business Stealing** - A firm entering the market does not account for the fact that its entry takes customers away from incumbent firms - Causing a consumer to switch between firms does not necessarily increase surplus, but it does mean the economy has to bear another firm's fixed costs of production - Suggests that number of firms in market is too high • **Product Variety** - A firm entering the market offers additional differentiation in the market - Greater variety of products can better cater to various tastes of consumers - Increase in consumer surplus - Suggests that number of firms in market not high enough

17. Externalities

External Costs and Benefits

- **Externality**
  - Cost/benefit of an economic activity that accrues to a person not directly involved in that activity
- **Positive Externality**
  - Economic activity results in external benefits for 3rd party
- **Negative Externality**
  - Economic activity results in external costs for 3rd party
- **Positive Consumption Externality**
  - Presence of positive externality, MSB > MPB
  - MSB = MPB + MEB
  - No positive externality, MEB = 0
  - MSB = MPB
- **Negative Production Externality**
  - Presence of negative externality, MSC > MPC
  - MSC = MPC + MEC
  - No negative externality, MEC = 0
  - MSC = MPC

Problem with Externalities

- **Positive Consumption Externality**
  - MSB > MPB
  - Underproduction of goods
  - Units not traded because, MPC > MPB
  - Society wants trade because, MSC < MSB
  - DWL
- **Negative Production Externality**
  - MSC > MPC
  - Overproduction of goods
  - Units traded because, MPB (consumer) > MPC (producer)
  - Society doesn't want trade because, MSC > MSB
  - DWL
- **Negative Consumption Externality**
  - MSB < MPB
  - Overproduction of goods
  - DWL
- **Positive Production Externality**
  - MSC < MPC
  - Underproduction of goods
  - DWL

Private-Market Solutions

- **The Coase Theorem**
  - Correction of externalities via private bargaining between individual parties
  - Market participants and 3rd parties affected can 'negotiate' the market outcome, such that socially optimal outcome is implemented and DWL eliminated
  - Provided property rights have been clearly assigned and there are no transaction costs, bargaining will lead to an efficient outcome, regardless of the initial allocation of property rights
- **Limitations of Coase Theorem**
  - Property rights not originally defined
  - Transaction costs assumed to be 0; there are implicit and explicit costs in the real world
  - Identity of parties unknown; negotiation unable to take place

Government Solutions

- **Taxes and Subsidies**
  - Tax/subsidy aims to increase/reduce quantity traded in the market to socially optimal level
  - Tax: Decrease quantity traded
  - Subsidy: Increase quantity traded
  - Size of tax/subsidy should be = size of externality
- **Quantity Regulation**
  - Government can regulate the quantity traded in the market
  - i.e. Requirement of a license to consume/produce a certain good/service and limiting the licenses issued
- **Tradeable Permits**
  - A special type of license that may be transferred between parties
  - i.e. Consumers/producers may trade with each other for the right to consume/produce units of output