

Economics 214

Student**Summaries** 

CHAPTER 1: THINKING LIKE AN ECONOMIST

Microeconomics refers to the study of the smallest component of the economy, i.e. the individual firm and/or consumer. **Macroeconomics** is the study of the economy as a whole and studies factors such as GDP and inflation rates.

Microeconomics entails the study of how people make choices under conditions of scarcity. Scarcity refers to the problem that exists regarding the fact that we have limited resources (where time is included as a resource) and unlimited wants that cannot all be satisfied with our limited resources.

COST-BENEFIT APPROACH

The cost-benefit approach is based off the fact that you will only perform a specific activity if the benefit of that particular activity outweighs the cost associated with that activity.

Money is often used as a unit in such cases, even if the action is not directly linked to monetary values, in which case we will make use of a “hypothetical monetary value”. This is to simplify decision making. When we compare costs and benefits they need to represent the monetary value of both as at the same time, i.e. you need to discount future values to their current values. For example, how much is a morning at the beach “worth” to you? If it is worth R100, but you need to pay R200 for an Uber to get there, which means you are unlikely to go, because the benefit of performing an activity is outweighed by the cost associated in performing that particular activity.

Another important concept is the **reservation price of an activity**, which represents the price at which an individual would be indifferent between doing an activity and not doing an activity, i.e. the maximum cost that the consumer is willing to pay for the activity.

COMMON PITFALLS IN DECISION-MAKING

From an economists’ point of view, there are some common mistakes that are made when individuals make decisions:

- We **should not ignore implicit costs** when doing the calculation of the cost of an activity, because in the process of doing one activity you had to forego doing another activity.

Implicit costs (opportunity cost) of an activity refers to the value of all things that must be sacrificed to do a particular activity.

- **Sunk costs must be ignored**, because you are not sacrificing a sunk cost as you would an opportunity cost, as it has already been incurred.

Sunk cost are costs that are beyond recoverable (e.g. insurance at the time that you embark on a specific journey) at the time that a specific activity is performed, or a decision is made.

- Costs and benefits must be **measured in absolute rand amounts**, not in percentages.
 - The percentage (or proportion) of something does not matter, i.e. you would treat a R40 saving on R5000 the same as a R40 saving on R100, regardless of what the percentages in savings are.
- A clear distinction should be made between the marginal and average concept.

Marginal cost (MC) refers to the increase in total cost that results from the utilization of an additional unit of an activity/consumption of an additional product. **Average costs** refer to the value obtained when you divided the total cost of Q units by the number of units, Q.

Marginal benefit (MB) refers to the increase in total benefit that results from the utilization of an additional unit of an activity/consumption of an additional product. **Average benefit** refers to the value obtained when you divided the total benefit obtained from Q units by the number of units, Q.

Consider the following example: You are a fisherman with five boats currently in operation. On average, they have been earning R2 000 per boat per day (i.e. **total earnings** are R10 000 and you have 5 boats, therefore their **average earnings** are $\frac{10\ 000}{5} = 2\ 000$). The cost of launching a new boat is R1 000 per day (**marginal**

CHAPTER 2: SUPPLY AND DEMAND

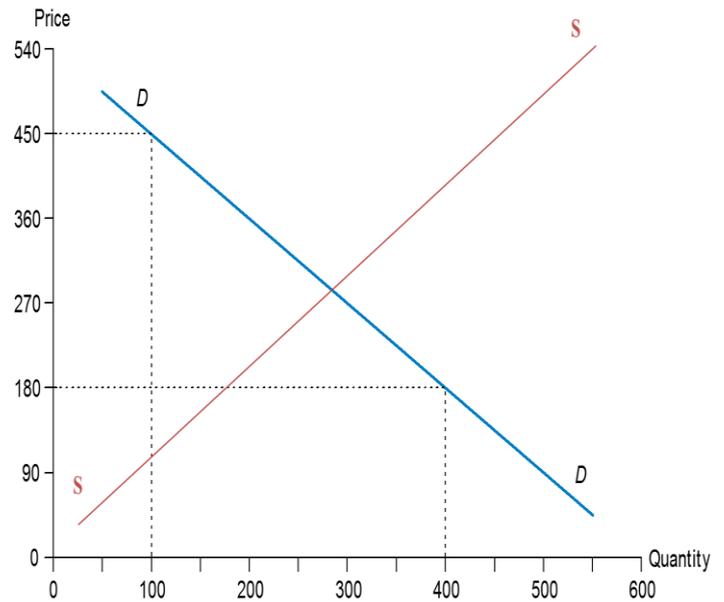
Market refers to a place or situation where buyers and sellers or their agents make contact to negotiate prices and quantities of a good or services to be traded.

DEMAND CURVE

The demand curve is a simple mathematical function that relates the quantity bought at various possible prices and can be expressed as follow (in the most general form): $P_D = c - m Q_D$. It is graphically represented by the D-D curve in the figure to the left. From the Demand curve, we can deduce the following:

The **Law of Demand** refers to the inverse relationship between price and quantity demanded, i.e. when price increases, quantity demanded decreases, and vice versa.

When the graph and axis-system is constructed, we have price on our vertical axis and quantity (either demanded or supplied, depending on which curve you are operating on) on the horizontal axis. It is important to note that the price on the vertical axis refers to the **real price**.



Real price refers to the price of one good relative to the price of another good, i.e. it is the ratio between the prices of the two different goods, i.e. **Real price** = $\frac{P_x}{P_y}$.

The supply curve is a simple mathematical function that shows how much a seller is willing to sell at various possible prices and can be expressed as follow (in the most general form): $P_S = c + m Q_S$. It is graphically represented by the S-S curve in the figure to the left. From the Supply curve, we can deduce the following:

The **Law of Supply** refers to the direct relationship between price and quantity demanded, i.e. when price increases, quantity demanded will also increase, and vice versa.

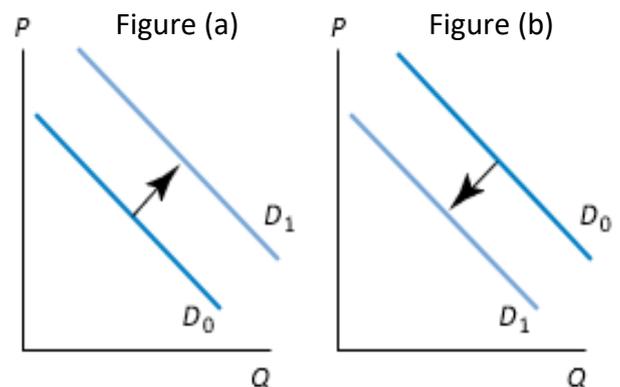
DETERMINANTS OF DEMAND

Price

When the price of a product increases, quantity demanded by the consumers will decrease, which will lead to an upward movement **along the same demand curve**, i.e. you will stay, e.g. on D_0 or D_1 . Similarly, if price decreases, quantity demanded will increase and we will have a downward movement **along the same demand curve**.

Factors that lead to a shift in the demand curve

- Incomes
 - Normal goods** refer to the goods with the property that the quantity demanded at every price level (i.e. **because the quantity demanded changes at every price level, the whole demand curve will shift, which is the same as saying the "demand for a good changed" as will be used in the following examples**) will rise as income rises, i.e. the demand curve will shift right, as in figure (a).
 - Inferior goods** refer to the goods with the property that the quantity demanded at every price level will fall as income rises, i.e. the demand curve will shift left, as in figure (b).



CHAPTER 9 PERFECT COMPETITION

PROFIT

It is generally accepted that the main goal of any firm is that of profit-maximization, but a distinction needs to be made between different profits.

- **Accounting profit** is merely the firm's total revenue less all explicit costs incurred.
- **Economic profit** refers to the accounting profit less all costs incurred, both explicit and implicit (i.e. the normal profit or opportunity cost, which refers to the "what could have been" aspect of decision making).

The abovementioned concept can easily be explained by the following example.

Cullen Rupert runs a putt-putt gold course in Manaba Beach, KwaZulu-Natal. He rents the course and equipment from a large recreational supply company and supplies his own labour. His monthly earnings, net of rental payments, is R12 000 and he considers working at the golf course just as attractive as his only other alternative, working as a grocery clerk for R12 000 per month. Cullen learns that his Uncle Johan has given him some land in Durban, which is conservatively estimated to be worth R150 000 000 if it were to be sold and assume the interest rate is 1% per month. The land has been cleared and Cullen discovers that a construction company is willing to install and maintain a putt-putt golf course on it for a payment of R60 000 per month. Cullen also commissions a market survey, which reveals that he would collect R900 000 per month in revenue by operating a putt-putt golf course there. Advise Cullen whether he should, as a profit maximizer, switch his operations to Durban or not, assuming that the cost of living for both locations are the same.

1. First of all, it is important to note that he will only switch operations if the new economic profit will be higher, therefore we need to calculate the economic profit for both locations to make this decision.

Economic profit in Manaba Beach: R12 000 (accounting profit) – R12 000 (opportunity cost for not working as a grocery clerk) = R0.

Economic profit in Durban: R900 000 – R60 000 (accounting profit) – R12 000 (opportunity cost for not working as a grocery clerk) – R1 500 000 [150 000 000 (0,09) – opportunity cost of not selling the land per month] = – R672 000.

2. Compare the economic profit of the two locations to make the final decision.

It is clear that the economic profit in Manaba Beach is higher than in Durban, even though it is R0. Accordingly, Cullen would decide to stay in Manaba Beach and rent out the piece of land per month or sell it for an additional income.

FOUR CONDITIONS FOR PERFECT COMPETITION

1. Firms sell a standardized product
The product sold by one firm is assumed to be a perfect substitute for the product sold by any other. Realistically, this condition is rarely ever satisfied. If we define a market sufficiently narrow, e.g. being specific as to saying the market for button-up, long-sleeved blue shirts, it is possible to achieve a reasonable degree of similarity among the products produced by the competing firms. When we have standardized products, it means they are homogenous and no firm is able to raise its price without losing some of its business. It also means that branding means nothing because every product is the same.
2. Firms are price takers
This means that the individual firm treats the market price of the product as given; more importantly, the assumption is made that the market price is not affected by the output produced by the firm or any of its competitors. This is a condition that can be satisfied, especially in a market with a large number of firms, because every firm has such an insignificant fraction of the market demand, that he