

Producer Theory

Lecture 15: Elasticity — Demand Recap & Supply Elasticity

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Recap: Lecture 3

Key Concepts from Last Class:

 **Rationality:** Cost-benefit decision making

 **Marginal Analysis:** Decisions at the margin (MB vs MC)

 **Opportunity Cost:** Value of best alternative foregone

 **Sunk Costs:** Ignore them in decisions!

 **Today:** We build on opportunity cost to understand:

- Production factors (inputs)
- **Production Possibilities Frontier (PPF)**
- Society-level trade-offs and efficiency

Production Factors

The Three Main Inputs

PRODUCTION FACTORS

To produce goods and services, economies use three main factors: **Land** (natural resources), **Labor** (human effort), and **Capital** (produced goods used in production).

Land

- Agricultural land
- Minerals & energy
- Water resources
- Natural beauty
- Climate

Tourism: Beaches, mountains, heritage sites

Labor

- Physical work
- Mental work
- Skills & training
- Time & effort
- Entrepreneurship

Tourism: Staff, guides, managers, chefs

Capital

- Buildings
- Machinery
- Infrastructure
- Technology
- Equipment

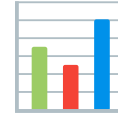
Tourism: Hotels, planes, booking systems

Factor Payments

Each factor receives compensation:

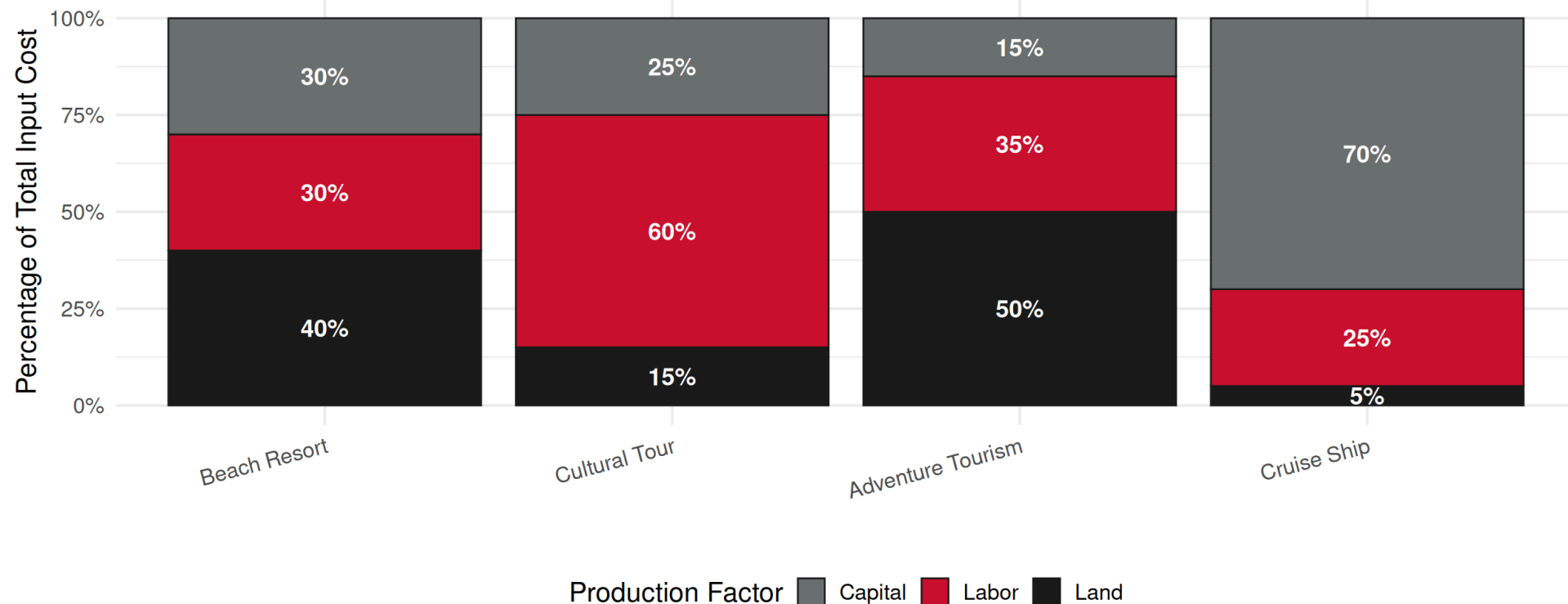
| Factor | Payment Name | Example in Tourism |
|-------------------------|----------------|--|
| Land | Rent | Payment for beach concession, property lease |
| Labor | Wages/Salaries | Hotel staff wages, tour guide fees |
| Capital | Interest | Return on hotel investment, equipment loans |
| Entrepreneurship | Profit | Hotel owner's profit, airline earnings |

Tourism Production: Example



Factor Intensity in Different Tourism Products

Different activities require different combinations of Land, Labor, and Capital



Hypothetical illustration of factor intensity

 **Insight:** Cruise tourism is **capital-intensive**, cultural tours are **labor-intensive**, beach resorts balanced

Production Possibilities Frontier (PPF)

What is the PPF?

PRODUCTION POSSIBILITIES FRONTIER (PPF)

The PPF shows the **maximum combinations** of two goods an economy can produce given fixed resources, current technology, and full employment.

Key Insight

With scarcity, producing more of one good requires producing less of another

→ **This is opportunity cost visualized!**

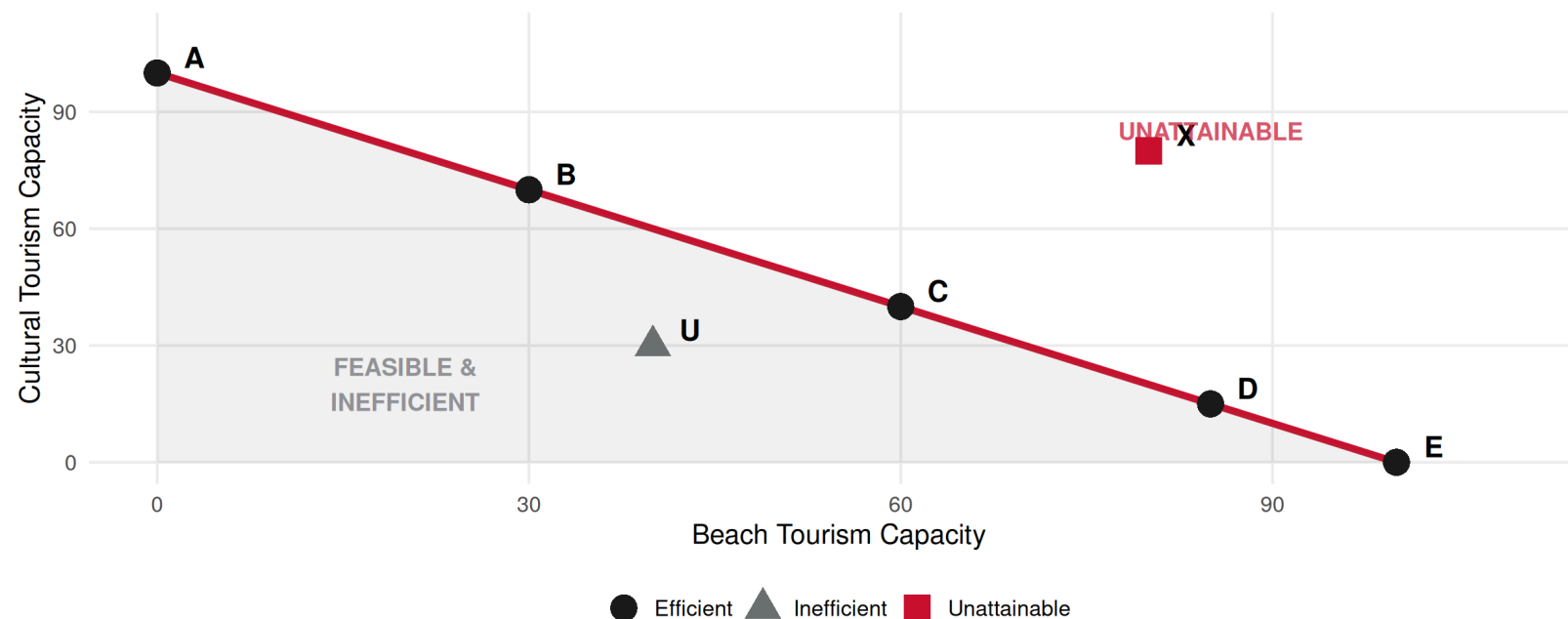
Simple PPF Example: Tourism

Imagine an economy producing only:

- **Beach Tourism** (hotels, resorts)
- **Cultural Tourism** (museums, tours, heritage sites)

Linear Production Possibilities Frontier

Constant Opportunity Cost (1:1 Swap Ratio)



Interpreting the PPF

Point A (0, 100): All resources → cultural tourism, no beach tourism

Point E (100, 0): All resources → beach tourism, no cultural tourism

Point C (60, 40): Mixed economy, balanced allocation

Point U (40, 30): **Inefficient** — inside PPF

- Resources unemployed or misallocated
- Could produce more of both goods!

Point X (80, 80): **Unattainable** — outside PPF

- Not enough resources with current technology
- Would need economic growth

Moving Along the PPF

From B (30, 70) to C (60, 40):

 Gain: 30 units of beach tourism

 Loss: 30 units of cultural tourism

 **Opportunity Cost:** 30 cultural units

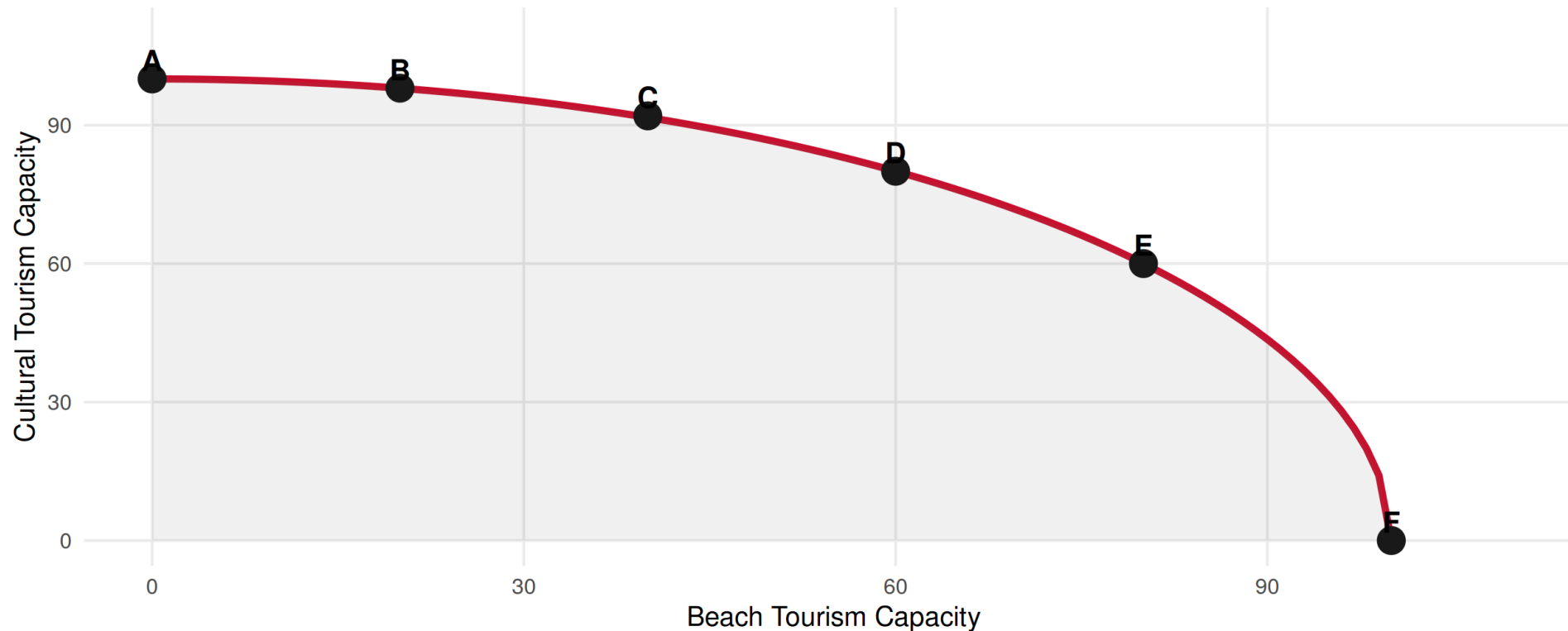
Key Point

- Moving along PPF = **reallocation** of resources
- All points on PPF are **efficient** (no waste)
- But different distributions (different answers to WHAT question)
- Trade-offs are unavoidable!

Bowed-Out PPF: Increasing Opportunity Cost

Bowed-Out PPF: Increasing Opportunity Costs

As you produce more of one good, opportunity cost increases



 **Why bowed out?** Resources aren't perfectly adaptable — some resources are better suited for beach tourism, others for cultural tourism

Calculating Opportunity Cost on PPF :calculator:

Example: Moving from C to D

Point C: (40 beach, 92 cultural)

Point D: (60 beach, 80 cultural)

Change:

- Gain: 20 beach units
- Loss: 12 cultural units

Compare: D to E

- Gain: 20 beach (60→80)
- Loss: 20 cultural (80→60)
- $OC = 20/20 = 1.0$ (higher!)

Opportunity Cost:

$$OC = \frac{\text{Units Lost}}{\text{Units Gained}} = \frac{12}{20} = 0.6$$

👉 Each additional beach unit costs **0.6 cultural units**



Opportunity cost **increases** as we specialize more

Economic Growth & PPF Shifts

Shifting the PPF Outward

ECONOMIC GROWTH

An outward shift of the PPF represents economic growth — the ability to produce more of both goods. Caused by: more resources, better technology, or improved productivity.

Three ways to shift PPF outward:

 **More resources** (population growth, discover new land)

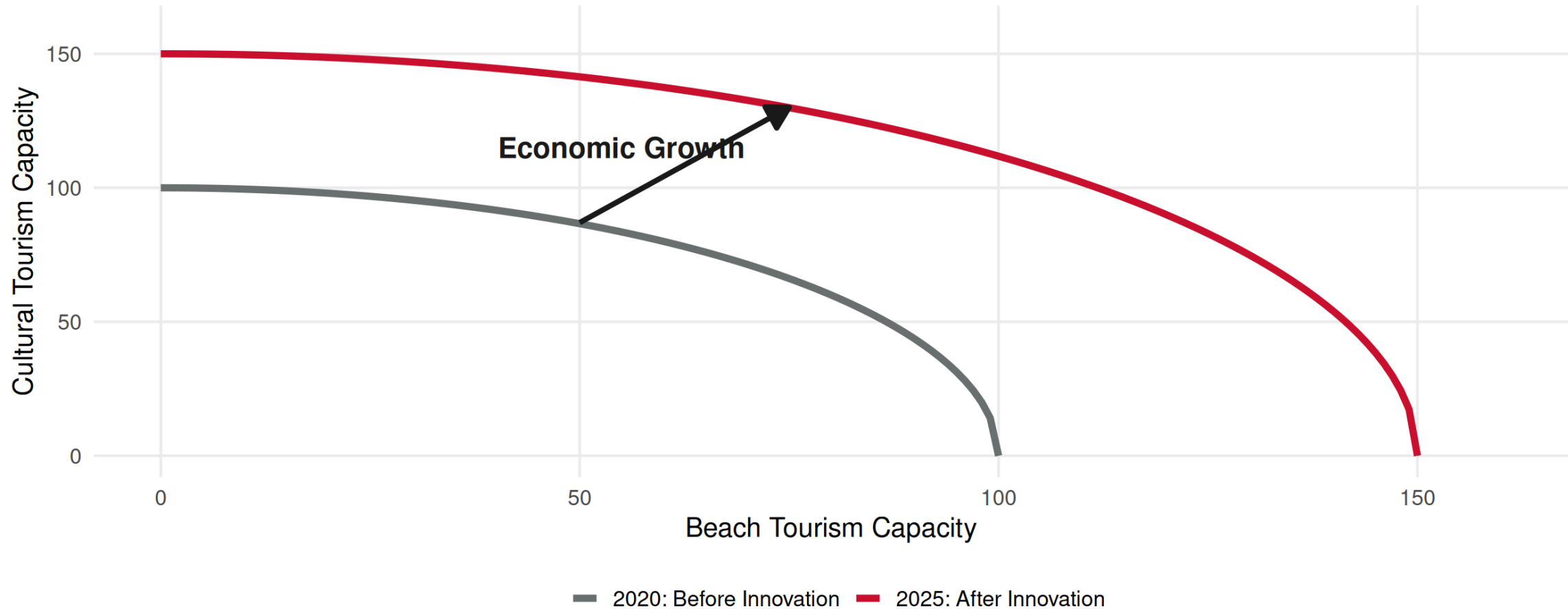
 **Better technology** (innovation, improved processes)

 **Human capital** (education, training, skills)

PPF Shift Example

PPF Shift: Technological Innovation in Tourism

New technology (AI, digital platforms) expands production possibilities



Investment Trade-off: Present vs Future


Key Economic Decision: Consumption today vs. Growth tomorrow

More Consumption Goods Today

- ✓ Higher current standard of living
- ✓ Immediate satisfaction
- ✗ Less investment in capital
- ✗ Slower future growth

More Capital Goods Today

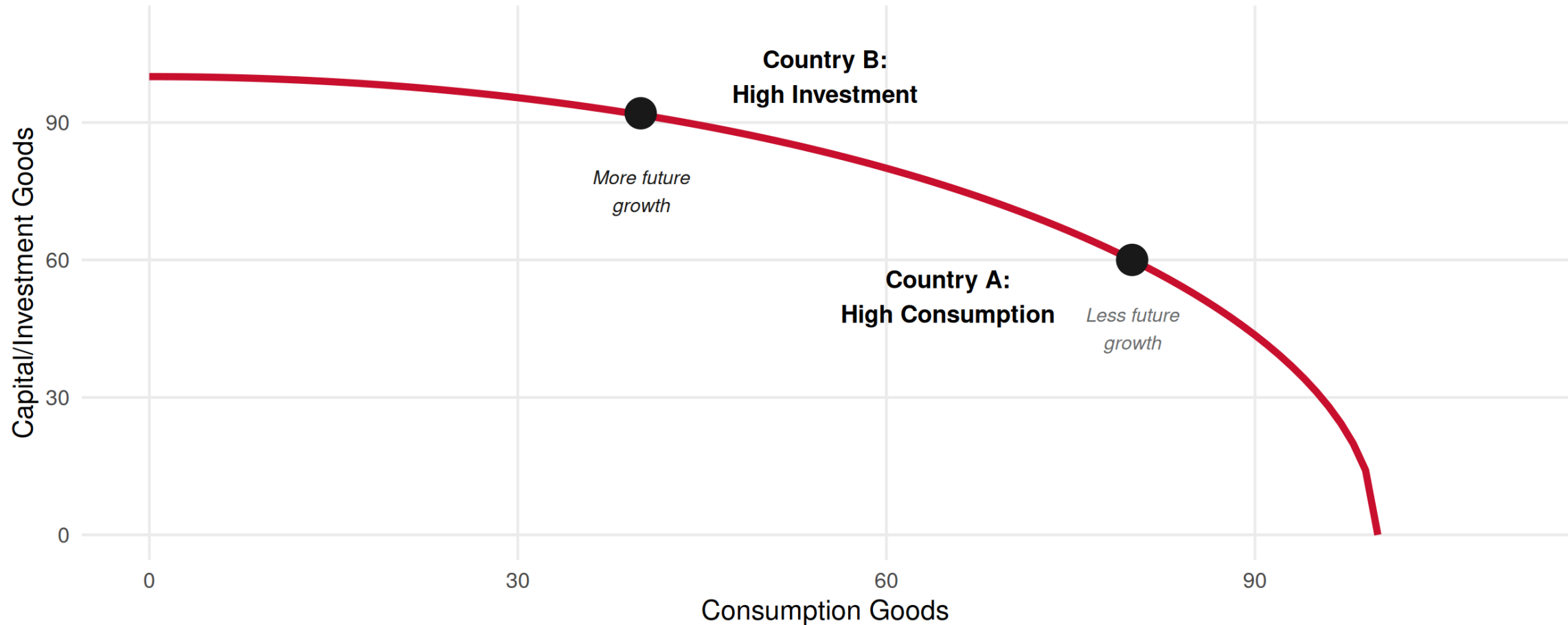
- ✓ Faster PPF outward shift
- ✓ Higher future production
- ✗ Lower current consumption
- ✗ Sacrifice today for tomorrow

 **Tourism Example:** Build hotels now (consume less) → More capacity future → Higher tourism revenue later

Investment Trade-off Visualization

Consumption vs. Investment: Different Choices

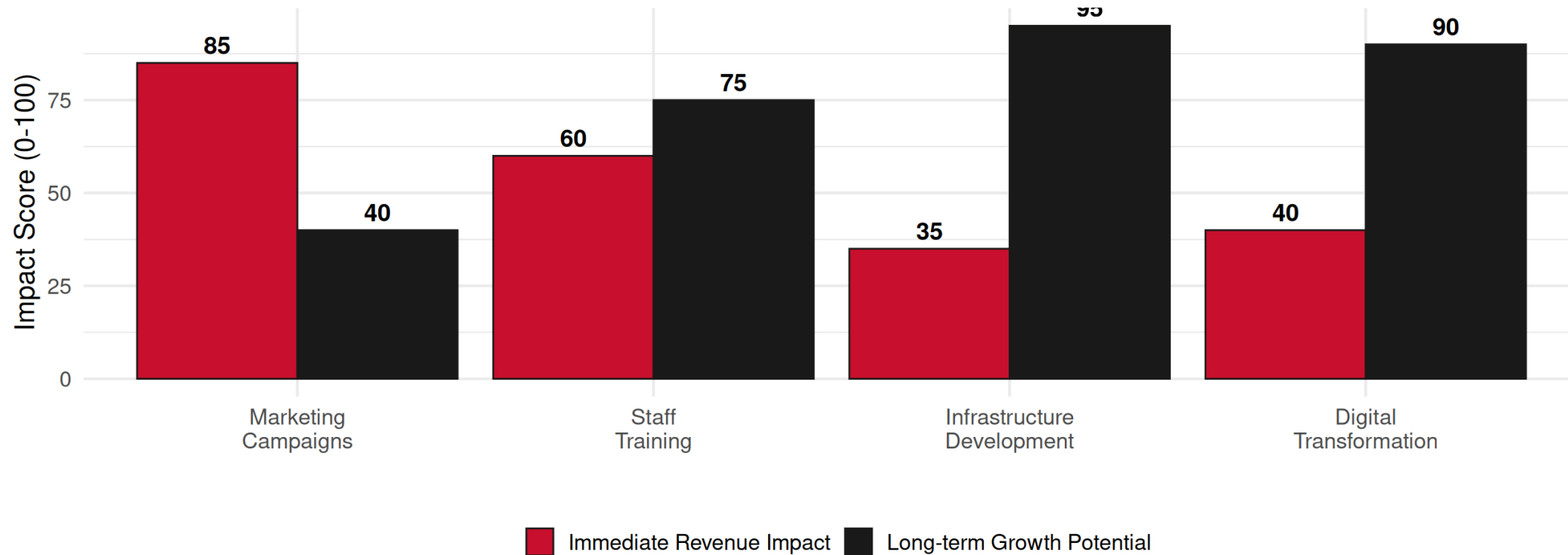
Country B sacrifices consumption today for higher growth tomorrow



Tourism Investment Example

Tourism Investment Categories: Trade-off Analysis

Infrastructure & Digital have high long-term impact but low immediate returns

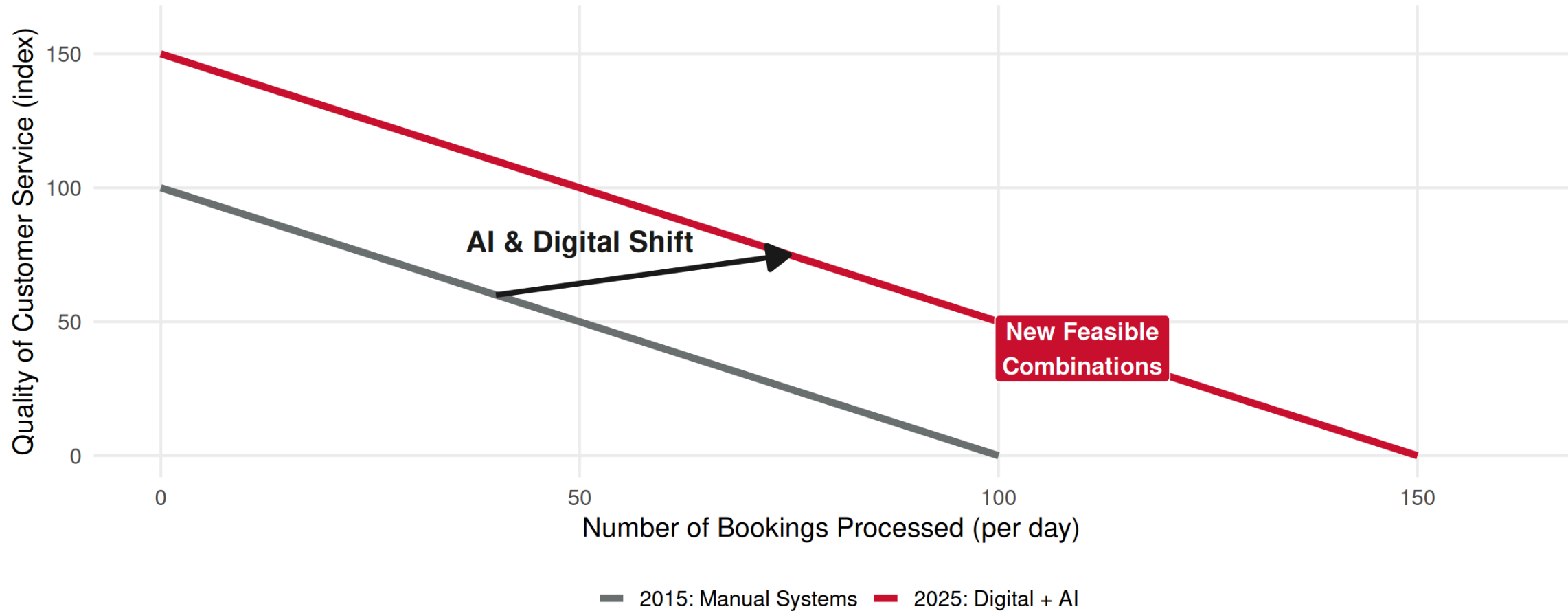


👉 **Strategic choice:** Prioritize long-term growth (infrastructure, digital) despite lower immediate returns

Technological Change Example

Technology Impact: Travel Agency PPF Shift

Digital transformation enables higher efficiency across all services



PPF Summary: Key Insights

- 1 Shows maximum production** given resources & technology
- 2 Points on PPF** = efficient (can't produce more without trade-off)
- 3 Points inside PPF** = inefficient (unemployment, waste)
- 4 Points outside PPF** = impossible (currently unattainable)
- 5 Moving along PPF** = reallocating resources (opportunity cost)
- 6 Shifting PPF outward** = economic growth (more resources, better technology)
- 7 Investment trade-off** = consumption today vs. growth tomorrow

Real-World Applications

PPF thinking helps answer:


- ? Should Portugal build more hotels or preserve more heritage sites?
- ? How much should airlines invest in fuel efficiency vs. passenger comfort?
- ? Trade-off between mass tourism revenue and sustainable tourism?
- ? How much GDP to allocate to tourism vs. other sectors?



All involve opportunity costs and efficiency considerations!

Complete Picture: Integration

Today's Lecture Integration:

- 1 **Production Factors** (Land, Labor, Capital) are scarce inputs
 - 2 **Scarcity** forces choices between alternatives
 - 3 **PPF** visualizes society's production possibilities
 - 4 **Opportunity Cost** = moving along PPF (what's foregone)
 - 5 **Efficiency** = operating on (not inside) PPF
 - 6 **Economic Growth** = PPF shifts outward
 - 7 **Investment** today enables faster growth tomorrow
-  **This connects to:** Lecture 3 (opportunity cost), Lecture 2 (WHAT/HOW/FOR WHOM), Lecture 1 (scarcity & efficiency)

Exercises

Application Time!

PPF and opportunity cost calculations.

Exercise 1: Multiple Choice

An economy is producing at a point **INSIDE** its PPF. This indicates:

- A. The economy is efficiently using all resources
- B. The economy has economic growth
- C. There is unemployment or resource misallocation
- D. It's impossible to produce more of any good

Answer: C - Inside PPF means inefficiency — resources are unemployed or misallocated. Could produce more of at least one good without sacrificing the other (move toward frontier).

Exercise 2: Multiple Choice

A country's PPF shifts outward. This could be caused by:

- A. Higher unemployment
- B. Decrease in the labor force
- C. Technological innovation
- D. Producing less capital goods

Answer: C - Outward PPF shift = economic growth. Caused by: more resources, better technology, improved productivity. Options A, B, D would shift PPF inward or cause movement inside PPF.

Exercise 3: Open Question - Setup

Scenario: The Portuguese Algarve region has limited land and labor. It can allocate resources between golf tourism and beach tourism. Current production possibilities:

| Combination | Golf Resorts | Beach Hotels |
|-------------|--------------|--------------|
| A | 0 | 50 |
| B | 5 | 48 |
| C | 10 | 44 |
| D | 15 | 38 |
| E | 20 | 30 |
| F | 25 | 0 |

Exercise 3: Questions

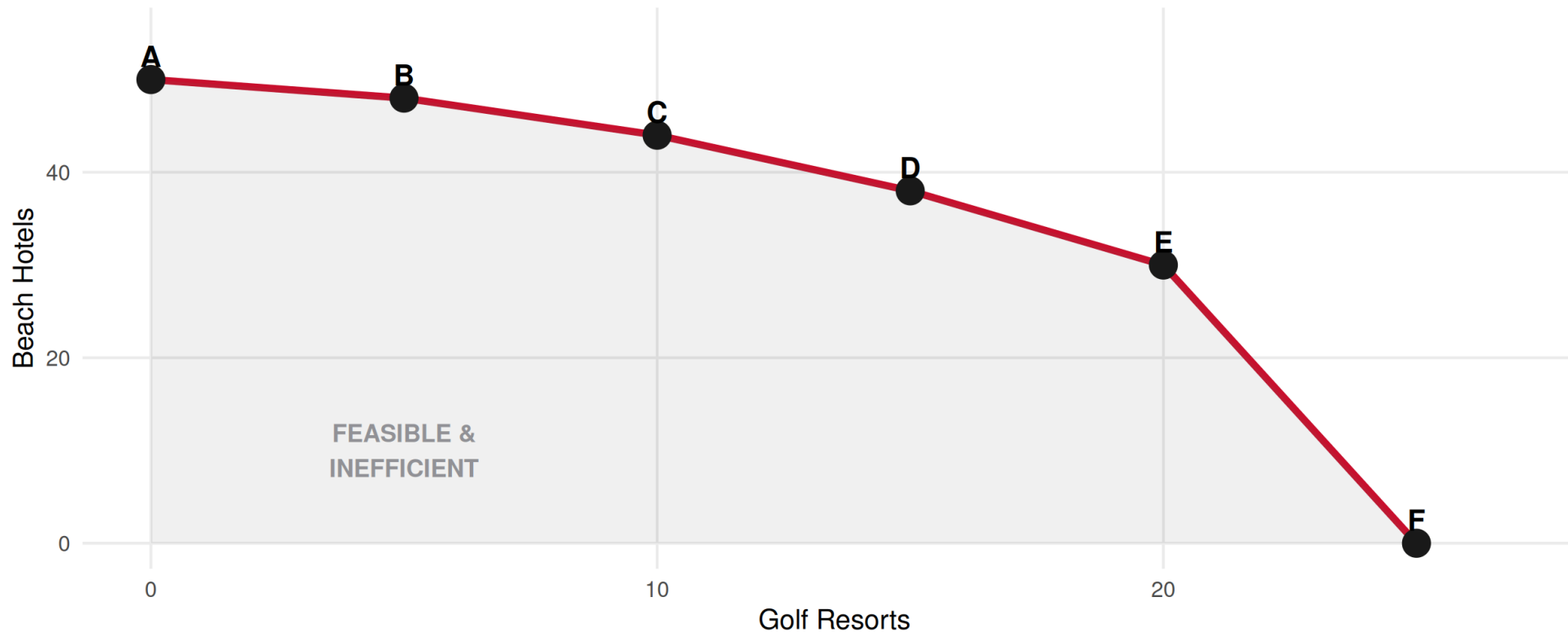
Questions:

- a. Draw the PPF with Golf Resorts on x-axis, Beach Hotels on y-axis
- b. Calculate the opportunity cost of moving from:
 - Point B to Point C
 - Point D to Point E
- c. Does the PPF exhibit increasing opportunity costs? Explain.
- d. If region currently operates at point U (12 golf, 30 beach), what does this indicate?
- e. A new tourism development technology is invented. How would this affect the PPF? Draw the new curve.

Exercise 3: Solution - Part a (PPF Graph)

Algarve Tourism PPF: Golf Resorts vs. Beach Hotels

Bowed-out curve indicates increasing opportunity costs



a) The PPF shows all efficient combinations (points A-F) and the bowed-out shape indicating increasing opportunity costs.

Exercise 3: Solution - Part b

b) Opportunity Cost Calculations:

B → C (5 golf → 10 golf):

$$\text{Gain in Golf} = 10 - 5 = 5 \text{ resorts}$$

$$\text{Loss in Beach} = 48 - 44 = 4 \text{ hotels}$$

$$\text{Opportunity Cost} = \frac{4 \text{ hotels}}{5 \text{ resorts}} = 0.8 \text{ beach hotels per golf resort}$$

Exercise 3: Solution - Part b continued

D → E (15 golf → 20 golf):

$$\text{Gain in Golf} = 20 - 15 = 5 \text{ resorts}$$

$$\text{Loss in Beach} = 38 - 30 = 8 \text{ hotels}$$

$$\text{Opportunity Cost} = \frac{8 \text{ hotels}}{5 \text{ resorts}} = 1.6 \text{ beach hotels per golf resort}$$

Exercise 3: Solution - Part c & d

c) Increasing Opportunity Costs?

YES! Opportunity cost increases from 0.8 (B→C) to 1.6 (D→E).

Explanation: As more resources shift to golf, we use resources less suited for golf (originally better for beaches). Each additional golf resort requires sacrificing more beach hotels.

d) Point U (12 golf, 30 beach):

This is **INSIDE the PPF** (compare to point D: 15 golf, 38 beach).

Indicates:

- **Inefficiency** (unemployment or resource misallocation)
- Could produce more golf without reducing beach (move to D: 15 golf, 38 beach)
- Could produce more beach without reducing golf

Exercise 3: Solution - Part e

e) New Technology Effect:

Technology shifts PPF **OUTWARD** (economic growth).

New PPF might be:

| Combination | Golf Resorts | Beach Hotels |
|-------------|--------------|--------------|
| A' | 0 | 60 (+10) |
| C' | 12 | 55 (+11) |
| E' | 24 | 38 (+8) |
| F' | 30 | 0 (+5) |

Effect: Can now produce MORE of both types of tourism with same resources!

Graph: Draw original PPF, then new PPF further from origin (parallel or biased depending on where technology applies).

Next Lecture

February 19, 2026: Budget Set and Budget Constraint



Preparation: Think about how you allocate your own limited budget across different goods!

Thank You! 🙌

Questions?

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Next class: Thursday, February 19, 2026