COMPLETE THEME 1 NOTES

1.1 Nature of economics

Economics as a social science

- Economics is concerned with the study of human behaviour. Economists develop models which attempt to simplify and improve our understanding of how consumers and producers behave. These include assumptions.
- **Economics** = the allocation of scarce resources to provide for unlimited human wants.
- **Scarcity** = the economic problem is based on scarcity. This arises when there are infinite human "wants" but finite resources.
- Due to scarcity, we have to make a judgement about how to allocate scarce resources. This incurs an **opportunity cost** - the value of the next best alternative foregone.
- **Utility** = the satisfaction gained by consuming a product.
- Consumers are assumed to want to maximise utility, whilst firms are assumed to want to maximise profits.
- ***Ceteris paribus*** = all other things being equal.
- **Productivity** = the output per unit input.

Positive and normative economic statements

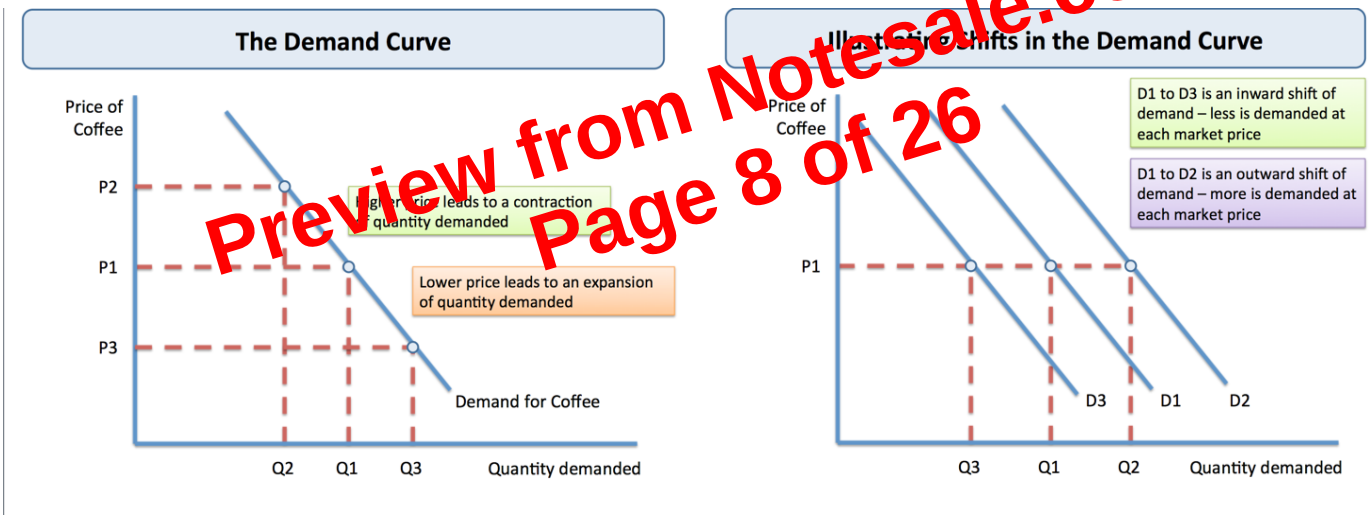
- **Positive statement** = a statement that can be judged as true or false through the available evidence. It does not carry a value judgement.
- **Normative statement** = a statement which is subjective and therefore carries a value judgement (non-scientific).

The economic problem

- **The economic problem** = this involves 3 parts: what to produce, how to produce it and how to distribute it.
- **Renewable resource** = one whose stock level can be replenished naturally over a period of time (e.g. solar energy, wind and tidal power).
- **Non-renewable resource** = one whose stock level decreases over time as it is consumed (e.g. coal, oil and steel).
- **The 4 factors of production** = land (any natural resource), labour (any human resource), capital (any man-made resource) and enterprise (ties the other 3 factors together and takes the risks).
- **Opportunity cost** = the value of the next best alternative foregone.

consumes more of a good, the utility gained from each extra unit will tend to fall.

- As marginal utility falls from each extra good consumed, it means consumers will only buy more of it if the price falls - hence the downwards-sloping demand curve.
- So whilst total utility actually increases, this occurs at a diminishing rate.
- A shift in the demand curve is caused by PASIFICL = Population, Advertising, Substitute's price, Income effect, Fashion/tastes, Interest rates, Complement's price and Legislation.
- **Equilibrium** = when demand equals supply. Also called the **market clearing price** (because there is no excess demand or supply, so the market is "clear").
- **Income effect** = when prices rise but real incomes stay the same so demand decreases.
- **Law of demand** = as prices rise, quantity demanded falls (and vice versa - inverse relationship).
- **Substitution effect** = spending money on a cheaper product.
- **Complements effect** = if demand for one product (e.g. dishwashers) rises, then demand for related or similar products will also rise (e.g. dishwasher tablets).



Elasticities of demand

Price elasticity of demand

- **PED** = a measure of how responsive demand is to a change in price.
- **Elastic** = if a price change leads to a considerably bigger change in quantity demanded.
- **Inelastic** = if a similar price change leads to a much smaller change in demand.
- **Percentage change** = (difference/original) x 100
- **PED = % change in quantity demanded / % change in price.**

revenue for subsidising positive externalities would be to tax goods with negative externalities, e.g. tax cars driving in city centres (congestion charge) and use the money to pay for public transport.

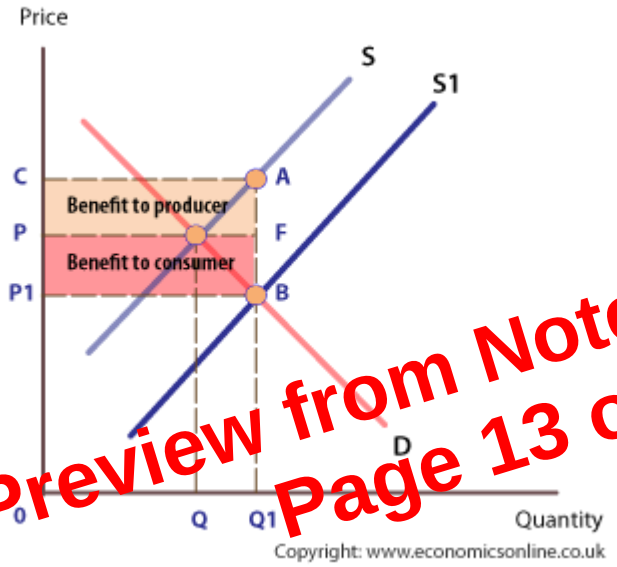
➔ Difficult to estimate the extent of the positive externality. Therefore the government may have poor information about the service and how much to subsidise. Difficult to quantify external benefits and place a monetary value on them.

➔ Opportunity costs for the government.

➔ There is a danger that government subsidies may encourage firms to be inefficient and they come to rely on subsidy rather than improve efficiency.

➔ The effect depends on the elasticity of demand.

Producer subsidy and consumer subsidy on a graph

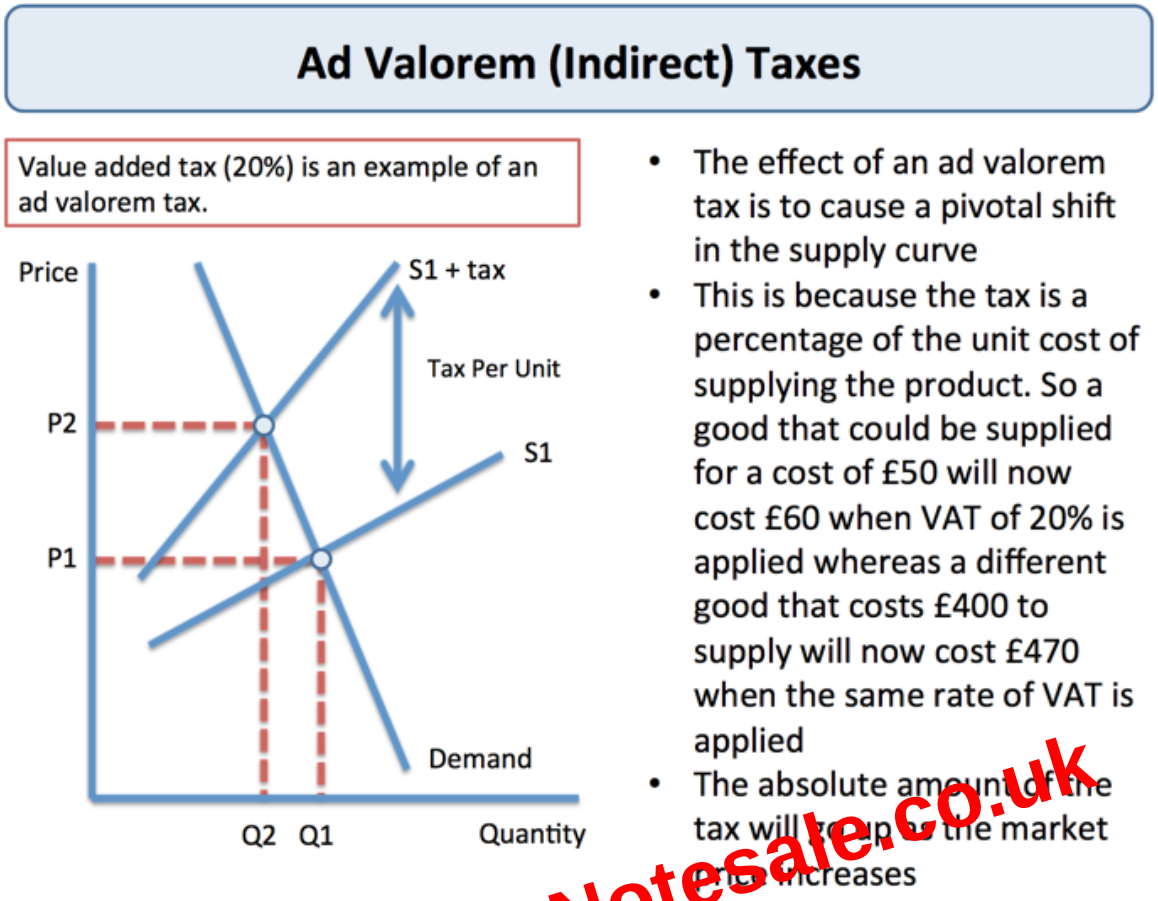


Alternative views on consumer behaviour

- **Reasons why consumers may not make rational decisions** = the influence of other people's behaviours, addiction, consumer weakness at computation or habitual behaviour.
- Consumer weakness at computation describes how consumers do not think fully about the consequences of their actions and how probable these consequences are.
- BUT the underlying assumptions for all rational decision making is that customers aim to maximise utility, companies aim to maximise profit and governments aim to maximise welfare of citizens. However, people do not always behave rationally and this occurs for three main reasons:

1. **Influences of other people:** Rationality assumes people act individually to maximise their own benefits but sometimes individuals are influenced by social norms, known as a bias. For example, someone may buy something to 'fit-in' or because everyone else has it, and so they are expected to too.

Ad-valorem tax diagram



Indirect taxes - advantages

- ➔ The external costs are internalised by making both the producer and consumer pay tax.
- ➔ They work with market forces so there is still choice over production and consumption (unlike some regulations/legislation).
- ➔ Tax funds raised by the government can be used to clean up the environment or to compensate the victims of pollution.
- ➔ Convenient - paid in small amounts and regularly rather than one lump sum.
- ➔ Level of pollution should fall as output is reduced and the price increased - social optimum can be reached.

Indirect taxes - disadvantages

- ➔ Difficult to quantify external costs and then place a monetary value on them.
- ➔ Increase the costs of production for firms, so they are less competitive.
- ➔ Widespread use may be inflationary.
- ➔ Firms may relocate to countries with less stringent taxes on production.
- ➔ Tax revenue raised may not be used to compensate victims/clean up the environment.
- ➔ Unintended consequences might occur - e.g. tobacco and alcohol smuggling and illegal markets.