

IB Diploma: Economics

Section 1: Microeconomics COURSE COMPANION

First Edition (2017)

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Foundations of Economics

Introduction to Microeconomics

- Microeconomics is the study of economics at the level of the individual firm, industry or consumer/household.
- We study how prices and wages are determined in markets; how consumers decide what to buy; how businesses determine what is produced and how it is supplied.
- Microeconomics involves analysing the effects of government regulations, subsidies, taxes and maximum & minimum prices on prices and quantities of goods and services and the allocation of scarce resources

Economics as a Social Science

- Economics studies the choices people take under the conditions of scarcity and uncertainty
- Because Economics is a social science we can never be sure of the ways in which people and businesses will respond to changing circumstances around them
- Traditional economic theories have assumed that rational consumers seek to maximise their own satisfaction and that businesses aim to maximise profit
- But new theories including those from Behavioural Economics suggest alternatives and focus on the social aspect of our behaviour in day-to-day life

Positive and Normative Economics

- Positive statements:
 - Positive statements are objective statements that can be tested, amended or rejected by referring to available evidence.
 - Positive economics deals with objective explanation and the testing and rejection of theories.
 - A false statement is also a positive one!
 - For example: The falling price of crude oil on world markets will lead to a fall in demand for fuel efficient cars
- Normative statements:
 - Normative statements are subjective statements – i.e. they carry value judgments about what ought to be
 - For example: A high level of unemployment is more harmful to the economy than a high rate of inflation

Most economic decisions and policy are influenced by value judgements, which vary from person to person, resulting in fierce debate between political parties

Rational decision-making

- What makes people happy?
- Why despite several decades of rising living standards, surveys of happiness suggest that actually, people are not noticeably happier than previous generations?
- Typically, we assume that, when making decisions people aim to maximise their own welfare.
- They have a limited income and they allocate money in a way that improves gives them the highest total satisfaction.

- In reality, when making day-to-day decisions, consumers rarely behave in a well-informed and rational way!
- Often decisions are based on incomplete information which causes a loss of welfare not only for people themselves and affect others and our society as a whole.

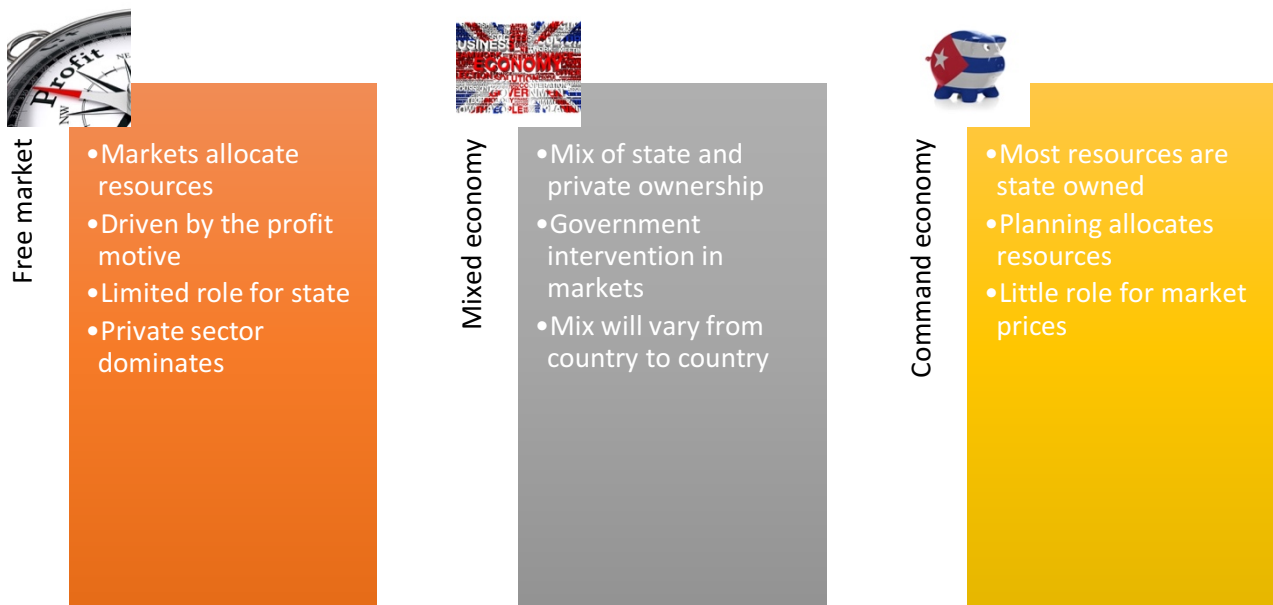
Assumptions about the Objectives of Agents

- For most of the standard microeconomics course we assume that
- Rational consumers wish to maximize their satisfaction or utility from consumption by correctly choosing how to spend their limited income.
- Producers/firms wish to maximize profits, by producing at lowest cost the goods and services that are desired by consumers. Profit = total revenue – total costs.
- Government wishes to improve the economic and social welfare of citizens.

Behavioural economics theories challenge the assumption of pure rationality in our decisions

Free Market, Mixed and Command Economies

An economic system is a network of organisations used to resolve the problem of what, how much, how and for whom to produce

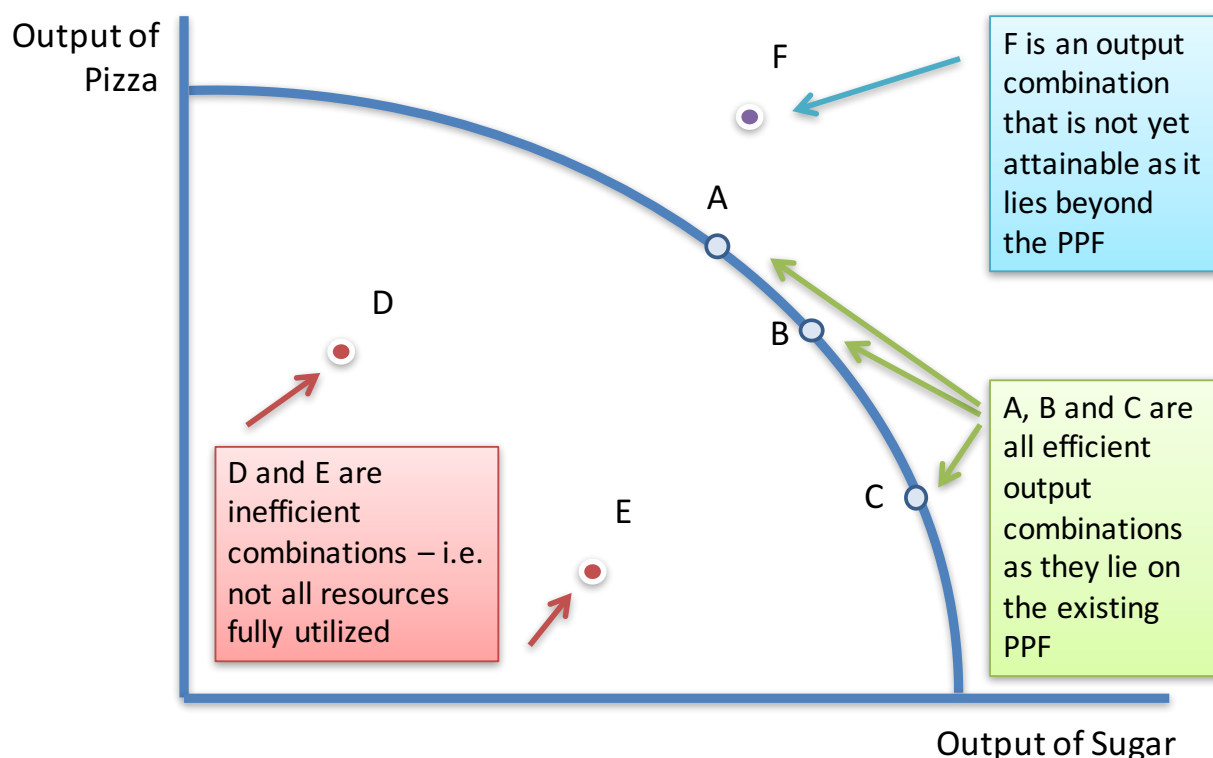


Production Possibility Frontiers (PPF)

A PPF shows alternative combinations of two goods or services attainable when all resources are fully and efficiently employed

- We normally draw a PPF as concave to the origin i.e. when we move down along the PPF, as more resources are allocated towards Good Y the extra output gets smaller
- This is explained by the law of diminishing marginal returns. It occurs because not all factor inputs are equally suited to producing items leading to lower productivity
- Land, labour and capital are imperfect substitutes

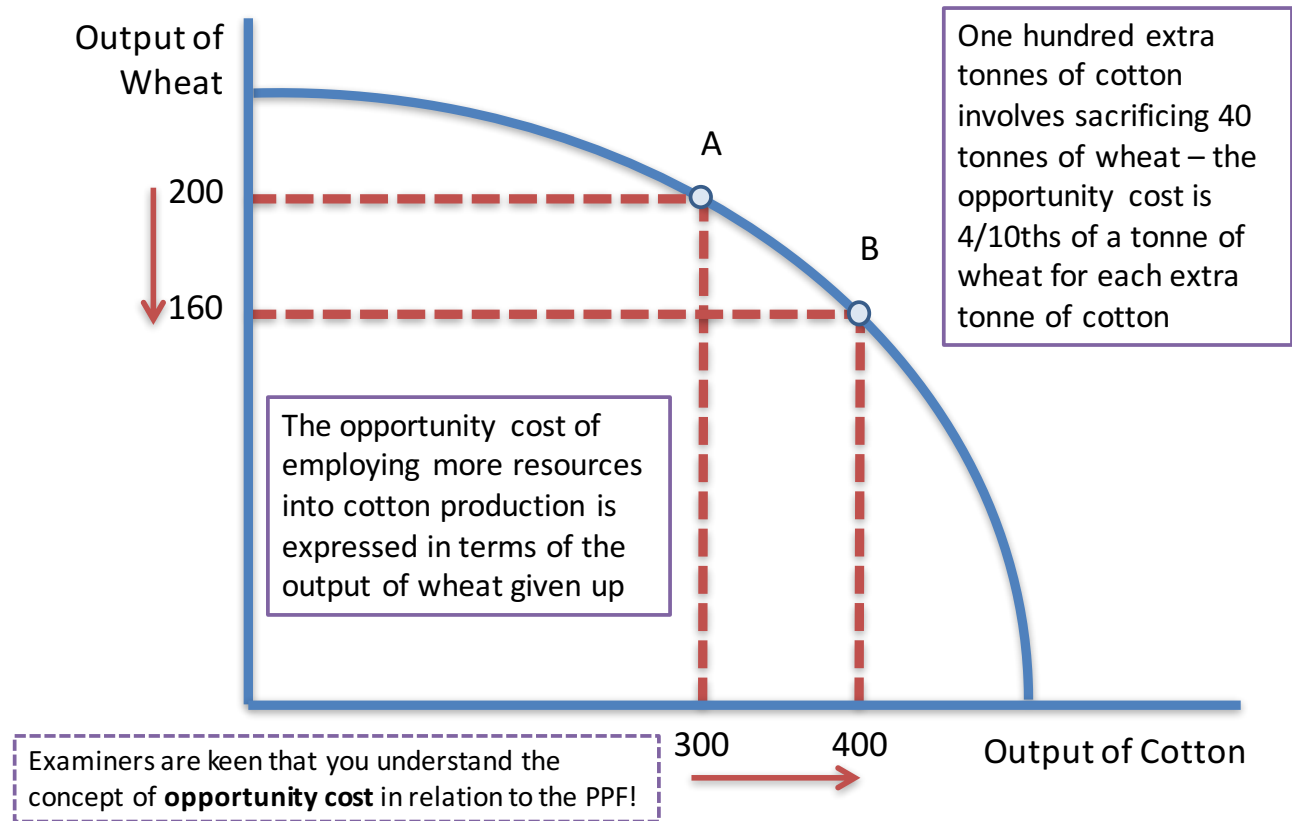
Drawing the Production Possibility Frontier (PPF)



Understanding the PPF and Economic Efficiency

- Combinations of the output of consumer and capital goods lying inside the PPF happen when there are unemployed resources or when resources are used inefficiently. We could increase total output of goods and services by moving towards the PPF
- Combinations of goods and services that lie beyond the PPF are unattainable at the moment
- A country would require an increase in factor resources, an increase in productivity and/or an improvement in technology to achieve an outward shift of the PPF
- Trade between countries also allows nations to consume beyond their own PPF potentially leading to gains in economic welfare
- Producing more of both goods with the same resources represents an improvement in welfare and a gain in allocative efficiency

The PPF and Opportunity Cost



PPF, Diminishing Returns and Opportunity Cost

