EOCT Study Guide
Adapted from GA Dept. of Education Economics EOCT Study Guide
Unit 2: Microeconomic Concepts

Microeconomics- the study of the interactions of individuals and business (aka: firms) within a single market "small economics"

Topic 1: Circular Flow of Goods and Resources (SSEMI 1)

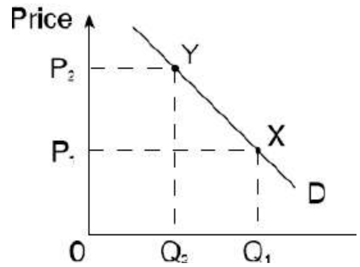
- The Circular Flow of goods and resources through a market economy is illustrated by the circular flow diagram seen below:

- There are two areas where households and businesses make exchanges with one another.
    - The Product Market is the area in which households provide money (expenditures) to businesses for finished goods & services (products), which the businesses collect in the form of revenue.
    - The Factor or Resource Market is the area in which households provide productive resources (resources) to businesses in exchange for income, which businesses provide in the form of wages, interest, or net profit.
- The outer arrows on this diagram represent the flow of resources (in the lower half) and products (in the upper half).
- The inner arrows on this diagram represent the flow of money through the market
- The key to understanding the Circular Flow Diagram is to realize that in a market economy, the households own all the productive resources and sell them to the businesses. They then use that income to purchase the products made by businesses
- Money is an important factor in promoting the flow of goods and resources through the market. Without money, these transactions would be extremely difficult for households and businesses to negotiate.
- This diagram leaves out the role of the government:
    - The government's role includes purchasing products/resources and taxing businesses/households
    - The government also attempts to keep the flow of money & products/resources equal by injecting money into the system if necessary.

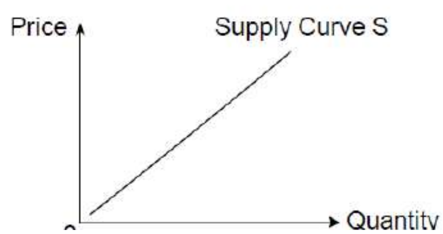
Topic 2: The Laws of Supply & Demand (SSEMI 2)

- In a market economy, prices and production levels are determined through the interaction of supply and demand.
    - This interaction is governed by the laws of supply and demand and can be illustrated on graphs called supply & demand curves.
- Demand:
    - Demand is the amount of a product that consumers are willing and able to purchase at different prices.
    - The Law of Demand states that the higher the price of a good, the less people will be willing and able to buy

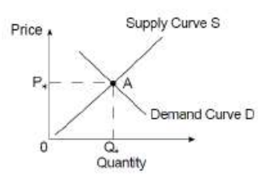
- Demand Curves:
  - The demand curve (below) shows that as price increases (Y axis), quantity demanded (X axis) decreases in accordance with the law of demand.
  - At point Y, the price is high and the quantity demanded is low.
  - At point X, the price is low and the quantity demanded is high.
  - *Demand curves always have a downward slope from left to right.*



- Supply:
  - Supply is the amount of a product that producers are willing and able to provide at different prices
  - The Law of Supply states that the higher the price of a good, the more people will be willing and able to sell
- Supply Curves:
  - The supply curve (below) shows that as price increases (Y axis), quantity supplied (X axis) also increases in accordance with the law of supply.
  - *Supply curves always have an upward slope from left to right.*



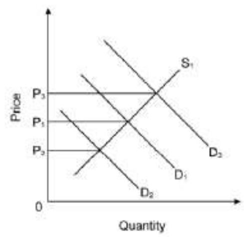
- Supply & Demand Curves
  - Supply & Demand for a single product can be graphed on the same graph (see below).
  - This allows us to see the interaction of each force and determine the best price and production level.
    - In this graph the Y axis remains price and the X axis can be seen as either quantity supplied (if reading the supply curve) or quantity demanded (if reading the demand curve)



- At point A (where the price is P_* and the quantity is Q_*) the quantity demanded and quantity supplied are equal.
  - This is called the Equilibrium Price or Market Clearing Price
  - At this price, the suppliers are willing and able to sell exactly the same amount of a product that consumers are willing and able to purchase.
  - This represents the most efficient choice of price because producers will sell all of their products without having any left over, and consumers' demand will be met

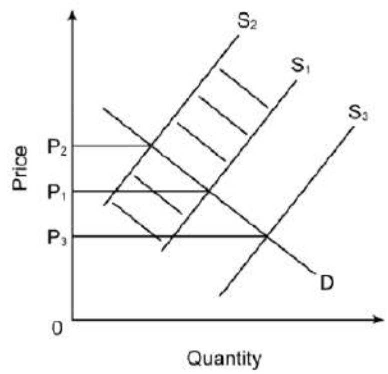
Topic 3: Forces Affecting Price Determination (SSEMI 3)

- **Shifts in Supply and Demand**
- Quantity demanded and supply demanded can and do change over time. This results in a change in the equilibrium or market clearing price.
- Demand Shifts:
  - Demand can change for a variety of reasons causing the demand curve to shift to the left or right, while the supply curve does not change. (See graph below)



  - D_1 represents the original demand curve D_2 and D_3 represent new curves caused by a change in demand.
  - D_2 represents a left shift in demand, or a decrease in demand for this product at all prices.
    - This could have been caused by a change in consumer tastes or advertising that caused people to be less willing to buy this product.
  - D_3 represents a right shift in demand, or an increase in demand for this product at all prices.
    - This could have been caused by a decrease in the price of a complimentary good.
- **Causes of Demand Shifts:**
  - Consumer tastes and advertising
    - A popular new commercial can increase the willingness of consumers to buy a product, which shifts demand right; while a vicious rumor about a product can decrease the willingness of consumers to buy it, which shifts demand left.
  - Changes in price of related goods
    - An increase in the price of a compliment (products that are generally purchased at the same time) can cause demand to shift left; while a decrease in the cost of a compliment can cause demand to shift right
    - In increase in the price of a substitute (products that can be interchangeable) can cause demand to shift right; while a decrease in the cost of a substitute can cause demand to shift left
  - Consumer expectations of future price
    - If price is expected to increase in the future, present demand will shift right; while an expectation of a decrease in future prices will cause present demand to shift left.
  - Population Changes
    - Increases in total population, or the part of a population that demands a particular product can cause a right shift in demand; while decreases in population can cause a left shift in demand.
  - Income
    - An increase in income means people are able to buy more of a product, which can cause a right shift in demand; while decreases in income can cause left shifts in demand.

- Supply Shifts:
  - Supply can change for a variety of reasons causing the supply curve to shift to the right or left while the demand curve remains the same. (See graph below)

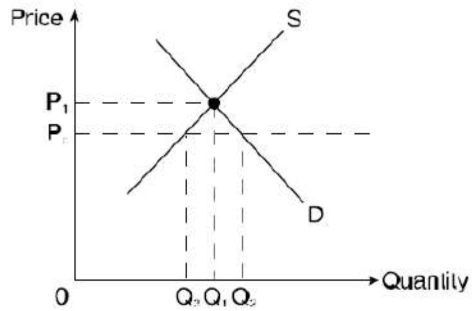


- S_1 represents the original supply curve and S_2 and S_3 represent new curves caused by a change in supply.
- S_2 represents a left shift in supply, or a decrease in supply for this product at all prices.
  - This could have been caused by an increase in the cost of inputs.
- S_3 represents a right shift in supply, or an increase in supply for this product at all prices
  - This could have been caused by suppliers expecting future price to decrease.

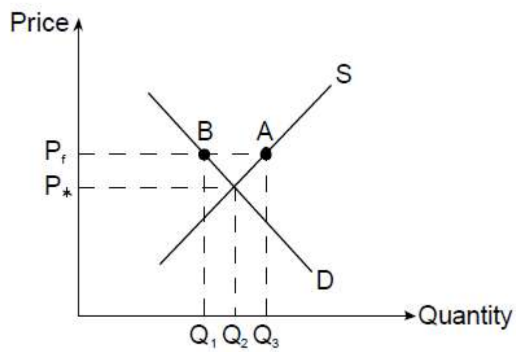
- **Causes of Supply Shifts:**
  - Changes in Input Costs
    - An increase in input costs (factors of production) can cause supply to shift left; while a decrease in input costs can cause supply to shift right.
  - Government
    - An increase in government regulations over a product can cause supply to shift left; while deregulation can cause supply to shift right.
  - Global Economy
    - Changes in the global economy can cause supply to shift to the right or left.
  - Future Expectation of Price
    - An expectation of a future increase in price can cause present supply to shift left; while an expectation of a future decrease in price can cause present supply to shift right.
  - Number of Suppliers
    - An increase in the number of suppliers of a product can cause supply of that product to shift right; while a decrease in the number of suppliers can cause supply to shift left.
- **Changes in Equilibrium/Market Clearing Price**
  - Shifts in supply or demand will cause the equilibrium price to change. The price will either increase or decrease depending on how the curve has shifted.
  - A right shift in demand will cause the equilibrium price to increase to raise supply to meet the new (higher) demand; while a left shift in demand will cause the equilibrium price to decrease to lower supply to meet the new (lower) demand.
  - A right shift in supply will cause the equilibrium price to decrease to raise demand to meet the new (higher) supply; a left shift in supply will cause the equilibrium price to increase to lower demand to the meet the new (lower) supply.
- If the equilibrium price is not changed to reflect shifts in supply or demand, a surplus or shortage will occur.
  - Surplus- caused by demand being lower than supply
    - Suppliers will produce more of a product than consumers demand at that price
  - Shortage- caused by supply being lower than demand
    - Suppliers will not produce enough of a product to meet the demand at that price
  - Surpluses and shortages are examples of <u>disequilibrium</u>, when price is too high or low for equilibrium to occur.

- **Other Factors Affecting Price**
- The government can enact price ceilings and floors which can result in disequilibrium
  - Price Ceilings are maximum prices that can be charged for a product. Ex: Rent control

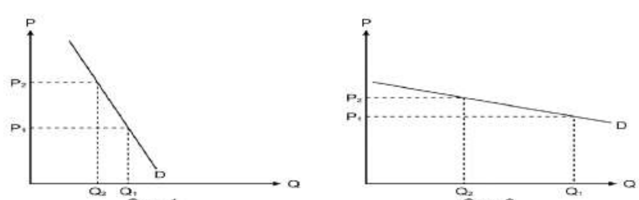
- Price ceilings can prevent the market from reaching equilibrium and can lead to shortages (as shown on the graph below) by encouraging consumers to demand more (Q_2) than producers are willing to supply (Q_3).



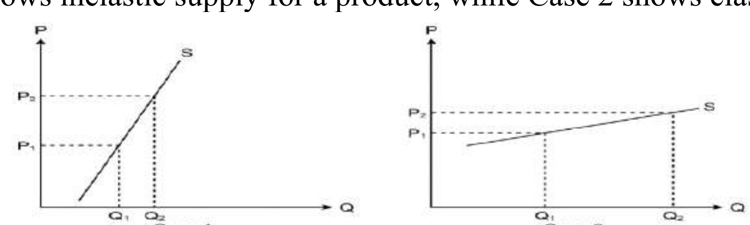
- Price Floors are minimum prices that can be charged for a product. Ex: Minimum wage
  - Price floors can prevent the market from reaching equilibrium and can lead to a surplus (as shown on the graph below) by encouraging producers to supply more (Q_3) than consumers are willing to purchase (Q_1)



- **Elasticity**
- Elasticity applies to both supply and demand and refers to how a change in price affects quantity.
- Some products are extremely responsive (elastic) to changes in price and some are not (inelastic)
- This can be seen on a graph:
  - Below, Case 1 shows inelastic demand for a product, while Case 2 shows elastic demand for a product.



  - Below, Case 1 shows inelastic supply for a product, while Case 2 shows elastic supply for a product.



Topic 4: Types of Business Organizations and Market Structures (SSEMI 4)

- **Business Organizations**
  - <u>Sole Proprietorship</u>- a business with a single owner

        - Advantages: adaptability, total control, sole receiver of profit, ease of start up
        - Disadvantages: limited capital, complete liability
    - Partnership- a business with multiple owners
        - Advantages: Similar to a sole proprietorship, but with limited liability, and greater capital
        - Disadvantages: Similar to sole proprietorships, but with lower reward, and control
        - Types of partners:
            - Silent partners- have no say in business decisions, but share the profits
            - Minority partners- have less say than majority partners, and receive a lower share of profits
    - Corporations- a business owned by its shareholders, but run by a board of directors and a CEO
        - Advantages: higher capital (can raise money by selling stock), no liability, receive profit (dividends) without working for the business
        - Disadvantages: lack of control over business decisions
- **Market Structures**
    - There are four types of markets in which businesses participate, they are determined by the following:
        - Numbers of firms
        - Barriers to entry
        - Products
        - Competition
    - Monopoly**-** A single firm in a market, high barriers to entry, a single product, no competition
        - Very rare, sometimes allowed by the government (Macon Water Authority)
        - Problems: monopolies are called price makers because, without competition, they have total control over the price. This can cause higher prices and shortages.
    - Pure or Perfect Competition- unlimited # of firms, low barriers to entry, homogenous products, unlimited competition
        - Example: Corn
        - Opposite of monopoly, firms have no control over price and are called price takers, because competition within the market determines price
    - Monopolistic Competition- large # of firms, low barriers to entry, similar products, high competition
        - Combination of monopoly and competition
        - Example: Hand Soap
        - Products are slightly different, allowing firms some control over price
    - Oligopoly- few firms, high barriers to entry, varied products, some competition
        - Example: Airline Industry
        - A few firms control the entire industry. They are sometimes competitive like soft drink companies, but can also work together to determine price- this is called a cartel (illegal)