

# Topic 1 - Ten Lessons In Economics & What is It

## Microeconomics v Macroeconomics

- Microeconomics is the study of how households and firms make decisions and how they interact in markets whereas macroeconomics is the study of economy wide phenomena including inflation, unemployment and economic growth.

## Lesson 1: People Face Trade-Offs

- Making decisions requires trading off one goal against another
- E.g. consider a student who must decide how to allocate her time. She can spend all her time studying economics or studying psychology or she can divide her time between the two fields. For every hour she studies one subject, she gives up an hour she could have used studying the other.

## Lesson 2: The cost of something is what you give up to get

- Because people face trade-offs, making decisions requires comparing the costs and benefits of alternative courses of action.
- E.g. the decision whether to go to university. The benefits include intellectual enrichment and a lifetime of better job opportunities, but what is the cost? The answer to this question, you might be tempted to add up the money you or your parents spend on fees, books, rent and food.
- Two problems with this calculation. First it includes some things that are not really costs of university education. Even if you quit university, you would need a place to sleep and food to eat. Rent and food are costs of going to university. For instance, you might have to move cities to attend university and live away from home. Indeed, the cost of your room and food at your residential college or home might be less than the rent and food expenses that you would pay living on your own. In this case, the savings on the room and food are a benefit of going to university.
- The opportunity cost of an item is the best alternative you give up to get that item.
- Opportunity cost: the best alternative that must be given up to obtain some item.

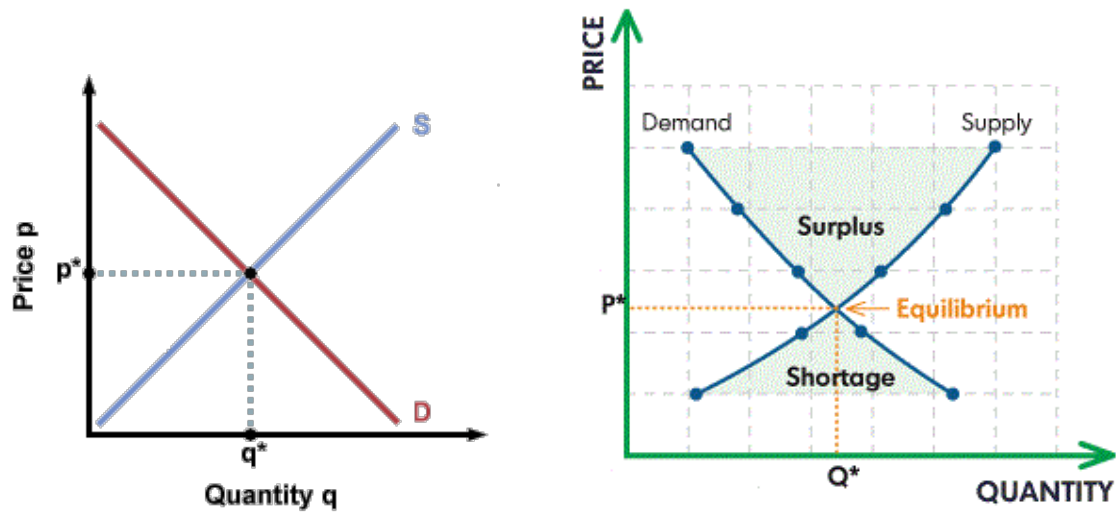
## Lesson 3: Rational People Think at the Margin

- Rational people systematically and purposefully do the best they can do to achieve their objectives, given the opportunities they have.
- Rational people know that decisions in life are rarely black and white but usually involve shades of grey.
- E.g. at dinnertime, the choice you face is not 'should I fast or eat like a pig'. More likely you will be asking yourself 'should I eat that extra spoonful of mashed potatoes.'
- E.g. when it's exam time, your decision is whether to spend an extra hour reviewing your notes instead of watching TV.
- Marginal change: a small incremental adjustment to a plan of action
- Thinking at the margin works for business decisions as well. E.g. consider an airline deciding how much to charge passengers who fly standby. An airline can often increase its profits by thinking at the margin.

## Lesson 4: People Respond to Incentives

- An incentive is something (such as a punishment or a reward) that induces a person to act.
- People make decisions by comparing costs and benefits and they respond to incentives
- Incentives are crucial to analysing how markets work e.g. when the price of an apple rises, people decide to eat fewer apples, at the same time, apple orchards decide to hire more workers and harvest more apples.

**Equilibrium quantity:** the quantity supplied and the quantity demanded at the equilibrium price



**Surplus:** a situation in which quantity supplied is greater than quantity demanded

**Shortage:** a situation in which quantity demanded is greater than quantity supplied

### Three Steps for Analysing Changes in Equilibrium

1. Decide whether the event shifts the supply or demand curve (or both)
2. Decide which direction the curve shifts
3. Use the supply and demand diagram to see how the shift changes the equilibrium

### Shifts in Curves v Movements Along Curves

- CHANGE IN PRICE = MOVEMENT
- A shift in the supply curve is called a change in supply and shift of the demand curve is called a change in demand

#### *Example: A Change in Supply*

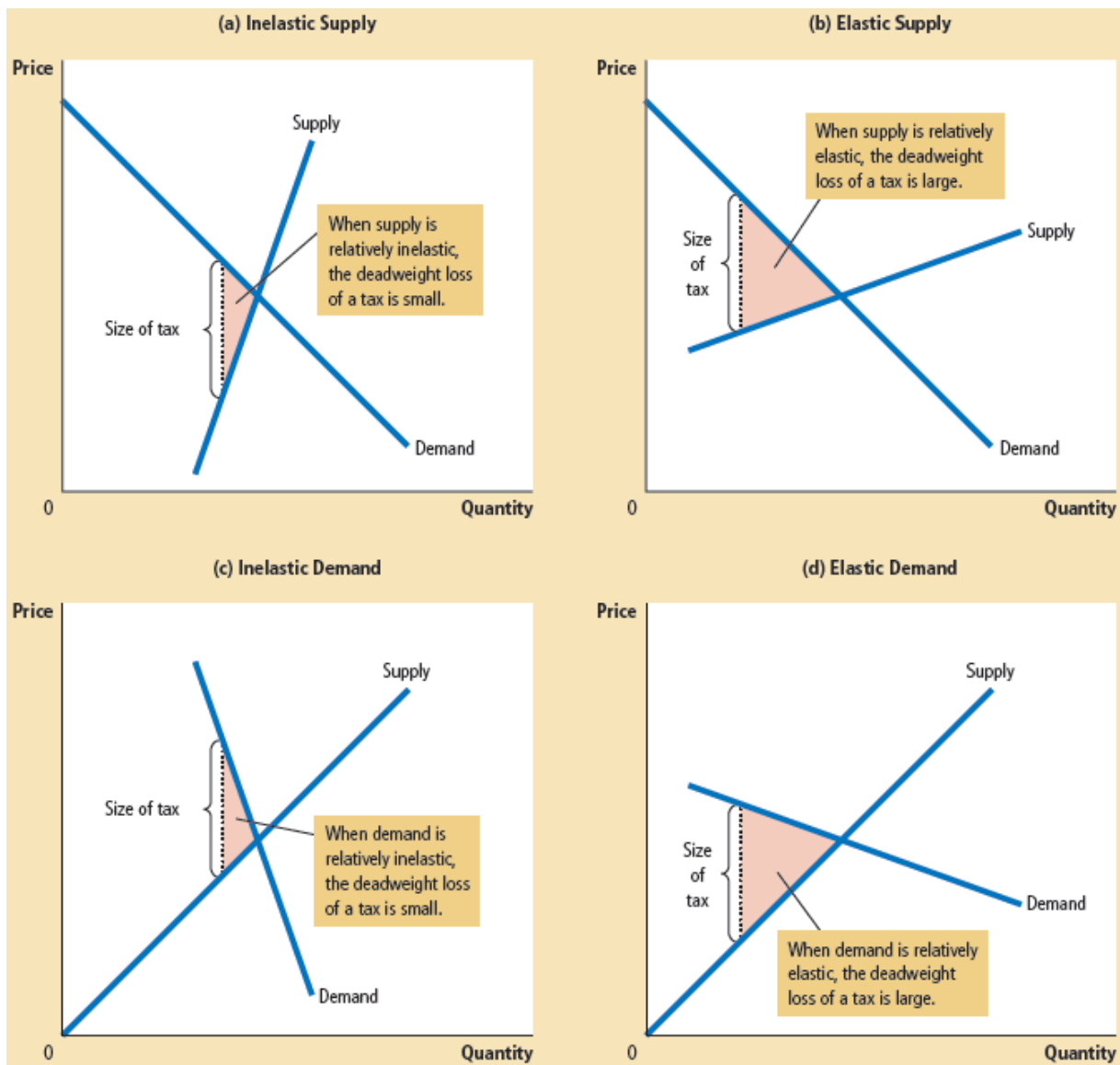
During summer a bushfire destroys several ice-cream factories. How does this affect the market for ice-cream?

1. The fire affects the supply curve. By reducing the number of sellers, the fire changes the amount of ice-cream that firms produce and sell at any given price. The demand curve is unchanged because the fire does not directly change the quantity of ice-cream households wish to buy
2. The supply curve shifts to the left because at every price, the quantity of ice-cream that firms are willing and able to sell is reduced.
3. At the old price of \$2.00 there is now an excess demand for ice-cream. This shortage causes ice-cream sellers to raise the price. As a result of the fire, the price of ice-cream rises and the quantity of ice-cream sold falls.

#### *Example: A Change in Supply & Demand*

The hot weather and a fire occur at the same time.

We determine that both curves must shift. The hot weather affects the demand curve because it alters the amount of ice-cream that households want to buy at any given price. At the same



In panels (a) and (b), the demand curve and the size of the tax are the same, but the price elasticity of supply is different. Notice that more elastic the supply curve, the larger the deadweight loss of the tax.

In panels (c) and (d), the supply curve and the size of the tax are the same, but the price elasticity of demand is different. Notice that the more elastic the demand curve the larger the deadweight loss of the tax.