“A” LEVEL ECONOMICS

TOTAL RREVISION

Taking economics to the nation

PAPER 3 ESSAYS

QUESTION & ANSWERS

Tinofamba nevanofamba

QUESTION 1

Apart from profit maximisation, explain other objectives of a firm (10)

Objectives are goals or aims that are set in order to be achieved. Profit maximisation is achieved when marginal cost is equal to marginal revenue. This objective would be achieved when the firm produces an output level where total revenue-total cost would be greatest. However, there are a host of other objectives that can be pursued by a firm

- Making profit
- Minimising costs
- Expansion growth
- Survival
- To be socially responsible
- To fight competition
- To increase market share
- To penetrate international markets
- Prestige
- To be a market leader
- To increase sales revenue

Example of developing a point: To increase sales revenue. One of the rational objectives of any rational firm would be to increase sales revenue. This happens in the short run due to entrance of many players to share the abnormal profits. This entrance increases the market supply such that the supply curve would shift downwards or to the right thereby pushing down the price. When the price being charged by each firm is now less than ATC, each firm would make some losses. Given the absence of exit barriers, the loss making firms may quit the market causing the supply curve to shift upwards. Existing entrance of firms would only stop when firms are neither making losses nor profits

QUESTION 2

Explain the causes of unemployment in your country (10)

Unemployment is whereby able bodied people who are willing to work and are looking for jobs but cannot find any. There are various causes of unemployment in our country such that various types of unemployment are existing.

In a bid to attain efficiency through reducing the wage bill, many companies have resorted to the employment of capital intensive methods. This has seen them purchasing state of the art machinery that has led to retrenchment of workers. For instance Delta corporation recently acquired advanced technology for the production of soft drinks. The technology has the ability to clean bottles, fill them and many other functions that could be done by workers instead. In the banking industry, one automated teller machine can displace 19 bank tellers. The resulting unemployment is known as technological unemployment

- Seasonal unemployment
- Frictional unemployment
- Structural unemployment, caused by/ structural changes in the economy e.g. adoption of a policy e.g. ESAP (economic structural adjacent programme) structural changes like droughts, when companies are restructuring e.g. changing production methods
- Demand deficiency/cyclical unemployment, linked to business cycles
- Voluntary unemployment

QUESTION 3

Discuss the effects of high unemployment **(15)**

Effects of unemployment

Negative effects of unemployment

- Reduced effective demand for the firms products
- It increases anti social behaviour such as robbery, whoring, selling of placenta
- It reduces investor confidence
- It reduces government revenue since government would be having less workers to tax
- Under utilisation of scarce resources
- Brain drain
- In a bid to reduce unemployment inflation would rise
- It reduces GDP
- Living standards would decline
- It strains the government in paying unemployment benefits
- It hampers economic growth and development

Positive effects of unemployment

- High unemployment reduces inflation (Phillips Curve Analysis)
- It forces policy makers (government) to implement sound policies
- It forces people to be innovative
- Technologic unemployment improves efficiency and production and service delivery

QUESTION 4

Discuss the measures that a government may take to address the market failure of a free market economy (25)

A free market economy is an allocative mechanism in which there is little or no government interference in the economy. The questions in what to produce, how to produce, for whom and in quantities are addressed through the interplay of market forces of demand and supply. Traditionally the free market economy has been credited with efficiently allocating of resources but however empirical evidence has shown that the allocative mechanism has many inadequacies, inefficiencies, imperfections on market failures that has necessitated for government intervention to address them both radically and rationally

- The use of progressive taxation

The free market has been criticised for allowing the gap the rich and the poor to widen. This is done to self inherit dominating national interest. As a result serious income distribution disparities have been noted. Therefore the government can implement progressive tax system whereby those workers who earn progressively higher income are taxed more. However this method if used to increase G.D.P only works if the marginal propensity to consume is higher with low income earners and lower with higher income earners. Also the measure might create idleness among the citizens as they might be afraid to gather more wealth.

- Increasing tax rates so as to make available funds to provide public goods since the free market economy cannot provide them.
- Increasing carbon tax in order to reduce negative externalities such as pollution.
- Unsidising companies which provide merit goods such as health and education
- Nationalisation designed to gain control of astrategic industries.
- Licensing, designed to reduce conflicts in the provision of a good or a service
- Formation of ministry of anti monopolys to deter monopolies from making "windfall gains"
- Use of price controls to make basics affordable to the general of the populace
- Raising corporate tax
- Use of coupons etc
- Load shedding

QUESTION 5

How do economists measure the size of firm **(10)**

a)
- Size of the market share
- Annual output
- Annual sales
- Annual profit
- Amount of capital injected
- Number of employees
- Monetary value of fixed assets
- Number of branches
- How it is organised

b. Discuss the real benefits of a big firm to society (15)

Benefits

- Employmnet creation
- Infrastructural development
- Provision of a wide variety of goods thereby enhancing consumer sovereignity
- A rise in G.D.P
- A rise in government revenue through taxation which can be used to provide public goods
- Large firms can be used to import basics etc

However large firms may negatively impact a society:

- May cause serious land degradation
- May cause land pollution that may lead to global warming and desertification
- Large firms like monopolies are associated with several inefficiencies such as poverty inefficiency, X inefficiency, productive inefficiency etc

QUESTION 6

a. Discuss the effects of inflation on an economy (15)

Inflation refers to the sustained rise in the average price of basic commodities in an economy. It is not a once and for all rise in price level but a persistant or continuos. As a macro economic woe, inflation have some devastating effects on an economy although there are some positive effects associated.

Negatives

- Closure of companies
- Rise in the rate of unemployment
- Loss of value of the domestic currency
- Leads to a decadence in peoples living standards
- Planning becomes very difficult
- Brain drain
- Loss making by many firms
- Can promote black marketing
- A rise in cost of production e.g. rise in bank rates, wages
- Shortage of basics on the market
- Can lead to the eruption of anti social behaviour
- Fall in investor confidence
- Wage price spiral, as wages are increased prices also increase
- Erosion of peoples purchasing power
- Erosion of profits
- Corruption becomes rampant (order of the day)
- General macro economic and political instability

Positive effects

- It leads to redistribution of income i.e. borrowers would gain whilst lenders will lose, income redistributed from the rich (lenders) to the poor (borrowers)
- Citizens
- Inflation unites conflicting parties
- It forces policy makers to be wide awake and implement sound policies
- Profiteering by firms

b. **Explain the causes of inflation in your country (10)**

Inflation refers to a sustained or a continuous rise in prices of basic commodities in an economy. It can be categorised differently either by cause or by rate. There are different theories put up by different scholars to explain the causes of inflation but there are some causes that are perculiar to the Zimbabwean economy especially over the past decade prior to the dollarization policy

a) An increase in cost of production such as:

i. Increase in wages
ii. Increase in raw material prices
iii. Increase in rentals
iv. Increase in interest rates

Suppliers or producers would pass over this cost to the final consumer in the form of high prices. This leads to cost push inflation

b) An increase in aggregate demand which would be greater than aggregate supply

- The shift of the AD above can be brought about by an increase in government expenditure on defence equipment to control violence during elections, increase in consumption, increase in investment expenditure
- The scenario above result in demand pull inflation

c) Increase in money supply caused by indiscretionary printing of bearer cheques by the central bank

d) Heavy dependence on imports. The demand for imports increased which then led to an increase in the price of imports. Imported inflation was triggered

e) Structural changes in the economy e.g. cyclone Eline, Elnimo and the 2002 devastating drought. This impacted negatively on the agro sector, an important source of raw materials for Zimbabwean manufacturing industries. It resulted in shortages of raw materials such that less output was realised than demand. This triggered structural inflation

f) Quasi fiscal policies by the Reserve Bank resulted in unplanned government expenditure which triggered an increase in aggregate demand

g) Appreciation of the South African Rand against the US $ resulted in higher prices in Zimbabwean given that Zimbabweans currently depend on South Africa products

From the above analysis, it is crystal clear that there are numerous causes of inflation in Zimbabwe such that no single type of inflation existed or is existing. However, cost push inflation appears to be the main type given the wage price spiral currently bedevilling the economy

QUESTION 7

Discuss the measures that can be used to reduce inflation in your country (15)

Given that inflation has some catastrophic consequences, the monetary authorities usually implement various policies in a bid to tackle it head on but however some of the policies usually fire blanks.

In order to enhance the effectiveness of a policy or measure there is need to identify the type and cause of inflation before diagonising the problem. The various types of inflation to be eradicated by government policies include demand pull, cost push, monetary, imported and structural inflation

<u>Demand Pull Inflation</u>

- Government can implement demand side policies
- Increase PAYE
- Increase corporate tax
- Income policy e.g. wage freeze
- Aligning fiscus to budgeted levels
- Reducing government expenditure through retrenching the civil service

N.B Explain how the above work including their possible limitations

<u>Cost Push Inflation</u>

- Government can employ supply side policies
- Granting subsidies
- Price controls
- Increasing productivity through training
- Reducing interest rates
- Reducing VAT

<u>Imported Inflation</u>

- Embargoes
- Increasing import tarrifs
- Import substitution
- Trade licences

<u>Monetary Inflation</u>

- Matching money supply growth with GDP growth
- Avoid printing money unnecessarily
- Devaluation
- OMO

- Avoid quasi fiscus policy

Structural Inflation

- Setting aside drought relief funds
- Maintaining or creating buffer stocks

Never the less, it is not the desire for the government to see its policy being a total flop. So before implementing any policy, there is need to evaluate the timing, various factors like political and congesting all stakeholders involved. HOWEVER I throw my weight behind Keynisians solutions to inflation when compared to Monetarists solutions

QUESTION 8

Describe how a planned economy makes economic decision on what how and for whom to produce (10)

Economics is a discipline which deals with how to allocate scarce resources efficiently in order to satisfy as many human needs and wants as possible. Scarcity as the basic economic problem has to be solved. So in a bid to solve it there are basic economic questions that economic agents who include the government, private firms and individuals have to answer. Such basic economic questions include what to produce and in what quantities, how to produce and for whom to produce.

The nature of the answers given to the above basic economic questions depend on the allocative mechanism being persued. Chiefly , there are 3 economic systems/allocative mechanisms and these include the free market economy, the command economy and the mixed economy. In a command economy the government would be the chief allocation of scarce resources which decide on the nature and magnitude of economic activities.

On WHAT TO PRODUCE, the type of a good and its quantity would be refered. Given that the major aim of the state is to maximise people's welfare through the provision of essential public services at affordable prices, the government carries out a survey in order to come up with what the NATION wants. Therefore more of public goods would be provided. Such goods lack the profit motive and carry the following features:

- Non excludability
- Non divisibility
- Non exhaustibility
- Non rivalry
- Have a free rider problem

Also the government can provide more merit goods such as health and education. These are goods which the state believe consumers derive greater benefits than they themselves think and as such they have social benefits greater than private benefits. Both merit and public goods receive mass production

On HOW TO PRODUCE, the method of production that can be used to produce the godds would be referred to. The government selects a central planning committee to oversee allocation. The state carries out a cost benefit analysis (CBA) before embarking on a large investment. When total benefits outweigh total costs, the government may proceed to provide such a good. Also in a bid to maximise peoples welfare, the government can choose labour intensive methods of production which create employment to many people. Apart from these, the government can set up some parastatals that are meant tp provide essential services at affordable prices to the people for instance Zimbabwe Broadcasting Corporation, the Zimbabwe Electricity Supply Authority, Zimbabwe National Water Authority and National

Railways of Zimbabwe. Licences and paterns can be granted to such companies. Rationing would be used

On FOR WHOM TO PRODUCE, the beneficiaries of a good or a service are being referred to. In the command economy, all economic activities are meant for the benefit of all the people. The government would aim at eradicating income distribution disparities or widening gap between the rich and poor. Through the budget, the government can allocate more resources to needy ministries for example in Zimbabwe, in the last fiscus, the health ministry, education ministry and mining ministry were prioritised although in the preceeding budgets, the agriculture and defence ministries used to receive some favourable shares. In many countries that are still persuing the command system, dualistic economies are still existing i.e. rural and urban setups. So in a bid to improve the welfare of the rural folk, the government may devote resources to points as well as food for work programmes

From the above analysis it is crystal clear that the government employs different ways in a planned economy in order to make economic decisions on what, how and for whom to produce. HOWEVER over the last decades, the planned economies are increasingly becoming less important as conversion to free market economies is now being hailed

HOW RESOURCES ARE ALLOCATTED IN A PLANNED ECONOMY

There are a host of methods that can be used by the government in a planned economy in the allocation of scarce resources. These include the appointment of a central planning committee, rationing, loadshedding, price controls, forming some parastatals, nationalisation and many others as I shall explain later in this master piece

As sited above, one of the ways that can be used by the state to allocate scarce resources is rationing. This is usually used when a basic commodity would be in scarcity. In Zimbabwe, given the eratic water supply, if some if not all municipalities have resorted to rationimg of this life saving resource. During the day more water would be pumped to industrialists whilst in the evening, it would be pumped to households. Foreign currency can be rationed as well. The RBZ used this method in the mid 2000 whereby the scarce US$ were allocated more to the needy although some radicals have argued that the system lacked transparency

Another method that government can use to allocate scarce resources is through the formation of parastatals. These are state run entities formed through an act of parliament in order to over see the provision of an essential public service such as electricity and transport. The National Railways of Zimbabwe, ZUPCO, Air Zimbabwe, ZINWA were formed to provide the critical services at affordable prices. This would increase people's living standards

QUESTION 9

Explain how small firms survive competition from large firms

N.B Small firms are those businesses that operate on a small scale, employing a small labour force, have a smaller market share, have a smaller capital base, operating on a small area or produce low output. Despite the fierce competition they face from large businesses such as monopolies, oligopolies and perfect competitive firms, small firms have survived significantly. This has been attributed to a number of factors including:

- Operating in niche markets or areas
- Convinient location
- Flexible operating hours
- Selling personalised goods
- Offering informal credit facilities
- Selling goods in smaller units/breaking bulk
- Operating during holidays and weekends
- Offering personalised/ counter services
- Employing family members to cut operational costs
- Subcontracting (being suppliers/customers of big business)
- Merging with other small firms
- Forming co operatives
- Can apply for small firms grants from the state
- Dealing in the lines of business that are shun by larger business e.g. hair salooning etc

QUESTION 10

Discuss the benefits Zimbabwe may get from promoting small to medium enterprises

This question requires a sound explanation of the advantages and disadvantages we get from promoting SME's

Benefits

- Increases the country`s GDP
- Provision of a wide variety of products thereby enhancing consumer sovereignity
- Employment creation to the generality of the populace thereby reducing the eruption of anti social behaviour e.g. cigars, whoring and thuggery
- It enhances competition which leads to the depression of prices and provision of quality products
- Results in massive infrastructural development which benefits the country side e.g. The Gulf complex and Mupedzanhamo
- Increased government revenue through taxation
- Increased exports which empower foreign currency generation
- Enhances peoples living standards
- Increased exports which increase GDP via the multiplier effect
- Improves export which improves the countrys BOP
- Small firms are breeding ground for large business, every large business was once a small business

Limitations

- Small firms develop an over dependence syndrome to an extent of failing to stand on their own feet
- Small firms are never grateful. After receiving "a... in the arm" from the government they may go on to undermine government policies by evading tax. Some of them may even go on to sponsor opposition parties
- The employment created by individual small firms is very negligible. Most of them employ work on a God-Fatherism basis or on a who knows who basis. Even some payments they give to their workers are a mockery
- Having many small firms in the country can be a mere wastage of resources as they create unnecessary competition
- Some government funds extended an assistance to small business may be a mere or sheer wastage of public funds that should otherwise be used towards improving health service delivery. Such funds are usually misappropriated or maladministered in the permit of self betterment

- Small firms usually find it difficult to take off and find it hard to sustain themselves etc

QUESTION 11

Discuss whether efficient allocation of resources is only possible with the presence of government intervention. [15]

In a market economy, resources are allocated according to price mechanism. The price mechanism is able to allocate resources efficiently. Efficient allocation of resources can be achieved when prices act as a signal to both consumers and producers in resource allocation. The prices decide what and how much to produce, how to produce and for whom to produce. On the case of what and how much to produce, consumers express their valuation of a good through prices. When there is increase in demand for a good there will be an increase in the price of the good. Producers then allocate more resources to the production of the good then to the alternate good with lower price using the same amount of resources. Consumers' welfare is maximised as goods that are valued more will be produced in the free market. The price differences across the goods thus signal the quantity that should be produced.

Given the assumption of perfect competition, producers would adopt the least-cost technique of production to produce the goods and services, thus ensuring that productive efficiency is achieved.

Goods are produce for those who are able and willing to pay. The ability to pay determine the factor price while the willingness to pay determine the product price. Consumers would be willing to pay more for the goods that they value more. This ensure that consumers' welfare is maximised as they get to enjoy the goods that give them most satisfaction.

As resources are allocated to the production of goods and services that society value more, society's welfare is maximise. Hence allocative efficiency is achieved.

However, the price mechanism may fail in certain circumstances such as when the production or consumption of goods general externalities and where public goods are concerned, in the case of market dominance and also imperfect information. Because of market failure there is thus the justification for government intervention.

Public goods is a form of complete market failure as it exhibit the characteristic of non-rivalry and non-excludability. Due to non-excludability in consumption, even non-paying users cannot be excluded from consuming the good. Hence no one will want to pay for the good and therefore demand is concealed and preferences are not revealed. Non rivalry in consumption means that the supply of public good is not depleted by an additional user and hence the marginal cost of producing the public good is zero. This the price charged for the good must also be zero, based on the condition for allocating efficiency where price=marginal cost. This the market fails as it is impossible to charge a market price for the public good. Thus the free market does not priced the public good even if there is demand for these goods. Hence there is market failure as the private market fails to allocate resources to produce public goods. There is thus the need for public good to be provided by the government.

Market failure can also be partial where some resources are still allocated to the production of good, but not of the correct quantity. Such market failure occurs under circumstances which involve a consumption or production activity that generates externalities, consumption of merit/demerit goods and production of goods by a firm with monopoly power.

An externality is known to arise if a third party is affected by the decisions and actions of others. Consuming and producing certain products often have third parties who are not involved in the transaction. Thus externalities occur when there is divergence between private benefit and social benefit, or between private cost and social cost.

For example, positive externalities arising from an economic activity are the incidental benefits to third parties that are not taken into account by those who undertake the activity. A positive externality will cause social marginal benefit to exceed private marginal benefit. Under the price mechanism, there would be under-allocation of resources to the production and/or consumption of good conferring externalities.

Negative externalities arising from an economic activity are the incidental costs to third parties that are not taken into account by those who undertake the activity. This happens when social marginal cost is greater than private marginal cost. This price mechanism would over-allocate resources to the production and/or consumption of a good conferring negative externalities.

Therefore to reduce these externalities, it is only possible with government intervention.

However even with government intervention, efficient allocation of resouces may not be achieved due to imperfect information or political interest.

Generally, the market does achieve an efficient allocation of resources for most goods and services that are marketable and externalities are not created. Government intervention is thus not required to in most products markets. This is seen in the real world where most economics are market based. When market fails, it is not always necessary that government intervention could bring about efficient allocation of resources as government may lack resources.

QUESTION 12

Explain the role of the price mechanism in allocating resources in an economy

As resources are scarce relative to the insatiable demands of human wants, economies are concerned with basic questions of allocation. The free market price mechanism (is the forces of demand and supply) answers the questions of- What and how much to produce? For whom to produce? How to produce?

In a market, resources are allocated based on the demand/supply in which prices plays an signalling function as it allocates resources to the production of different types of goods. It also acts as signalling mechanism between buyers and sellers telling them how much and what to produce.

What and how much to produce?

Resources are limited and cannot produce enough goods and services to satisfy human wants which are unlimited.

The economy must make a choice on the types of goods and services that it wants to make available to the country. For example, an economy has to decide on the different types of goods to produce, determined jointly by producers and consumers through the signalling role of prices and their self-interest. Price shows how much consumers are willing and able to pay , signalled by the demand curve. How much producers are willing and able to produce , is shown by supply curve.In this way, the price acts as a signal telling the producers what to produce and how much of the good to produce.

Thus determines the allocation of resources among various goods. If market is in disequilibrium, the market will adjust until equilibrium price and quantity achieved a satisfaction of both buyers and sellers maximised. For example, when $Qd < Qs$ for rice, ceteris paribus, a shortage results. There will be upward pressure on the price and the price increase will signal an increase in profit which leads to a reallocation of resources into the production of that good.

For whom to produce?

Price mechanism also shows who to produce these resources for. This is shown by the demand curve which signifies consumers' willingness and ability to pay. In a way it represents their economic dollar votes and shows that producers should produce for these consumers.

Resources are scarce, no society can satisfy all the wants of its people.

How the limited supply of final goods/services produced is allocated among people?

Price acts as a mechanism in a market economy and distributes the output only to people who are able and willing to pay for the good.

This in turn depends on the purchasing power and the value that people place on the good. Consumers pay and consume goods to maximise consumer welfare while producer try to maximise profits. Using the DD/SS diagram above, the equilibrium output at Qe will be allocated to consumers who are willing and able to pay at least the equilibrium price which is set at Pe.

How to produce?

Prices of resources and factors of production also address the question of how to produce various goods and services. An economy can choose to produce using use various factors of production like labour (human) or capital (machines). Price of resources should guide firms' production methods and firms choose resources that are cheapest and incur the lowest opportunity cost.

In the factor market the producers demand for resources and the consumers are factor owners that supply the resources. The allocation of resources among the competing uses is based on the prices of the resources.

For example, a manufactured good can either be produced by capital intensive methods (where there is little use of labour and greater use of machines) which are more efficiency or labour intensive methods (where greater use is made of labour).

A firm's main aim is to reduce the cost of production as guided by relative prices of factors of production. In countries like China, where resources like LAND and LABOUR are abundant, they tend to be engaged in labor intensive production due to and it is easier to produce using such methods.

QUESTION 13

What is the basic economic problem of scarcity [25]

The basic economic problem of scarcity refers to the situation in which finite factor inputs are insufficient to produce goods and services to satisfy infinite human wants. It is incontrovertible and irrefutable that all societies face the basic problem of scarcity due to limited resources and unlimited wants. Scarcity makes it necessary for us to make the most of what we have. In trying to obtain the highest level of satisfaction from available resources, good or rational choices have to be made. The concept of choice applies to all decision-making units.

We are continually uncovering new wants and demands. Scarcity implies that not all of society's goals can be pursued simultaneously, as the many different kinds of resources (production factors) are available only in limited amounts. The various factors of production refer to the inputs used in the production of goods and services. They are divided into four broad categories: land, labour, capital and entrepreneurship. Labour refers to human effort-physical and mental-which is directed to the production of goods and services. Normally the labour force of a country consists of everyone of the working age (14-64), and this form of resource is largely dictated and governed by the demographic distribution within the country (or any other geographical entity), and is therefore restricted by dependency ratio. Land refers to all the productive resources supplied by nature, and various aspects of such a form of resource are limited and exhaustible. Capital is a man-made resource used in the production of goods and services, which includes machines, tools, and buildings. The production capacity of a country therefore, is dependent on the amount of capital the country possesses. Entrepreneurship is a human resource that is separate from labour. An entrepreneur is one that performs the functions of organizing and managing the factors of production, of innovating new products and ways of production and he takes the risks of being in business. Without entrepreneurship, virtually no business organisation can operate. However, such a form of human resource depends on amount of talented people capable of generating innovative ideas.

It is generally understood that the self-interested nature of economic agents compels them to make rational decisions and choices to maximise utility and welfare. The basic assumption of Economics is that all decision-making units make rational choices. Rational choices maximize the well-being of economic agents. Rational choices are made by different decision-making units to maximize different objectives. To obtain the highest level of satisfaction, a rational decision must be made. This decision has to be an optimal one. Assuming rational behaviour on the part of decision-making units, this optimal choice must be the one that chooses the most desirable alternative among the possibilities that the available resources permit. These decision-making units include household, firms and the government.

The figure above shows a PPC (production possibility curve). A production possibility curve is a graph that shows the maximum attainable combinations of output that can be produced in an economy within a specific period of time, when all the available resources are fully and efficiently employed, at a given state of technology.

The PPC is a economic framework that can be used to illustrate concepts of scarcity, choices and opportunity costs. All the points on the PPC represent productive efficient levels of production. Scarcity is illustrated, therefore, by the unattainable combinations outside the PPC as well as the fact that society has to choose between combinations of the two goods as resources cannot be used to produce all at the same time, and the combinations of goods (such as amount od capital and consumer goods in the case of the PPC above) the economy eventually chooses depends on its priorities). The downward (negative) sloping gradient of the PPC also illustrates the concept of opportunity cost. To choose to have more of one good means having to give up some of the other good, given that the limited resources have been fully and efficiently employed (increased output of one product in turn causes the out put of the other product to fall due to limited resources and scarcity)

Economic agents employ several analytical tools to make rational choices. They take into account the opportunity costs and often make decisions based on the marginalist principle. Every time a choice is made, an opportunity cost is incurred. Opportunity cost refers to the real cost in terms of the next best alternative that has to be forgone, and it arises due to the fact that the resources available to meet the unlimited wants are limited so that not all of the wants can be fully satisfied. An economic agent, therefore, has to make a decision based on his current priorities and sacrifice the next best alternative.

Economics, as mentioned before, is about making rational/optimal choices. Economic choices are made at the margin. The margin is the edge or border where we must decide whether to take one more step or to produce one more unit of a particular good or whether to use one more unit of a particular resource. Rational decisions are made at the margin involve weighing up marginal costs and marginal benefits. Generally, economic agents are compelled to continue producing a particular type of good until the marginal cost is equals to the marginal benefit (ie the production of one additional unit would mean that the marginal costs would outweigh the benefits).

In conclusion, due to the fact that resources are high limited, all societies face the problem of scarcity and hence have to make decisions like a household does. A society has to decide what and how much to produce, how to produce and for whom to produce. Firstly, the society must decide what goods it is going to produce (and hence what not to produce). Such choices usually take the form of more of one thing and less of the other (i.e. it needs to choose the composition of total output. Secondly, most goods can be produced by a variety of methods, and a society must decide on the methods of production to be adopted. Thirdly, the total output needs to be distributed among members of the society, and the society therefore needs to consider how it can distribute its goods. Therefore, we can conclusively assert that the basic economic problem of scarcity compels economic agents to make rational decisions (such as choosing the composition of total output) to maximize total profit and to comply with their current priorities.

QUESTION 14

Discuss the advantages and disadvantages of a free-market economy. [25]

ADVANTAGES:

Price Mechanism:

Through free market concepts such as price signal and opportunity cost, the free market supplies a method of pricing resources without government intervention. An example being if there is great demand for a resource and it is scarce price rises, and vice-versa.

Self-Adjustment (equilibrium):

Resources are basically allocated by the supply and demand relationship, if there is a demand for a resource then someone will look to make profit and provide a supply. However the market ultimately decides the price, and self-adjusts so unless there is a sudden change in supply or demand theoretically there will be no shortage or surplus.

Human Psychological Aspect:

Each person effectively looks after themselves; there is that necessity of personal gain to feel progress is being made to achieving happiness.

We have been brought up to believe that the way to gain is to obtain employment, therefore earning money, allowing us to express effective demand over wants and needs.

Competition:

The free market allows the creation of competition which suits the consumer; people like to have options this therefore creates space for producers to create better products cheaply aiming to achieve a greater hold over the market.

DISADVANTAGES:

Speculation & Bubble:

The free market can allows certain resources to be over-valued on false pretences, factors such as insider information or industrial espionage can lead to price surge or crash. A superficial bubble can be produced, as a certain resource should crash but people are continually trying to keep it up.

Undervaluation of Needs:

Since there is a concentration on immediate gain and short term perspective through the free market, important services such as education and health tend to be undervalued by consumers. In a utopian free-market these services would be accurately priced, but this does not occur in reality.

Monopoly & Duopoly:
If a producer gains to great of a market share they begin to control prices themselves, which leads to the failing of the pricing mechanism and the supply/demand relationship. This is against the interest of the consumer, and misallocates resources. An example of a prominent duopoly situation is Airbus vs. Boeing.

QUESTION 15

Discuss the advantages and disadvantages of a command economy. [25]

Advantages:

Planned & Greater Predictability:

In a command economy the government sets production and growth targets, there is an idea of the bigger picture on how the economy will perform in the future. This theoretically increases the economic stability, such as maintaining the value of a currency or given resource (less volatile, fluctuation a rare occurrence)

Elimination of Opportunity Cost:

Since the government allocates the resource the consumer does not question the practicality or use of a given resource, this usually takes the form of coupons. The consumer does not lose out the ability to consume another resource when a coupon is used as it only works for a certain resource.

Valuation of Services (education, health, etc.):

There is the organisation of a social health and education system, ensuring that everyone can attend school and receive an education as well as ensuring that people are medically taken care of. This stops people from thinking in the short term, and the government is allowed to independently decide the value of education (i.e. the creation of an education budget).

Reduction of Inequality:

The government decides on how the country's wealth is distributed, in theory this stops anyone from having more money than they "need". This allows people with service jobs to still have food, healthcare, and education. This achieves social justice as those with jobs such as janitors are valued workers.

Disadvantages:

Misallocation of Certain Resources:

The government will not always know how much to give or produce of a certain resource. For the government to effectively allocate resources in this situation it must have large amounts of information on the populace of the country. This also raises the question does a doctor deserve more or equal to someone of a lesser profession such as a cleaner.

Lacking Innovation (no choice or variety):

There is only ever the production of one type of product, as it becomes a national brand as if there could only be Marlboro Cigarettes and Colgate toothpaste. This means there is no competition which leads to a lack of innovation.

Shortages & Surplus

When the government misallocates resources, it may decide to change production of the resource. The problem with this aspect may lead to too little of the resource being produced or too much, this is because it is difficult to understand consumer demand.

Efficiency

The free-market handles itself, whereas the command economy requires people to regulate all aspects and control it. This means that the producers lack profit motive and see no reason to "work harder" but to simply meet the quota.

QUESTION 16

Discuss the benefits of changing from command economy to market economy. [25]

A country that changes its economy from a command/planned economy will see a lot of benefits when it adopts a market economy approach when solving the Economic Problem. A free market economy promotes the production and sale of goods and services, with little to no control or involvement from any central government agency. Instead of government-enforced price controls, as seen in many socialist and communist countries, a free market economy allows the relationships between product supply and consumer demand to dictate prices. With these benefits however there are drawbacks.

To start with, through price mechanism free market concepts such as price signal and opportunity cost, the free market supplies a method of pricing resources without government intervention. An example being if there is great demand for a resource and it is scarce price rises, and vice-versa.

In addition when resources are basically allocated by the supply and demand relationship, if there is a demand for a resource then someone will look to make profit and provide a supply. However the market ultimately decides the price, and self-adjusts so unless there is a sudden change in supply or demand theoretically there will be no shortage or surplus.

In a free market economy there is Human Psychological Aspect, each person effectively looks after themselves; there is that necessity of personal gain to feel progress is being made to achieving happiness. We have been brought up to believe that the way to gain is to obtain employment, therefore earning money, allowing us to express effective demand over wants and needs.

The free market allows the creation of competition which suits the consumer; people like to have options this therefore creates space for producers to create better products cheaply aiming to achieve a greater hold over the market.

The free-market handles itself, whereas the command economy requires people to regulate all aspects and control it. This means that the producers lack profit motive and see no reason to "work harder" but to simply meet the quota.

There is only ever the production of one type of product, as it becomes a national brand as if there could only be Marlboro Cigarettes and Colgate toothpaste. This means there is no competition which leads to a lack of innovation. All this supports the foregoing assertion that it is beneficial to change from a plannef economy to a market economy.

However it also need to be noted that lack of government control allows free market economies a wide range of freedoms, but these also come with some distinct drawbacks. These drawbacks show that at times it is of no benefit to change from command to market economy. The free market can allows certain resources to be over-valued on false pretences, factors such as insider information or industrial espionage can lead to price surge or crash. A superficial bubble can be produced, as a certain resource should crash but people are continually trying to keep it up.

In a command economy the government sets production and growth targets, there is an idea of the bigger picture on how the economy will perform in the future. This theoretically increases the economic stability, such as maintaining the value of a currency or given resource (less volatile, fluctuation a rare occurrence)

Since there is a concentration on immediate gain and short term perspective through the free market, important services such as education and health tend to be undervalued by consumers. In a utopian free-market these services would be accurately priced, but this does not occur in reality.

The government decides on how the country's wealth is distributed, in theory this stops anyone from having more money than they "need". This allows people with service jobs to still have food, healthcare, and education. This achieves social justice as those with jobs such as janitors are valued workers.

If a producer gains to great of a market share they begin to control prices themselves, which leads to the failing of the pricing mechanism and the supply/demand relationship. This is against the interest of the consumer, and misallocates.

In conclusion, it is to a large extent beneficial changing from command economy to market economy because of price mechanism, competition, equilibrium. The drawbacks are just minor and can be minimised with proper planning.

QUESTION 17

Resources allocation under free market economies is more efficient than command economies. Discuss. [25]

Nowadays, resource allocation in both command and free market economies is a widely discussed the basic economic essay. It ties in which means what is produced, how and for whom. The main advantages and disadvantages of recourse allocation in command and free market economies will be discussed in this essay.

To begin with, recources allocation in command economies is fairer than in free market but not necessarily efficient. Cuba, North Korea, China, Russia and Iran are current examples of economies that are closest to perfect command economies. An economy that is planned and controlled by a centre administration, as in the former Soviet Union is a perfect example of command economy.

Free market economies operate through the price mechanism. It is based upon transactions without government involvement. In the real word, transactions usually involve some government guidelines. An example of this would be buying a BigMac in the US or UK where a government controls certain health standards, imposition of a tax and as little input over competition as required by law. But in a free market economy, there would be no laws against creating a monopoly.

However, problems also related to command and free market economies. In command economies, there are three major problems. First, the government plans do not necessarily reflect the goals of the consumers--only their own. Second, recources are not used productively. Sometimes, command economies have been criticized because they tend to be badly organized, lack quality-control and possibly worker incentives, resulting in responsibility for severe environmental degradation. Third, lack of choice and poor allocation of recources.

QUESTION 18

Explain the concept of elasticity of demand. [25]

There are generally three types of elasticity of demand, which are price, cross-price and income elasticity of demand. These three will be explained individually in order in the following paragraphs.

Price elasticity of demand is a measure of the responsiveness of change in quantity demanded of a good/service to a change in price, ceteris paribus. As the law of demand indicates, when the price of a good/service increases, the demand of it will decrease. Conversely, when the price of a product decreases, the demand of the product will increase. However, the extent to which a price change impacts the demand differs widely from produce to product. PED=(change in quantity demanded)/(change in price). If this value is bigger than one, the product is said to be price elastic (price sensitive), whereby a change in price will lead to a greater than proportionate change in quantity demanded. If the PED is smaller than one, the product will be price inelastic (price insensitive), where a percentage change in price will lead to a smaller percentage change in quantity demanded. And when PED=1, the product is unit elastic, where an X% change in price will result in an X% change in quantity demanded.

One of the factors that affect the PED is the substitutes and complementary product that a good/service has. And cross-price elasticity of demand measures the responsiveness of demand for good X following a change in the price of a related good Y.

For complementary goods, the two goods are in joint demand. That is, the relationship between the price of good Y and quantity demanded for good X will look like a normal demand curve. Goods in joint demand are closely related, and the stronger the relationship between two products, the higher cross-price elasticity of demand will be. A good example would be games and game consoles, as one cannot function without another. And as the price of one increase, the quantity demanded for the complementary good will decrease like any other normal goods due to joint demand, and vice versa. On the other hand, with substitute goods such as several competing brands of bread, an increase in the price of one good will lead to an increase in demand for the rival product, as consumers will likely switch to the cheaper product. And conversely a decrease in price of one good will lead to a decrease in demand for the rival product. However when consumers become regular purchasers of a product (effect of brand loyalty), the cross price elasticity of demand against rival products will decrease. This reduces the substitution effect that causes consumers to switch to another product when an increase in price occurs, which makes demand less sensitive to price. The result is that firms will potentially be able to charge a higher price, increase total revenue and achieve higher profits.

Lastly there's the income elasticity of demand. Another factor that can affect PED would be the price of a good relative to a proportion of one's disposable income; so as one's income changes, the price of the good in terms of a percentage of one's income will change, thus affecting quantity demanded. Income elasticity of demand measures the relationship between a change in quantity demanded for a good and a change in real income. The income elasticity is calculated by (% change in demand)/(% change in income). For normal goods, as consumers' income rises, the quantity demanded will rise. Necessities such as food will have a Income Elasticity of Demand smaller than 1 (whereby a change in income will bring about a less than proportionate change in quantity demanded) and luxury goods such as TV sets will have a Income Elasticty of Demand bigger than 1 (whereby a change in income will bring about a more than proportionate change in quantity demanded). However for inferior goods as consumers' income rises quantity demanded will decrease. Potential examples of inferior goods (this occurs only when there are superior goods available, and only if consumers can afford them) include the demand for low-price foods, cigarettes and alcohol.

QUESTION 19

Discuss why it may be important for a firm to have knowledge of price elasticity of demand. [25]

The concept of PED generally help firms decide whether to raise or drop the price of their product in order to maximize revenue. For example, when the PED of a good is inelastic, it would be best to increase the price to maximize revenue; and when the PED is elastic, it'd be best to decrease the price to maximize revenue. However this is only a general idea, and simple PED does not take into account of the firm's costs, rivalry/substitute goods, etc

However, firms need to know their product's PED in order to alter prices; but how would they know a product's PED? That's when knowledge of PED is needed. Firms would first need to know some factors that may affect PED, and then use that information to evaluate the approxiamte PED of a product. For example, a firm can estimate PED for a product depending on the number of substitutes that exist in the market. The more substitutes in the market, the more elastic the demand for a product is, because consumers can more easily switch their demand if price of one particular product changes. Firms can also assume the PED of a product by having an idea about the degree of necessity of that particular good/service. Products such as food (bread, rice), or even habitual products such as cigarretes are necessities and tend to have an inelastic demand whereas luxury goods such as TVs will tend to have a much more elastic demand because consumers can make do without these luxuries when their budgets are limited. Lastly, the firm need to know how cheap their product in terms of a proportion of the consumer's income. Goods and services that take up a small proportion of a household's income will tend to have an inelastic demand, as a price% rise in that product will make almost no difference for consumers. For example if a newspaper's price increased from $1.00 to $1.10, very little people will fuss over this 10% (seemingly large percentage increase) increase in price because it is so insignificant compared to their income, and thus its demand is insentive to price change. So in short, producers need to have sufficient knowledge of PED to determine the PED of their product, which will in turn help them to set prices that can potentially maximize their revenue.

Furthermore, PED may help firms to set their policy on price discrimination. The firms will most likely be monopoly suppliers, and may decides to charge different prices for the same product to different segments of the market. Examples of this can be increase in price for peak-hour public transportation, more charge for hotel rooms during public holidays, because the products/services during those time periods have an inelastic demand; or vice versa, firms may decrease the price when the product/service is price elastic, such as unsold plane tickets the week before flight, or out-of-season clothes that won't sell in a clothing store. This concept can actually also be linked back to basic knowledge of the PED, because the time period at which the product is sold is also a factor that can determine the PED of a product.

More specifically, concept and knowledge of PED can be applied in some tricky situations: for example, when government imposes indirect taxes on certain products that one firm produces. In this situation, knowing how price elastic the demand of the product is will help the firm to decided whether it is able to pass on the tax (or some of it) onto the consumers. If it's goods like cigarretes which has an inelastic PED due to its habitual nature, it's likely that firms may decide to pass the tax onto consumers as it will result in only a small decrease in quantity demanded. On the other hand, if it's a luxury good such as cars, the firm may decide to not pass any of the tax onto consumers due to the product's elastic demand, because an increase in price can potentially decrease total revenue for a price elastic good, as shown in diagram before.

In conclusion, knowledge of PED is very important because firms need it in order to determine the PED of products, which then in turn help them to estimate and predict the effect of a change in price on the total revenue.

QUESTION 20

How do small scale firms survive competion from large businesses. [15]

Small scale production firms has the actual survival value side by side with large scale production. The facts are that small scale firms have a firm footing along with the large scale firms. The reasons are that small scale firms concerns enjoy certain advantages which are peculiar to their own. They are following:

Reasons for Survival of Small Scale Firms:

(i) Close supervision. When production is being carried on a small scale, the producer can easily supervise each part of the work. The raw material is fully utilized by avoiding the waste. As the workers are closely supervised they work efficiently. The machines are carefully handled. All this results in lowering of cost production.

(ii) Economic independence. In a small firm, the producer is generally the sole proprietor himself. When he clearly knows that the whole profit will go to him and not to anybody else, he works untiringly.

(iii) Economy in management. A large firm has to spend a sizeable portion of the income on maintaining administrative machinery but that is not the case with the small firm. In a small firm, the proprietor himself is the manager. He does not need superfluous account keeping. He just writes the income and expenditure of his business on a small notebook and keeps that with himself.

(iv) Close contact with customers. As the, workers employed in a small firm are few in number, the employer can have a close contact with them. He can listen to their grievances personally and can redress them if he thinks them justified. Due to better understanding between the and the employees, the chances of industrial disputes are reduced.

(v) Greater adaptability to Changes. Another advantage claimed by a small firm is that it can easily adjust its supply to the changed conditions in demand. As the small firm has not to consult the various share-holders of the business, so it can easily arrive at quick decisions and these decisions can be promptly executed.

Small Scale Firms VS Large Scale Firms:

In addition to the advantages discussed above, there are some special circumstances where small scale production is most suitable and economical than large scale production :

Advantages of Small Scale Production Firms:

(i) When the demand for a commodity is small and is expected to remain as such for many years to come, then the production will not be carried out on a large scale. Similarly, if the demand is of a fluctuating nature, the goods are produced on small scale and not on large scale.

(ii) Production is also carried on small scale where the scope of division of labor is limited. For example, in tailoring, repairing agricultural concerns, the division of labor cannot be introduced on a large scale. In tailoring, the clothes are prepared according to the individual tastes of the customers. So, is also the case in repairing. In agricultural work cannot be divided into processes and sub-processes. So, it is generally organized on a small scale.

(iii) Small scale production is also able to hold its own in that field where production is carried on according to the individual tastes. For instance, in jewellery, embroidery works and in other autistics wares, the demand is met locally and the work is done strictly according to the wishes of the customers.

(iv) The goods are also produced on small scale where it is not possible to standardize them.

QUESTION 21

Large companies are important than small companies. Discuss. [25]

Large companies have quite a few advantages over smaller companies, but smaller companies have a corresponding set of advantages over large companies.

ADVANTAGES OF LARGE COMPANIES:

Economies of scale - Large companies have economies of scale in many areas of the business including obtaining capital, production, and leverage of their R&D efforts. This of course reduces the cost of doing business and makes the ROI on certain projects more attractive. Spreading out development costs over more units reduces the overall cost of each piece. These economies of scale often allow for the large companies to do things like investing in training or medical facilities, have good legal counsel, invest in intellectual property protection, or pay above-market wages, which a smaller company wouldn't be able to do.

Political clout - Large companies often have enough money to devote to political campaigns to tilt laws and regulations in their favor. Also since a large company may be a significant employer in a town they might have an incredibly large influence over the decisions made - for example when US Airways threatened to pull its hub out of Pittsburgh International Airport if it didn't receive the concessions it wanted (and it didn't get those concessions - so it pulled out).

Specialization of roles - Having many thousands of employees allows large companies to not only treat their employees as "cogs in the machine," reducing their reliance on any one individual, but also allows it to hire people who are experts in each area instead of the generalist "jack-of-all-trades" types who are more necessary in smaller businesses.

Set policies and procedures - By the time a company gets large there are plenty of rules and procedures in place to ensure coordination, consistency, and to eliminate confusion. Many smaller companies have a "seat-of-the-pants" feeling to them.

More opportunities for advancement - Employees are often attracted to large companies because of opportunities to "climb the corporate ladder" because their jobs can grow in responsibility (and pay) over their career. In addition to that there are opportunities in many different areas of the company so that employees can keep learning new things and won't get bored.

More diversified revenue streams/risk profile - While a smaller company may only be able to concentrate on one or two products, a larger company might have thousands of products in different areas, especially if it is a conglomerate. A larger company might also sell to a larger market (worldwide vs. regional). This diversity can protect the company from variability that might significantly harm a smaller company.

Perceived employment stability and/or prestige - Many people don't want to work for a "fly-by-night" small company that may or may not be around in a few years. Large companies are often perceived to be more stable sources of employment as many people have spent their entire careers (or significant portions of them) at a large company. The name recognition can also be important to some people - to be able to say "I work at X," which makes them feel like a part of something important, as opposed to working for a small company that nobody has ever heard of before.

Specialized capabilities/knowledge that are barriers to entry - Any company that got large and is doing many different things has the specialized knowledge necessary to keep their operations running. Developing this know-how from scratch could be prohibitively expensive and often prevents smaller companies from entering or competing in the same areas.

Branding and history - Any company that got to be large didn't get that way overnight. Therefore the company has a history and likely a brand that is fairly well-known, which can make marketing easier (or more difficult, depending on how tarnished the brand is).

DISADVANTAGES OF LARGE COMPANIES:

Bureaucracy - With all the policies and procedures in place it's often tough to do things that should be simple, which reduces productivity, and it can be tough to change the way things are done, which makes the company inflexible.

Lawsuit magnets - It's much more attractive to sue a company that has money to pay a judgment than a company that has no money. Large companies are cognizant of this risk and it often constrains their actions.

Market saturation - It's much tougher for a large company to grow than a small one, especially if the major markets it serves are nearly saturated.

Individual employee disconnection from success - Since individual employee contribution matters so little in a large company (the company will continue on with or without you) it is possible for many employees to coast along and add little or no actual value to the company, or attempt to personally benefit from the company as much as possible by focusing more on self-promotion and avoiding work than actually accomplishing things that help the company.

Lack of clear vision/direction - In a small company it can be very easy to figure out what the goal is, and everyone might be working toward it - and it might be something like "Develop X." In a large company there are often many competing goals and not necessarily any one thing that anyone is working toward, except "staying the course." This can lead to lack of employee motivation.

Risk aversion - Many large companies and people in large companies are risk averse because they're afraid of losing what they have (market share, employment, profits) and thus are poor at innovation or innovate only incrementally. Too much of a focus on current products can leave them wide open to disruptive innovation from competitors.

Mediocrity - While small companies and startups often try to hire the absolute best people they can, which might be feasible if you have a company of 10 people, if you have a company of 10,000 people they're not all going to be geniuses. Large companies design their job descriptions so that employees are replaceable cogs in the machine and as such often strive to hire people that are competent but not necessarily excellent because there just physically aren't enough excellent people available and the excellent people often leave for opportunities where they can use their talents more effectively instead of being constrained by the environment of a large company.

QUESTION 22

a. Explain the different types of unemployment. [15]

Unemployment as defined by the International Labour Organization occurs when people are without jobs and they have actively looked for work within the past four weeks. The unemployment rate is a measure of the prevalence of unemployment and it is calculated as a percentage by dividing the number of unemployed individuals by all individuals currently in the labour force

2. Types of Unemployment:

i. Frictional Unemployment:

Frictional unemployment is a temporary condition. This unemployment occurs when an individual is out of his current job and looking for another job. The time period of shifting between two jobs is known as frictional unemployment. The probability of getting a job is high in a developed economy and this lowers the probability of frictional unemployment. There are employment insurance programs to tide over frictional unemployment

ii. Structural Unemployment:

Structural unemployment occurs due to the structural changes within an economy. This type of unemployment occurs when there is a mismatch of skilled workers in the labour market. Some of the causes of the structural unemployment are geographical immobility (difficulty in moving to a new work location), occupational immobility (difficulty in learning a new skill) and technological change (introduction of new techniques and technologies that need less labour force). Structural unemployment depends on the growth rate of an economy and also on the structure of an industry.

iii. Classical Unemployment:

Classical unemployment is also known as the real wage unemployment or disequilibrium unemployment. This type of unemployment occurs when trade unions and labour organization bargain for higher wages, which leads to fall in the demand for labour.

iv. Cyclical Unemployment:

Cyclic unemployment when there is a recession. When there is a downturn in an economy, the aggregate demand for goods and services decreases and demand for labour decreases. At the time of recession, unskilled and surplus labours become unemployed. Read about causes of economic recession.

v. Seasonal Unemployment:

A type of unemployment that occurs due to the seasonal nature of the job is known as seasonal unemployment. The industries that are affected by seasonal unemployment are hospitality and tourism industries and also the fruit picking and catering industries

b. Discuss the causes of unemployment.[10]

i. Rapid changes in technology

ii. Recessions

iii. Inflation

iv. Disability

v. Undulating business cycles

vi. Changes in tastes as well as alterations in the climatic conditions. This may in turn lead to decline in demand for certain services as well as products.

vii. Attitude towards employers

viii. Willingness to work

ix. Perception of employees

x. Employee values

xi. Discriminating factors in the place of work (may include discrimination on the basis of age, class, ethnicity, color and race).

xii. Ability to look for employment

QUESTION 23

Explain the importance of National Income. [10]

The concept of national income occupies an important place in the sphere of production and distribution in economic theory. National income consists of the aggregate value of all goods and services produced by the community in a given period, usually a year, deducting wear and tear and depreciation of the plants and machines that were used in the production of goods and services constituting national income.

The first and foremost importance of national income estimate is that it gives us a correct picture of the structure of the economy, as well as a correct picture of the distribution of income according to regions industrial origin, functional services and persons: If, exhaustive, detailed and consistent national income estimates are available over a long period of time. It will be easy to assess the trends in the country's economic growth and also analyze the factors responsible for this trend. The government can be enabled to formulate intelligent economic policies, based on empirical data rather on conjecture, to accelerate or modify the trend, and to influence the dynamic aspects of the economy like capital investment, distribution of income between groups, etc.

Again national income estimate gives us an idea of the purchasing power of the people in the country. Inflationary and deflationary gaps of purchasing are revealed by income and product figures. This is of great value in working out the details and tuning of anti-inflationary and deflationary programmes.

National income figures attempt to forecast the level of business activity for months and years ahead, since it enables us to compare and analyze changes in the output, income and expenditure of the various sectors as need as the entire economy over a period of time. These figures are absolutely fundamental to the analysis of the overall economic and business situation, particularly with reference to its cyclical aspects. As is well-known, the cyclical behavior of the economy as a whole is of major importance in assessing the prospects for any given industry despite the fact that there are always peculiar circumstances which have to be taken into account. Thus, the changes in prospect for business as a whole must be considered in deciding the production, pricing purchasing and selling policies which the individual business adopts. The importance of national income with regard to long range business planning as concerns questions of investment policy and plant expansion. Thus, national income statistics are, thus not only useful to the government but are equal useful to businessman.

National income figures have been found useful for studies of the problems of the economically under-developed Countries. Besides the aggregate national figure estimates of income, various branches of industry and of capital formation are of particular importance for these areas.

Lastly, some type of comparison between nations is made possible through aggregates as well as per capita income figures.

IMPORTANCE OF NATIONAL INCOME STUDIES

Economic Policy:

National income figures are an important tool of macroeconomic analysis and policy. National income estimates are the most comprehensive measures of aggregate economic activity in an economy. It is through such estimates that we know the aggregate yield of the economy and can lay down future economic policy for development.

Economic Planning:

National income statistics are the most important tools for long-term and short-term economic planning. A country cannot possibly frame a plan without having a prior knowledge of the trends in national income. The Planning Commission in India also kept in view the national income estimates before formulating the five-year plans.

Economy's Structure:

National income statistics enable us to have clear idea about the structure of the economy. It enables us to know the relative importance of the various sectors of the economy and their contribution towards national income. From these studies we learn how income is produced, how it is distributed, how much is spent, saved or taxed.

Inflationary and Deflationary Gaps:

National income and national product figures enable us to have an idea of the inflationary and deflationary gaps. For accurate and timely anti- inflationary and deflationary policies, we need regular estimates of national income.

Budgetary Policies:

Modern governments try to prepare their budgets within the framework of national income data and try to formulate anti-cyclical policies according to the facts revealed by the national income estimates. Even the taxation and borrowing policies are so framed as to avoid fluctuations in national income.

National Expenditure:

National income studies show how national expenditure is divided between consumption expenditure and investment expenditure. It enables us to provide for reasonable depreciation to maintain the capital stock of a community. Too liberal allowance of depreciation may prove harmful as it may unnecessarily lead to a reduction in consumption.

Distribution of Grants-in-aid:

National income estimates help a fair distribution of grants-in-aid by the federal governments to the state governments and other constituent units.

Standard of Living Comparison:

National income studies help us to compare the standards of living of people in different countries and of people living in the same country at different times.

International Sphere:

National income studies are important even in the international sphere as these estimates not only help us to fix the burden of international payments equitably amongst different nations but also enable us to determine the subscriptions and quotas of different countries to international organizations.

Defence and Development:

National income estimates help us to divide the national product between defence and development purposes. From such figures we can easily know how much can be spared for war by the civilian population.

Public Sector:

National income figures enable us to know the relative roles of public and private sectors in the economy. If most of the activities are performed by the state, we can easily conclude that public sector is playing a dominant role.

QUESTION 24

Explain the difficulties encountered in measuring national income. [10]

There are a number of difficulties in the measurement of national income of a country. The following are the important difficulties of national income analysis:

1. National income is always measured in terms of money, but, there are certain goods and services whose money measurement is not possible. For example: the services performed by housewife for her family, voluntary services performed with a charitable object, etc. such items are excluded from the national income figures. This leads to an underestimate of the national income.

2. Income obtained from illegal activities is not included in the national income and their exclusion results in an under-valuation of the national income.

3. It is difficult, to obtain accurate statistics. This is the reason, why there is big differences between the national income statistics collected by the different institutions.

4. The collection of depreciation on capital consumption, presents another formidable difficulty. There are no accepted standard rates of depreciation applicable the various categories of capital goods. Thus, the national income estimate will not be correct.

5. The difficulty of avoiding double counting in the national income. To avoid this difficulty, final goods and services are to be included in the national income, but it is not an easy task.

6. The difficulty of price changes arises in the national income estimate. When the general price index increases, the national income will also increase, even if the national output is reduced. Similarly, if general price index decreases, the national income will also decrease, although, there may be an increase in national output. Therefore, due to price changes, we may not find an accurate estimate of national income.

7. The prevalence of non-monetized transactions in underdeveloped countries creates an important problem in the measurement of national income. A considerable part of the output does not come into the market at all. In agriculture, a major part of output is consumed by the farmer themselves which reduces the national income figure to a great extent.

8. Due to illiteracy, most of the producers in less developed countries have no idea of the quantity and value of their output and do not keep regular accounts, which, creates difficulties in national income measurement.

QUESTION 25

ECONOMIC GROWTH

Economic growth is how much more the economy produces than it did before. If the economy is producing more, businesses are more profitable, and stock prices rise. That gives companies capital to invest and hire more employees. As more jobs are created, incomes rise. Consumers have more money to buy additional products and services, driving higher economic growth. For this reason, all countries want positive economic growth.

That makes economic growth the most watched economic indicator.

How Is Economic Growth Measured?

Economic growth is measured by changes in the gross domestic product (GDP). It measures a country's entire economic output for the past year. That takes into account all goods and services that are produced in this country for sale, whether they are sold domestically or sold overseas. It only measures final production, so that the parts manufactured to make a product are not counted. Exports are counted because they are produced in this country. Imports are subtracted from economic growth. Economic growth is measured quarterly measured using real GDP to compensate for the effects of inflation. Here's more on the GDP growth rate and how you can calculate it.

Measurements of economic growth do not include unpaid services. They include the care of one's children, unpaid volunteer work, or illegal black-market activities.

They also don't include the environmental costs. For example, the price of plastic is cheap because it doesn't include the cost of disposal. As a result, GDP doesn't measure how these costs impact the well-being of society. The true standard of living will be raised when these components are measured.

Only when something is measured does it become important.

That's how the measurement itself can lower growth. For example, Nordic countries rank high in the World Economic Forum's Global Competitiveness Report. According to Riane Eisler's book, The Real Wealth of Nations , that's because their fiscal budget focuses on the actual drivers of economic growth: world-class education, social programs that provide real value, and a high standard of living. That results in a high-skilled and motivated workforce. Yes, these countries have a high tax rate. But, they use the revenues to invest in long-term economic growth.

That contrasts with the United States. It uses debt to finance short-term growth through boosting consumer and military spending. That's because these activities do show up in economic growth measurements.

Ways to Spur Economic Growth

Most governments try to manage economic growth. For one thing, when the economy is growing, businesses make more money, which increases tax revenue. They also hire more people, which increases income. When people feel prosperous, they reward political leaders by re-electing them.

The government can stimulate the economy through expansive fiscal policy. That's when it either spends more, cuts taxes, or both. Since politicians want to get re-elected, they use expansive fiscal policy to stimulate the economy.

Expansive fiscal policy is addictive. If the government keeps spending more and taxing less to spur economic growth, it leads to deficit spending. It works for a while, but eventually leads to higher debt levels.

In time, as the debt to GDP ratio approaches 100%, it can slow economic growth. Foreign investors may stop investing funds in a country with a high debt ratio. They worry they won't get repaid, or that the money will be worth less.

Therefore, governments should be careful with expansive fiscal policy. It should only use it when the economy is in contraction or recession. When the economy is growing, its leaders should cut back spending and raise taxes. This conservative fiscal policy will ensure that the economic growth will remain healthy.

QUESTION 26

Discuss the advantages and disadvantages of Economic Growth. [25]

Economic growth can be defined as a process for indicating the increase or decrease in per capita GDP. There are a lot of other factors such as increasing in aggregate income of the individuals reflect economic growth. Economic growth is usually calculated as the rate of GDP changes in a particular period. The total of goods and services produced considered as a reflection for economic growth in the country. It can either be negative or positive in depend on the decrease or increase compared to data of previous years. Negative growth is often indicated to economic recession. When the GDP of a country increases means there is a economic growth existed in the country or the global economies

Advantages of Economic Growth.

Standard of living of the people will increase

Economy growth is an important point to bring better living standards and lower rates of poverty. The average income of people can said that increases and indirectly people able to consume more and motivate the economic growth increasing.

Rising Employment

Economic growth stimulates employment. The economic growth produces more vacancies for job and bring better standard of living to them.

Increased capital investment.

Economic growth can used to increasing the capital investment.

Benefit to Government

Economic growth brings advanced tax incomes for the government, Because of this, the government spends less unemployment benefits.

Superior public services.

Due to government got government income as economy growth, it can spend more on public services like education for contributing in superior public services.

Enhanced business confidence

Economic growth creates positive effect as encourage people running their businesses. As profits of small firms and business increase with economic growth, their business confidence and will to grow up to meet more challenges.

Disadvantages of Economic Growth.

Inflation

Potential High and rising inflation will occur due to demand grows faster than long run productive. It may destabilizing for an economy as interest rate may increase and can cause a loss of competitiveness in international markets

Regional disparities

Although average living standards may be rising, there is a gap between rich and poor. It can widen the issues of poverty and make a wide gap between different regions.

Pollution

Economic growth never separated from environmental issues. Rapid growth of production and consumption may create environment pollution such as sound and air pollution and road congestion. Environmental damage may bring negative effects on our quality of life. For the example, road congestion will produce more Co2 in a high density area. The health of residents in that area will been affected.

QUESTION 27

Explain the main causes of inflation. [10]

Inflation can come from several sources: Some come direct from the **domestic economy**, for example the decisions of the major utility companies providing electricity or water on their prices for the year ahead, or the pricing strategies of the leading food retailers based on the strength of demand and competitive pressure in their markets.
A rise in government VAT would also be a cause of increased domestic inflation because it increases a firm's production costs.

Inflation can also come from **external sources**, for example an unexpected rise in the price of crude oil or other imported commodities, foodstuffs and beverages.

Fluctuations in the exchange rate can also affect inflation – for example a fall in the value of sterling might cause higher import prices – which feeds through directly into the consumer price index.

We make a simple distinction between **demand pull** and **cost push inflation**

The main causes of demand-pull inflation

Possible causes of demand-pull inflation include:
A **depreciation of the exchange rate** which increases the price of imports and reduces the foreign price of UK exports. If consumers buy fewer imports, while exports grow, AD in will rise – and there may be a multiplier effect on the level of demand and output
Higher demand from a fiscal stimulus e.g. via a reduction in direct or indirect taxation or higher government spending. If direct taxes are reduced, consumers will have more disposable income causing demand to rise. Higher government spending and increased government borrowing feeds through directly into extra demand in the circular flow
Monetary stimulus to the economy: A fall in interest rates may stimulate too much demand – for example in raising demand for loans or in causing a sharp rise in house price inflation
Faster economic growth in other countries – providing a boost to UK exports overseas. Export sales provide an extra flow of income and spending into the UK circular flow – so what is happening to the economic cycles of other countries definitely affects the UK

Cost-push inflation

Cost-push inflation occurs when firms respond to **rising costs**, by increasing prices to protect their profit margins. There are many reasons why costs might rise:

Component costs: e.g. an increase in the prices of raw materials and other components used in the production processes of different industries. This might be because of a rise in world commodity prices such as oil, copper and agricultural products used in food processing

Rising labour costs - caused by wage increases, which are greater than improvements in productivity. Wage costs often rise when unemployment is low (skilled workers become scarce and this can drive pay levels higher) and also when people expect higher inflation so they bid for higher pay claims in order to protect their real incomes. **Expectations of inflation** are important in shaping what actually happens to inflation!

Higher indirect taxes imposed by the government – for example a rise in the specific duty on alcohol and cigarettes, an increase in fuel duties or a rise in the standard rate of Value Added Tax. Depending on the price elasticity of demand and supply for their products, suppliers may choose to pass on the burden of the tax onto consumers

QUESTION 28

Which government policies are most effective in reducing inflation? [10]

Inflation can be reduced by policies that (i) slow down the growth of AD or (ii) boost the rate of growth of aggregate supply (AS). The main anti-inflation controls available to a government are:

Fiscal Policy: If the government believes that AD is too high, it may reduce its own spending on public and merit goods or welfare payments. Or it can choose to raise direct taxes, leading to a reduction in disposable income. Normally when the government wants to **"tighten fiscal policy"** to control inflation, it will seek to cut spending or raise tax revenues so that government borrowing (the budget deficit) is reduced. This helps to take money out of the circular flow of income and spending

Monetary Policy: A **tightening of monetary policy** involves higher interest rates to reduce consumer and investment spending. Monetary policy is now in the hand of the Bank of England –it decides on interest rates each month.

Supply side economic policies: Supply side policies include those that seek to increase **productivity**, **competition and innovation** – all of which can maintain lower prices.

The most appropriate way to control inflation in the short term is for the government and the Central Bank to keep control of aggregate demand to a level consistent with our productive capacity.

The consensus among economists is that AD is probably better controlled through the use of monetary policy rather than an over-reliance on using fiscal policy as an instrument of demand-management.

But in the long run, it is the growth of a country's supply-side productive potential that gives an economy the flexibility to grow without suffering from acceleration in cost and price inflation.

INFLATION - POLICIES TO CONTROL INFLATION

Inflation can be reduced by policies that slow down the growth of AD and/or boost the rate of growth of aggregate supply (AS)

Fiscal policy :

1. Controlling aggregate demand is important if inflation is to be controlled. If the government believes that AD is too high, it may choose to 'tighten fiscal policy' by reducing its own spending on public and merit goods or welfare payments

2. It can choose to raise direct taxes, leading to a reduction in real disposable income

3. The consequence may be that demand and output are lower which has a negative effect on jobs and real economic growth in the short-term

Monetary policy :

1. A 'tightening of monetary policy' involves the central bank introducing a period of higher interest rates to reduce consumer and investment spending

2. Higher interest rates may cause the exchange rate to appreciate in value bringing about a fall in the cost of imported goods and services and also a fall in demand for exports (X)

Supply side economic policies:

1. Supply side policies seek to increase productivity , competition and innovation – all of which can maintain lower prices. These are ways of controlling inflation in the medium term

i.A reduction in company taxes to encourage greater investment

ii.A reduction in taxes which increases risk-taking and incentives to work – a cut in income taxes can be considered both a fiscal and a supply-side policy

iii.Policies to open a market to more competition to increase supply and lower prices

Rising productivity will cause an outward shift of aggregate supply

Direct controls - a government might choose to introduce direct controls on some prices and wages

1. Public sector pay awards – the annual increase in government sector pay might be tightly controlled or even froze (this means a real wage decrease).

2. The prices of some utilities such as water bills are subject to regulatory control – if the price capping regime changes, this can have a short-term effect on the rate of inflation

Evaluation points – how best can inflation be controlled?

The most appropriate way to control inflation in the short term is for the government and the central bank to keep control of aggregate demand to a level consistent with our productive capacity

AD is probably better controlled through the use of monetary policy rather than an over-reliance on using fiscal policy as an instrument of demand-management

Controlling demand to limit inflation is likely to be ineffective in the short run if the main causes are due to external shocks such as high world food and energy prices

The UK is an open economy in which inflation is strongly affected by events in the rest of the world

In the long run, it is the growth of a country's supply-side productive potential that gives an economy the flexibility to grow without suffering from acceleration in cost and price inflation.

QUESTION 29

WHAT ARE THE CAUSES, EFFECTS AND CONTROL MEASURES OF INFLATION?

Inflation is the upward movement of price rise of goods and services. We all are affected by inflation. Nowadays, controlling inflation is biggest challenge for the Indian government. Here in this article, I focused on the causes, effects and control measures of inflation. However, a common man cannot control inflation. It is the responsibility of the government to control it.

Introduction

Inflation is an increase of average prices of goods and services. Inflation is a state in which prices are rising and value of money decreases. It results in a decline of the purchasing power. Most of the developed countries use the Consumer Price Index (CPI) to calculate inflation rate whereas India uses the Wholesale Price index (WPI) to calculate the same.

Causes of inflation

1. Unfavourable agricultural production: Indian agriculture is largely dependent on monsoon. In case of drought or famine the agricultural production is adversely affected. Due to this, price of agricultural as well as agro-based industrial products increases.

2. Hoarding: Most of the wholesalers and businessmen practices hoarding of commodities which leads to inflation.

3. Deficit financing: If the government resorts to deficit financing in order to meet its developmental expenditure, then it makes available funds for the growth of economy. But huge deficit financing leads to inflation.

4. Population and black money: Rapid growth of population causes inflation. Tax is the most significant and major source of public revenue. But, most of the people practices tax evasion. It turns into black money which is responsible for inflation.

5. Upward revision of administered prices: Commodities produced in the public sector have government administration of price level. The government keeps on raising prices in order to compensate the losses. This leads to inflation.

Effects of inflation

1. People with low and fixed income: During inflation, the price rise is faster than rise in income, thus savings are reduced. There is an increase in expenditure of people. This causes distress and difficulties to the people with low and fixed income people.

2. Manufacturers and Businessmen: During inflation, due to increase in demand for goods and services, manufacturers and businessmen gain and expand their activities. Unemployment falls and opportunities arise for extra earning through overtime work.

3. Capital and quality of goods: The value of money falls. Capital may be driven out from the country. Quality of commodities affects adversely. Deterioration in the quality of goods produced in the country.

4. Wage-earners: The real incomes of the wage-earners are reduced. Rich become richer and poor become poorer. Due to this, social conflicts start gaining roots. Political instability might set in. Corruption, immorality, unethical conducts increases causing discontent and frustrations, especially among lower and middle class of the society.

Measures to control inflation

1. Monetary measures: Monetary measures are used by the government in order to control inflation. In India, it is implemented by Reserve Bank of India. Main tools of monetary measures of credit control include Bank Rate policy, Open Market Operations ,

Cash Reserve Ratio. These measures are used to achieve full employment, to maintain a fairly stable exchange rate, to achieve rapid economic growth and promote economic equality.

2. Fiscal measures: Fiscal measures relates to public revenue and public expenditure and matters related thereto. Important tools of fiscal measures are Public revenue and

Public expenditure. The major sources from where public revenue is generated include income tax, wealth tax, excise duty and sales tax. Public expenditure refers to the expenditure by the government on productive as well as non-productive activities. Productive expenditure includes expenditure on infrastructure development, development of industries like iron and steel, chemicals, heavy engineering, etc. Non-development expenditure includes expenditure on administrative machinery, law and order, defences, etc.

3. Other measures: These may be short term or long term. Short term concerns with the distribution of essential commodities on ration cards at reasonable price. Long term includes population and economic planning. Population planning is used to aware the people about family planning. Economic planning is used to accelerate the economic growth and development of country.

QUESTION 30

DISCUSS THE BENEFITS OF FREE MARKET ECONOMY

In a free market economy, the production and sale of goods and services are promoted without much control or involvement from any central government agency. Prices in this kind of economy is not dictated by the government but is determined by supply and demand. In short, free market economies are offered a wide range of freedoms because the government doesn't intervene one bit. However, no matter how good a free market economy may sound, it does have some drawbacks. Here's a look at the pros and cons of a free market economy.

Advantages of Free Market Economy

1. It drives innovation

A free market economy opens the door wide for innovation, which is highly important for businesses. Through this kind of economy, business owners can develop new products and services without much intervention from the government. They can create what they see is fit for the public based on consumer demands and popular trends. As such, they can provide consumers with what they need.

Innovation also drives competition. As such, products will only get better as companies try to improve upon previous models in order to best the competition.

2. It is powered by the customers

The success or failure of a product lies in the hands of customers. When they like it, they will demand more of it. If they don't, then there won't be any clamor for it. This is best demonstrated in products or services that are similar. It's pretty clear which one is preferred based on sales results.

Customers also provide the deciding factor when it comes to pricing. Producers set a certain amount but customers decide which one is best based on quality and affordability.

Disadvantages of Free Market Economy

1. It is a profit-driven economy

Profit is good for business. But businesses that are so focused on profit often forget the bigger picture: that there are employees working hard to make a product. Sometimes, businesses neglect their workers just for the sake of earning greater rewards. The health of employees is neglected because they have to produce a good product to earn bigger sales.

Sometimes, even environmental standards are forgotten just so a business can earn money. Take the Deepwater Horizon oil spill in 2010 which is the subject of a Hollywood film coming out this year. It is considered the largest environmental disaster in the history of the US and the catastrophe was traced to cost-cutting measures like using substandard cement.

2. It causes devastating results when it fails

There are severe consequences whenever a market fails. We can only look at history for evidence: the Great Depression of the 1930s and the real estate crash of 2008 are two good examples. It wasn't just one country that was affected – it was the whole world. People lost not just their jobs but also their homes. While some have managed to get back up on their feet, some have taken longer to recover.

There are products and services that won't perform well in a free market economy. As such, there needs to be government services or regulation to ensure not everything falls apart.

QUESTION 31

WHAT IS DEADWEIGHT LOSS?

Alice is the owner of a very successful coffee shop called the Daily Grind. Alice is so successful that she has plans to open a second location. In order for her to open a second location, she needs to hire another employee so that she doesn't have to be in the shop every day. She looks at her financials and determines that she can afford to pay a new employee $9 per hour. Alice then learns that her state government just increased the state minimum wage to $12 per hour.

Alice realizes that she cannot afford an employee at $12 per hour, so she is forced to cancel her plans of expanding her business. This represents a loss to Alice because she can no longer expand her business, a loss to the employee that she could have hired at $9 per hour, and a loss to her city which will not gain the benefit of another Daily Grind location. This loss is referred to as deadweight loss by economists. Deadweight loss is defined as the loss to society that is caused by price controls and taxes.

CAUSES OF DEADWEIGHT LOSS

There are three main causes of deadweight loss:

Price ceilings - These are government sanctioned price controls that prohibit a seller from charging above a set amount for a good or service. An example of a price ceiling is rent control. This occurs when the government sets a maximum amount of money that a landlord can charge for rent.

Price floors - These are government sanctioned price controls that prohibit a seller from charging below a set amount for a good or service. An example of a price floor is minimum wage. This occurs when the government sets a minimum amount of money that a person can sell their hourly labor for.

Taxes - This is the money that the government charges above the selling price of a good or service. An example of this would be the sales tax that some states charge on the sale of certain goods.

Price ceilings, price floors and taxes all cause deadweight loss by altering the supply and demand of a good through price manipulation. A rent-controlled building will have more people who want to live there than apartments available (demand is greater than the supply). A minimum wage will create unemployment because there will be some unemployed workers who are willing to work for a certain wage, and employers who need employees but cannot afford to pay the minimum wage. Taxes cause deadweight loss by increasing the price of a product which in turn decreases the demand for that product.

HOW TO CALCULATE DEADWEIGHT LOSS

In order to calculate deadweight loss, you are going to need to know four pieces of information:

1. The original price of the product being measured. We will call this P1.

2. The new price of the product after the price ceiling, price floor or tax is imposed. We will call this P2.

3. The original quantity demanded of the product being measured. We will call this Q1.

4. The new quantity demanded of the product after the price ceiling, price floor or tax is imposed. We will call this Q2.

The formula to determine deadweight loss is as follows:

Deadweight Loss = .5 * (P2 - P1) * (Q1 - Q2)

So, let's use this formula to see another way that Alice has experienced deadweight loss at Daily Grind.

QUESTION 32

DISCUSS WHAT POLICIES A GOVERNMENT MIGHT ADOPT TO ACHIEVE A MORE EFFICIENT ALLOCATION OF RESOURCES WHERE MARKET DOMINANCE EXISTS. [15]

Where market dominance prevails, resources are not channeled to maximise net social benefits. Various policies such as nationalization, marginal cost pricing and average cost pricing and liberalisation of market can be utilised to achieve a more efficient allocation of resources in the context of market dominance.

The use of liberalisation is the issuing of more licenses to encourage more entrants. This results in more supplier being involved in the competition. The demand for the dominant firm will then become more price elastic. The deadweight loss coming from the dominant firm will be reduced as compared to the past. With more suppliers, the output for the market will also increase and thus achieving a more efficient allocation of resources as output edges closer to the socially optimum point.

The use of liberalisation will force to firms to be more efficient in order to survive the more intense competition. Output might expand near or achieving the socially optimum level. More choices are available to the consumers if the products are differentiated, increasing consumer welfare. The deadweight loss are reduced as price are lowered due to more competition. However, it should be noted that if the barriers to entry still remains high, for example the high set up cost, new entrants will be deterred. If weak competition exists, then it will not make them more efficient.

Price regulation can be enforced on the firms to charge price at marginal cost. The firm would then need to expand output till the socially optimum level and lower price till marginal cost pricing. This policy ensure allocative efficiency as price=marginal cost thus consumer is not exploited at this price and output. Most firms would follow the new ruling as it is a regulation set by the government. The removal of deadweight loss due to the forcing of P=MC would ensure the market failure is corrected. However, the use of this policy might incur monitoring cost to ensure that firms are following the new regulation at such a low price. The price might be too low for the firm till they make heavy losses(subnormal profit), forcing them to leave the industry. In the case where the average cost is more than the average revenue, there is losses for the firm. There need to be subsidies by the government to maintain price at that low level. If firm is to shut down, zero production is also not allocating resources efficiently.

The use of nationalisation can help to tackle the market failure. This is to ensure a complete takeover of production by the government. The aim is to maximise welfare and not to maximise profits. This would ensure that allocative efficiency is achieved as p=mc as the traditional theory of firm where MC=MR is not used. Thus resources would be allocated efficiently by taking away the market power from the existing firm.

The use of this policy ensure that there is no deadweight loss on society since output is at efficient point. Resource would be efficiently allocated by the proper planning by the relevant authority. This provides a greater certainty in affecting a more efficient resource allocation when other policies like liberalisation and price regulation do not work effectively. However, the fucing issue might be a problem for a complete takeover by some poor government. Inefficiency might also happen due to much approval process and parliament debates in decision making. This might end up stifling private investment which is necessary for long term economic growth.

In conclusion, government policies are available to solve market dominance. However, there are some policies which are better based on the nature of the economy.

QUESTION 33

EXPLAIN THE ROLE OF THE PRICE MECHANISM IN ALLOCATING RESOURCES IN AN ECONOMY

As resources are scarce relative to the insatiable demands of human wants, economies are concerned with basic questions of allocation. The free market price mechanism (is the forces of demand and supply) answers the questions of- What and how much to produce? For whom to produce? How to produce?

In a market, resources are allocated based on the demand/supply in which prices plays ansignalling function as it allocates resources to the production of different types of goods. It also acts as signalling mechanism between buyers and sellers; telling them how much and what to produce.

What and how much to produce?

Resources are limited and cannot produce enough goods and services to satisfy human wants which are unlimited.

The economy must make a choice on the types of goods and services that it wants to make available to the country. For example, an economy has to decide on the different types of goods to produce, determined jointly by producers and consumers through the

signalling role of prices and their self-interest. Price shows how much consumers are willing and able to pay , signalled by the demand curve. How much producers are willing and able to produce , is shown by **supply curve**

In this way, the price acts as a signal telling the producers what to produce and how much of the good to produce.

Thus determines the allocation of resources among various goods. If market is in disequilibrium, the market will adjust until equilibrium price and quantity achieved a satisfaction of both buyers and sellers maximised. For example, when Qd < Qs for rice, ceteris paribus, a shortage results. There will be upward pressure on the price and the price increase will signal an increase in profit which leads to a reallocation of resources into the production of that good.

For whom to produce?

Price mechanism also shows who to produce these resources for. This is shown by the demand curve which signifies consumers' willingness and ability to pay. In a way it represents their economic dollar votes and shows that producers should produce for these consumers.

Resources are scarce, no society can satisfy all the wants of its people.

How the limited supply of final goods/services produced is allocated among people?

Price acts as a mechanism in a market economy and distributes the output only to people who are able and willing to pay for the good.

This in turn depends on the purchasing power and the value that people place on the good. Consumers pay and consume goods to maximise consumer welfare while producer try to maximise profits. Using the DD/SS diagram above, the equilibrium output at Qe will be allocated to consumers who are willing and able to pay at least the equilibrium price which is set at Pe.

How to produce?

Prices of resources and factors of production also address the question of how to produce various goods and services . An economy can choose to produce using use various factors of production like labour (human) or capital (machines). Price of resources should guide firms' production methods and firms choose resources that are cheapest and incur the lowest opportunity cost .

In the factor market the producers demand for resources and the consumers are factor owners that supply the resources. The allocation of resources among the competing uses is based on the prices of the resources .

For example, a manufactured good can either be produced by capital intensive methods (where there is little use of labour and greater use of machines) which are more efficiency or labour intensive methods (where greater use is made of labour).

A firm's main aim is to reduce the cost of production as guided by relative prices of factors of production. In countries like China, where resources like LAND and LABOUR are abundant, they tend to be engaged in labor intensive production due to and it is easier to produce using such methods.

QUESTION 34

WHAT ARE THE LIMITATIONS OF PRICE MECHANISM? CAN GOVERNMENT INTERVENTION SOLVE THE PROBLEMS CREATED BY PRICE MECHANISM?

The major limitations of the price mechanism are as follows:

1. The price mechanism is unable to cope with the supply of those goods or services where the benefit is diffuse or indiscriminate. These are goods such as defense or the services of the police force. These cannot be supplied by the market.

2. It is wrong to say that the price system leads to the production of goods which the consumers prefers the most. Rather, the consumer are hypnotized through high pressure salesmanship to buy goods which the producers think most profitable to produce. The consumer's sovereignty is myth.

3. The price system accent rates economic inequalities.

4. The effectiveness of the price mechanism is reduced by the existence of various imperfections in the market.

5. The price system has proved to be an imperfect mechanism for achieving full employment.

6. The price system does not help the economy of the country or adjust quickly to drentic charges is community's production targets.

7. The critics also point out that the price system fails to register all costs and benefits. It shows only the cost of the producers, but not the social courts.

Similarly, it only register utility of purchase to the individual consumer but takes no notice of the benefits to the society. The various limitation of the price mechanism call for some sort of government regulation and control over the working of the system.

Solution of economic problems created by price mechanism : In a free market (or capitalist) economy. The price mechanism solves the central problems. The working of the price mechanism is really remarkable. No individual is consciously Concerned with the problems of what, how and for whom, and yet a capitalist economy solves the central problem of

what to produce,

how to produce and

for whom to produce, through its working.

QUESTION 35

THE ROLE OF THE PRICE MECHANISM IS SOLVING THE PROBLEMS OF WHAT, HOW AND FOR WHOM' IS EXPLAINED BELOW:-

What to produce?: The problem of what to produce, is determined by consumers preferences expressed freely in the market. This power of consumers to determine the allocation of resources in the production of different goods and services is called consumer. sovereignty. The consumer is, so to say, a king, who decides what is to be, produced and in what quality by making his wishes known by the types and quantities of the goods he buys in the market. Thus, it is the demand of the consumers for a particular. Commodity that determines what commodity will be produced.

How to produce?: The decision of 'how to produce' is determined by competition among firms for the available factors of production (like labor and capital.). The prices of the factors of production are determined by demand and supply conditions. Profit maximizing firms can only achieve their objectives by keeping their cost of a minimum and making use of the most efficient methods of production. In other words, producers will produce with the least cost combination of resources that is, with the most efficient technique of production. If labor is relatively cheaper than capital, labor intensive methods of production will be used.

For whom to produce?: The decision of "for whom to produce" or distribution of national product" is also determined by demand and supply conditions in factors markets (Which are markets for the factors of production and similar to the markets for good). Thus it is the price of the factors of production in the factor markets which determines the distribution of national output between the different factors. These factors prices constitute the incomes of the owner's of the factors. Households are considered as the owners of the factors. They provide factors of production to the firms, in lieu of that, they earn incomes.

The income of a household depends upon the wage rate it can earn by selling labor services. In perfect competition, the wage rate will depend on the demand for and the supply of labor. The goods and services produced get distributed between different households on the basis of their income, thus, it is the price mechanism (using demand and supply of the factors and their prices) which determines the distribution of incomes to the households and share of each individuals in the national output.

QUESTION 36

WHAT IS CURRENCY DEVALUATION AND REVALUATION?

Devaluation refers to the official lowering of the value of a country's currency.

Currency devaluation and revaluation refer to opposite changes to a country's official currency in comparison to other currencies. Devaluation is the deliberate lowering of the exchange rate while revaluation is the deliberate rise of the exchange rate.

Currency Devaluation

Devaluation of a currency is a deliberate lowering of an official exchange rate of a country and setting a new fixed rate with respect to a reference of foreign currency such as the USD. It should not be confused with depreciation which is the decrease in the currency value as compared to other major currency benchmarks due to market forces. The process of devaluation tends to render the foreign currency more expensive than the local currency.

For instance, a country whose 10 units of its currency is equivalent to one dollar may decide to devalue its currency by fixing 20 units to be equal to one dollar. By doing so, the home country would be half as expensive as the dollar.

Reasons for Devaluation

Countries often use currency devaluation for economic policies. Lowering of the home currencies as compared to foreign currencies can improve exports, shrink trade deficits, and reduce a country's debt burden.

When the local currency is cheaper than the foreign currency, exports will be encouraged and imports discouraged. This is because foreign countries will find the prices of goods cheaper in the devaluing country. Caution should be exercised, however, to avoid extensive exports as this could cause an offset to the expected demand and supply which could increase the prices of goods and normalize the devaluation effect.

Devaluation helps solve the effects of trade deficit since it will cause a balance of payments since the exports will be higher than the imports.

If a government has sovereign debts to pay on a regular basis, and the payment of this debt is fixed, maintaining a weaker currency makes the debt less expensive over time. The same should also be done with caution as countries might resort to a race to the bottom war nullifying the effect of devaluing.

Effects of Devaluation

An increase in demand for exported goods can lead to inflation. When this happens, the government can raise interest rates but at a cost since it will slow the county's economy.

Devaluation can also cause psychological damage to the foreign investors. This is because a weaker currency may be viewed as an indication of economic weakness hence scaring away foreign investors.

Another effect of devaluation is that it may lead to concerns by neighboring countries to devalue their currencies too in the race to the bottom hence causing financial instability in the bordering markets.

Currency Revaluation

Revaluation is a significant rise in a county's official exchange rates in relation to a foreign currency. The process of revaluation can only be done by the central bank of the revaluing country.

For instance, if a countries currency trades at 10 units to 1 US dollar, to revalue it, the said country can change to using 5 units of its currency to be equivalent to 1 dollar in order to make it twice expensive compared to the dollar.

Causes of Currency Revaluation

Changes in interest rates of various countries could cause a country to resort to currency revaluation so as to maintain its profitability and economic competitiveness.

Countries can also revalue their currency for speculative purposes. For instance, prior to the 2016 Brexit by Britain, a lot of other countries' currencies fluctuated because of speculative reasons and need to remain profitable despite any outcome of the vote.

International Monetary Fund

The issue of currency revaluation and devaluation led to the establishment of the International Monetary Fund (IMF), a body that regulates the frequent devaluation and revaluation that are used by different countries to unfairly gain a competitive advantage over others. The IMF has also given each member a right to choose an exchange rate to use. These policies have helped the ill-advised motives of devaluation and revaluation.

QUESTION 37

DISCUSS WHETHER EFFICIENT ALLOCATION OF RESOURCES IS ONLY POSSIBLE WITH THE PRESENCE OF GOVERNMENT INTERVENTION. [15]

In a market economy, resources are allocated according to price mechanism. The price mechanism is able to allocate resources efficiently. Efficient allocation of resources can be achieved when prices act as a signal to both consumers and producers in resource allocation. The prices decide what and how much to produce, how to produce and for whom to produce. On the case of what and how much to produce, consumers express their valuation of a good through prices. When there is increase in demand for a good there will be an increase in the price of the good. Producers then allocate more resources to the production of the good then to the alternate good with lower price using the same amount of resources. Consumers' welfare is maximised as goods that are valued more will be produced in the free market. The price differences across the goods thus signal the quantity that should be produced.

Given the assumption of perfect competition, producers would adopt the least-cost technique of production to produce the goods and services, thus ensuring that productive efficiency is achieved.

Goods are produce for those who are able and willing to pay. The ability to pay determine the factor price while the willingness to pay determine the product price. Consumers would be willing to pay more for the goods that they value more. This ensure that consumers' welfare is maximised as they get to enjoy the goods that give them most satisfaction.

As resources are allocated to the production of goods and services that society value more, society's welfare is maximise. Hence allocative efficiency is achieved.

However, the price mechanism may fail in certain circumstances such as when the production or consumption of goods general externalities and where public goods are concerned, in the case of market dominance and also imperfect information. Because of market failure there is thus the justification for government intervention.

Public goods is a form of complete market failure as it exhibit the characteristic of non-rivalry and non-excludability. Due to non-excludability in consumption, even non-paying users cannot be excluded from consuming the good. Hence no one will want to pay for the good and therefore demand is concealed and preferences are not revealed. Non rivalry in consumption means that the supply of public good is not depleted by an additional user and hence the marginal cost of producing the public good is zero. This the price charged for the good must also be zero, based on the condition for allocating efficiency where price=marginal cost. This the market fails as it is impossible to charge a market price for the public good. Thus the free market does not priced the public good even if there is demand for these goods. Hence there is market failure as the private market fails to allocate resources to produce public goods. There is thus the need for public good to be provided by the government.

Market failure can also be partial where some resources are still allocated to the production of good, but not of the correct quantity. Such market failure occurs under circumstances which involve a consumption or production activity that generates externalities, consumption of merit/demerit goods and production of goods by a firm with monopoly power.

An externality is known to arise if a third party is affected by the decisions and actions of others. Consuming and producing certain products often have third parties who are not involved in the transaction. Thus externalities occur when there is divergence between private benefit and social benefit, or between private cost and social cost.

For example, positive externalities arising from an economic activity are the incidental benefits to third parties that are not taken into account by those who undertake the activity. A positive externality will cause social marginal benefit to exceed private marginal benefit. Under the price mechanism, there would be under-allocation of resources to the production and/or consumption of good conferring externalities.

Negative externalities arising from an economic activity are the incidental costs to third parties that are not taken into account by those who undertake the activity. This happens when social marginal cost is greater than private marginal cost. This price mechanism would over-allocate resources to the production and/or consumption of a good conferring negative externalities.

There fore to reduce these externalities, it is only possible with government intervention.

However even with government intervention, efficient allocation of resouces may not be achieved due to imperfect information or political interest.

Generally, the market does achieve an efficient allocation of resources for most goods and services that are marketable and externalities are not created. Government intervention is thus not required to in most products markets. This is seen in the real world where most economics are market based. When market fails, it is not always necessary that government intervention could bring about efficient allocation of resources as government may lack resources.

QUESTION 38

DISCUSS THE USEFULNESS OF THE CONCEPTS OF ELASTICITY OF DEMAND TO A FIRM THAT PRODUCES A FASHIONABLE PRODUCT. [13]

Essay requirements:

1. Definition of fashionable product

2. Clear explanation of how concepts determine price and revenue

A stand needs to be taken on whether demand for smartphones are price elastic or inelastic, both are fine with supporting arguments

1. Clear distinction between PED for smartphones and PED for smartphone produced by a firm

2. Evaluate every scenario

Introduction

The usefulness of the concepts of elasticity of demand to a firm that produces a fashionable product can be discussed in terms of how they can aid the firm in making pricing and capacity decisions. We will be discussing smartphones in this essay.

Point: Price elasticity of demand (PED)

PED allows a firm that produces smartphones to determine how to change its price to increase its total revenue

Large number of substitutes for smartphones (Eg Apple and Sony) → Price elastic as consumers can easily switch to alternatives –> Decrease price attracts consumers and increases quantity demanded –> Increase in total revenue

Explanation of graph above

Area A represents the gain in revenue resulting from the increase in the quantity demanded (Q) from Q0 to Q1 and area B represents the loss in revenue resulting from the fall in the price (P) from P0 to P1. Since the gain exceeds the loss, total revenue rises.

Limitations

If firm has no or little excess capacity or if rival firms follow suit and decrease prices, a fall in its price may not lead to an increase in total revenue.

Smartphones by some firms may be price inelastic as they have special and unique features

In such a case price should be increased as demand for smartphone is price inelastic → Fall in demand less than proportionate → Total revenue increases

Explanation of graph above

Area C represents the gain in revenue resulting from the rise in price (P) from P0 to P1 and area D represents the loss in revenue resulting from the decrease in the quantity demanded (Q) from Q0 to Q1. Since the gain exceeds the loss, total revenue rises.

However, if the firm also sells a complementary good, such as phone covers, due to the negative XED between complements,

Rise in the price of its smartphones → Fall in revenue from the sale of phone covers → Probable decrease in its total revenue

Point: Cross elasticity of demand (XED)

XED allows a firm that produces smartphones to determine how a change in price by a rival firm will affect the demand for its good

Sub point: Reducing prices due to price matching

Rival firm reduces price due to positive XED between substitutes → Own firm need to follow suit to avoid decrease in demand

May lead to price war

Firm should instead use non price strategies to boost demand

Sub point: Increasing prices due to price matching

Rival firm increases price → Own firm may allow prices to remain constant → Quantity demanded increases → Total revenue increases

However, total revenue may not rise if firm has little/no excess capacity

Point: Income elasticity of demand (YED)

YED allows a firm that produces smartphones to determine the future size of the market for its good and hence its production capacity

Smartphones normal good → YED positive → Demand rises when income rises

If firm predicts an economic boom → Increase production to meet higher capacity when boom comes

Furthermore, some smartphones have YED > 1 → These smartphones are luxury goods → Firms should increase its production capacity by large amount

However

Certain low end smartphones have YED < 1 → They are a necessity → Firms do not need to increase production capacity be large amount

If firms predicts a recession → Reduce production to minimise excess capacity

Anti-thesis (General limitations to use of concepts of elasticity of demand in decision making)

Data from past records may be irrelevant to calculating elasticities of demand as some of the determinants of demand may have changed

Technical analysis must not be the concluding factor for decision making due to changes in market environment

Although data from current surveys on market conditions may be relevant to calculating elasticities of demand, however:

They may be unreliable as the public may not be fully truthful in answering them

The survey pool may be small and is not reflective of the actual market of the good

Assumption of ceteris paribus made in calculating elasticities of demand is unlikely to hold in reality due to the constantly changing market conditions

Conclusion (General conclusion to usefulness of PED, YED and XED)

PED can be useful to a firm that produces smartphones for making proactive business decisions

YED and XED can be useful for making reactive business decisions

Since YED and XED can only be useful when consumer' income and prices of related goods change, one can argue that PED is more useful than YED and XED as it allows a company to be the initiator of change.

However, if the firm sells a complementary good, XED can also be useful for making proactive business decisions.

Increase or decrease in price of primary product can affect the revenue generated from complementary products

Although PED may allow a firm that produces smartphones to increase its total revenue, its profit may not necessarily rise if its total cost also rises.

Further, profit motivation may not be the main goal of new entrants in the market, for instinct they may want to maximise market share to compete with existing firms.

QUESTION 39

EXPLAIN THE IMPORTANCE OF ELASTICITY OF DEMAND

The concept of elasticity of demand is of considerable significance in various situations. The importance of elasticity of demand can be realised as follows:

(1) Business Decisions:

Change in price of a good brings about a change in the quantity demanded depending upon the value of elasticity of demand. Change in quantity demanded affects the total expenditure of the consumers and will, therefore, affect the profits of the business.

If the price elasticity of demand is low, the business firm can fix up a higher price for the commodity (to raise his revenue and profits).

If elasticity of demand is less than one, a reduction in price will reduce the total revenue of the firm. However, he would not be able to charge a high price for a commodity with elastic demand. The concept of elasticity of demand is of special importance to a monopolist while fixing a profit maximizing price and output. A monopolist fixes a higher price in a less elastic market and a lower price in a more elastic market.

(2) Economic Policies of Government:

A knowledge of the elasticity of demand helps the Government and economic planners in formulating its economic policies. Government can stabilise the prices of agricultural goods by following a policy of price support programme in the event of increased production.

A bumper crop instead of being a cause of prosperity may spell disaster, if the commodity has inelastic demand, particularly, when the produce is perishable. This is called the paradox of poverty amidst plenty, as poor people get less prices with almost same demand due to excess supply. To overcome this situation, the Government has to be prepared to procure the excess supply of the commodity from the farmers at certain minimum price.

This step is necessary to prevent a fall in food grains production and a fall in farmer's income on account of bumper crops. In the absence of such Government policy, the farmers may resort to destroying already produced crops. This would be a national wastage, particularly, in developing countries which are already plagued with poverty, hunger and malnutrition.

Similarly, in case of shortages and high price, the Government can protect the interests of the consumers by fixing 'ceiling price', the highest price beyond which the farmers cannot charge. As the situations of shortages and surpluses arise occasionally in agriculture, the Government follows buffer stock operations, i.e., procuring stocks from surplus areas and disposing them in deficit areas. Government can alternatively import the commodity from other countries to dispose off in deficit areas.

(3) Determination of Public Utilities:

The concept of elasticity of demand enables the Government to decide as to which industry should be declared as public utility and consequently owned and controlled by the state. The products like electricity, gas, water, transportation, etc. have inelastic demand.

The industries of these products should be taken over by the Government and should be declared as public utilities to avoid high prices, restricted output and exploitation of consumer by the monopolist.

Public utilities are vested with a public interest and raise the economic welfare of the community by facilitating cheap availability of the essential products like, electricity, gas, water, post, and telegraph, etc.

(4) Taxation Policy:

The Government interested in raising its revenue can impose higher indirect taxes (excise duty, sales tax, etc.) on the commodities with inelastic demand. The demand for such commodities does not much fall, even when prices rise after the imposition of taxes.

The burden of the tax is partly borne by the consumer and partly by the producer, depending upon the magnitude of the elasticity of demand, besides that of elasticity of supply. If the demand for commodity is perfectly inelastic, the entire burden of the tax will fall on to the consumer.

The reason is that, imposition of tax will raise the price of the commodity by an amount equal to the amount of tax, quantity demanded remaining the same. Further, taxes on commodities having elastic demand will not yield much revenue to the Government as the demand for such commodities will fall significantly with an increase in their prices. On the extreme, if the demand is perfectly elastic, the entire burden of the tax will be borne by the producer, as in this case, price of the commodity does not increase.

Thus, the knowledge of the elasticity of demand helps the Government to formulate suitable taxation policy, so that the burden of the tax is equitably distributed among different groups of tax payers. On considerations of social justice, the Government should levy higher taxes on goods not falling under the categories of necessities (having inelastic demand).

(5) Determination of Factor Pricing:

Elasticity of demand helps in the determination of wages and share of each factor of production in proportion to its demand in the product. A factor with an inelastic demand commands a higher price as compared to a factor with relatively elastic demand.

Further, any attempt by trade union to demand higher wages will be more successful, when the elasticity of demand for a product is low. Otherwise, it may cause unemployment among workers due to restricted production as a result of fall in demand at consequent high price of the product. The Government can determine minimum wage policy on the basis of elasticity of demand of labour input.

(6) International Trade:

The ‘terms of trade’ can be determined by measuring elasticity of demand in two countries for each other’s goods. In international trade, a country earns more profits by importing the commodities, which have elastic demand and exporting the ones, which have relatively less elasticities.

Here, the terms of trade are said to be in favour of the country and the country is in a position to export its goods at high prices, but, to import its requirements at low prices. Finally, at the time of taking decision to devalue or revalue the currency, the Government should carefully see the nature and the value of elasticity of demand and supply of both exports and imports.

When the balance of payments is adverse and continues to be adverse for the country for some years, the Government can devalue its currency to correct this imbalance. Such devaluation will make exports cheaper and imports dearer.

This will help in increasing export earnings and cutting down import payments. If the exports have inelastic demand and imports have elastic demand, devaluation will be successful. Otherwise, the policy of devaluation will fail. Elasticity of demand also helps the Government to maintain a proper rate of foreign exchange for its currency in relation to other currencies that will keep balance of payment in equilibrium.

Besides the practical importance of the concept of elasticity of demand, it has theoretical importance also. It can be used as a tool of analysis to explain many economic theories and problems. Keynes considered price elasticity of demand to be the most important contribution of Marshall.

Price elasticity of demand is useful in the theory of price determination. Under perfect competition, no firm has control over the price of the product. It implies that price elasticity is infinity in this case. While under imperfect competition or monopoly, a firm can exercise control over the price.

The degree of control (monopoly power) is inversely related to the coefficient of price elasticity of demand. The lesser is the elasticity of demand for a product, the greater is the degree of monopoly power. In perfect competition, the monopoly element is completely absent, as the elasticity of demand is infinity.

QUESTION 40

EXPLAIN THE FACTORS DETERMINING PRICE ELASTICITY OF DEMAND:

The price elasticity of demand is not the same for all commodities. It may be or low depending upon number of factor. These factors which influence price elasticity of demand, in brief, are as under:

(i) Nature of Commodities. In developing countries of the world, the per capital

income of the people is generally low. They spend a greater amount of their income on the purchase of necessaries of life such as wheat, milk, course cloth etc. They have to purchase these commodities whatever be their price. The demand for goods of necessities is, therefore, less elastic or inelastic. The demand for luxury goods, on the other hand is greatly elastic.

For example, if the price of burger falls, its demand in the cities will go up.

(ii) Availability of Substitutes. If a good has greater number of close substitutes available in the market, the demand for the good will be greatly elastic.

For examples, if the price of Coca Cola rises in the market, people will switch over to the consumption of Pepsi Cola, which is its close substitute. So the demand for Coca Cola is elastic.

(iii) Proportion of the Income Spent on the Good. If the proportion of income spent on the purchase of a good is very small, the demand for such a good will be inelastic.

For example, if the price of a box of matches or salt rises by 50%, it will not affect the consumers demand for these goods. The demand for salt, maker box therefore will be inelastic. On the other hand, if the price of a car rises from \$6 000 to \$9 000 and it takes a greater portion of the income of the consumers, its demand would fall. The demand for car is, therefore, elastic.

(iv) Time. The period of time plays an important role in shaping the demand curve. In the short run, when the consumption of a good cannot be postponed, its demand will be less elastic. In the long run if the rise price persists, people will find out methods to reduce the consumption of goods. So the demand for a good in the, long run is elastic, other things remaining constant.

For example if the price of electricity goes up, it is very difficult to cut back its consumption in the short run. However, if the rise in price persists, people will plan substitution gas heater, fluorescent bulbs etc. so that they use less electricity. So the electricity of demand will be greater (E d = > 1) in the long run than in the short run.

(5) Number of Uses of a Good. If a good can be put to a number of uses, its demand is greater elastic (E d > 1).

For example, if the price of coal falls, its quantity demanded will rise considerably because demand will be coming from households, industries railways etc.

(6) Addition. If a product is habit forming say for example, cigarette, the rise in its price would not induce much change in demand. The demand for habit forming good is, therefore, less elastic.

(7) Joint Demand. If two goods are jointly demand, then the elasticity of demand depends upon the elasticity of demand of the other Jointly demanded good.

For example, with the rise in price of cars, its demand is slightly affected, then the demand for petrol will also be less elastic.

QUESTION 41

DISCUSS WHETHER GOVERNMENT INTERVENTION IS ALWAYS SUCCESSFUL IN CORRECTING MARKET FAILURE. [8 MARKS]

This requires a balanced response in which both the advantages and disadvantages of government interventions must be discussed. One sided answer will lead to maximum half the marks.

Advantages of government intervention:

- indirect taxes to discourage consumption of demerit goods
- subsidies to encourage consumption of merit goods
- taxation to finance expenditure on public goods
- regulations to control private producers, e.g. on pollution and monopolies having market dominance.

Limitations of government intervention:

- consumption of demerit goods might be discouraged, but unlikely to end completely given inelastic demand, e.g. for cigarettes and alcohol
- consumption of merit goods might be encouraged, but still a limit to extent of increase in consumption
- available finance to provide public goods might be limited/restricted, especially if a large budget deficit
- regulations may not be adequately policed/enforced.

QUESTION 42

DO YOU AGREE THAT LARGE FIRMS ARE ALWAYS BETTER THAN SMALL FIRMS? JUSTIFY YOUR ANSWER. (25 MARKS)

Large firms can experience certain advantages that small firms cannot achieve thus can be argued to be better; however this may not always be true as they may also face disadvantages for example from diseconomies of scale. Furthermore the market is fundamental to determine if large firms are better than small firms, as perfectly competitive and monopoly markets varies the advantages and disadvantages of being a small or large firm.

Large firms tend to benefit more due to several factors from economies of scale; this means that the firm can benefit from falling average costs in the long run – however small firms cannot achieve such benefits. For example purchasing benefits whereby large firms are able to bulk buy raw materials as they are producing on a larger scale thus are able to receive discounts and therefore reducing production costs. Or they may experience technical economies whereby investment in more advanced machinery or larger premises will allow firms to experience increasing returns to scale where output is greater than input thus improving productive efficiency through division of labour and specialisation resulting again in lower costs. Economies of scale can be illustrated in diagram 1, whereby when output increases (Q to Q1), cost decreases (C to C1). Minimum efficient scale is illustrated at the constant part of the LRAC labeled QA firms are operating at the optimum point experiencing constant long run average costs where economies of scales are exhausted; the firm therefore is operating at long-run productive efficiency. This is the reason why large firms are considered to be better than small firms. However as the LRAC curve rises; large firms will experience diseconomies of scale. For example as a firm grows control becomes more difficult, monitoring productivity of each worker in a large firm will become more challenging thus may result in a loss of productive efficiency and therefore rising average costs. Additionally coupled with poor communication and co-ordination due to increasing size of firms increasing average costs are accelerated. Furthermore as large firms are often public limited companies ownership and control is often divided among a group of shareholders thus control over the firm is not subject to one person and instead are run by several directors who carry the interest of the shareholders. This makes management over large firms more difficult as negotiations and meetings are needed to carry out various operations thus reducing the efficiency of the firm whereas small firms are usually owned by one person thus management and decisions are able to be made swiftly. Also communication and co-ordination in small firms are much easier to manage and is less costly due to smaller amount of factors of production. In this sense, small firms can be argued to work more efficiently than large firms.

Some large firms strive for monopoly market power therefore enjoying greater market power and influence thus larger profits which may be used to finance and promote innovation can result in dynamic efficiency and therefore economic growth. Additionally it enables them to obtain supernormal profits however this is impossible for small firms to achieve. This is illustrated in diagram 2 where profit maximisation occurs at MC=MR output 'Q', ATC is 'Pn' however monopolists will charge 'Ps' exploiting consumers at the point of demand thus will make supernormal profits illustrated in the shaded region of the diagram. Monopolies are also able to protect their market position through the use of entry barriers. However monopolies are very rare thus such a market is not very likely to occur in the real world. Furthermore at the point of supernormal profits monopolists are not productively efficient as they are not operating at the optimum point of the ATC curve, this is because as a monopoly they face no threats to compete with others firms therefore can be considered X-inefficient as they are 'slacking' in efficiency if they were to be in a more competitive market. Also monopolies may not use their profits to invest to innovate thus may prevent growth. Therefore it can be argued that small firms are better as their objectives do not include exploiting consumers with high prices for supernormal profits thus may operate where they are productively efficient. Additionally since small firms cannot operate as a monopoly, there will be no abuse of monopoly power therefore small firms can be argued to be better.

However a perfectly competitive market is made up of a large number of small firms; the industry equilibrium of supply and demand which establishes the price – firms who try sell above this amount, consumers will not buy the product, similarly if the firm sells below this price consumers will purchase their goods however they will not be maximising returns. And thus the individual firms have no choice but to accept the price given by the industry and therefore act like price takers in a perfectly competitive market. However they can benefit from allocative efficiency; this is where the optimum allocation of scarce resources that best accords with the consumers' pattern of demand. As shown in diagram 3 price is equal to marginal cost (P=MC) thus allocative efficiency is achieved in both the short and long run, as at the ruling price 'P' firms are producing the exact quantity consumer's demand and thus there are no wasted resource thus total economic welfare is maximised.

Furthermore small firms in a perfectly competitive market often also benefit from productive efficiency as well as dynamic efficiency thus will lower costs. However the conditions for a completely competitive market are based on several assumptions such as perfect information – consumers will have all available information about price and products from competing suppliers and can access freely, many sellers and buyers, no externalities etc. however this is impossible to have in reality thus such market does not exist.

Overall large firms are better in terms of the benefit of economies of scale however there are pull backs if the firm becomes too large and diseconomies sets in. Additionally if a large firm becomes a monopoly; they can achieve high profits but only at the expense of exploiting consumers and they may not use profits to invest further thus abusing monopoly power this therefore suggests that large firms may not be better than small firms in all cases. In perfectly competitive market small firms has the advantage of great economic efficiency and are able to minimise costs unlike monopoly firms. However it must be emphasized that such markets are impossible in reality. Therefore overall both large firms and small firms are only better in than each another in certain cases.

KEY IMPORTANT IFORMATION

CONSEQUENCIES OF INFLATION

1) Leads to high lending rates, as lenders want to cushion themselves as high inflation creates uncertainty, which also increases risk.

2) Discourages borrowing by producers and makes it difficult for shrinking economies to recover as cost of finance production is high.

3) Causes a shift from Long term investment to investment in money and equity markets where returns are more attractive.

4) Leads to currency depreciation and for Less Developed Countries (LDCs) like Zimbabwe, which rely heavily on foreign borrowing and imported raw materials, cost of production is likely to be high and this pushes up prices of finished goods.

5) Since from (4) above, domestic production becomes more expensive, if the commodities are to be traded on the international market they become less competitive. As a result, the Balance of Payments situation is worsened as the country will not be able to raise enough forex, as it requires.

6) High poverty levels, with many people falling below the **Poverty Datum Line (PDL)**, that is surviving at an amount below that which is expected to sustain them.

7) Causes moral decadence like prostitution as well as social deviance behaviors like commission of crimes.

8) Causes unemployment because prices of labour (salaries and wages) become unsustainable and firms fire labour.

9) Causes the breakdown of the monetary system as people prefer to hold onto physical properties to hedge against spiraling prices.

10) Hits hard on people living on fixed incomes like pensioners, thus further straining the government (Fiscus) as it has to make more transfer payments in the form of free or subsidized food, health, shelter and education.

11) Harms the taxpayer as government increases taxes to get more money through its fiscal policy. This is particularly so with the workforce exposed to a progressive tax system, as was the situation in Zimbabwe. They are continuously pushed into higher tax brackets creating a phenomenon called **fiscal drag net**. Their living standards plummet as their incomes fall.

12) Rioting, industrial strikes, political upheavals can to some extent be attributed to high inflation levels as cost of living rise to leave many trapped under the Poverty datum Line (PDL). This was typical of the Zimbabwean situation during the period 2000 – 2009.

13) Redistributes income from lenders to borrowers. People who borrowed money during low inflation time repays it when it is useless in terms of what it can purchase.

14) Causes high level of corruption, even to the extent of externalisation of foreign currency and diversion of produce meant for local consumption to other countries.

15) Causes de-industrialization i.e. closures of firms which cannot operate in the prevailing environment.

EFFECTS OF UNEMPLOYMENT

1) High poverty levels associated with inability to buy basis commodities.

2) High moral decadence and crime rate, which in turn stifle economic growth and development.

3) Forced migration of some population units to neighbouring countries to look for work and decent living.

4) Political instability as people are easily incited against the government of the day.

5) Unemployment is normally associated with unprecedented levels of suicidal deaths and murders amongst the unemployed. In Britain in every one million, deaths, 15 000 are suicides.

6) Personal psychological torture suffered by the unemployed and their families, relatives and friends.

7) It creates a fiscal drag net where those who are employed are overburdened by high taxes to sustain the government.

8) It represents a cost to the government, as it has to pay out transfer payments and Unemployment Benefits.

9) It also represents a loss of potential tax revenue to the government as people only pay tax when employed.

Revising "A" Level Economics

Just have a look at these questions

NOVEMBER 2012/3

1a) How are the basic economic questions of what to produce, how to produce and for whom to produce answered in

i. Market economy
ii. Planned economy {12}

b) Assess the view that resources are more efficiently allocated in the market economy than in the planned economy. {13}

2 a) Explain

i. Price elasticity of demand
ii. Income elasticity of demand
iii. Cross elasticity of demand {12}

b) Discuss the usefulness of the elasticity of demand concepts to small scale miners in Zimbabwe. {13}

4a) Explain how are firms classified into small, medium or large firms. {10}

b) Discuss the benefits of small to medium scale enterprises (SMEs) in Zimbabwe. {15}

10a) Explain

i. Demand pull inflation
ii. Cost-push inflation {12}

b) Comment on the effectiveness of possible solutions to unemployment in your economy. {13}

12a) Analyse the relationship between inflation in each of the following:

i. the external value of money
ii. balance of payments
iii. unemployment {12}

b) Should the high rate of inflation be a worry to the government of your country? {13}

NOVEMBER 2013/3

1a) Explain what is meant by the basic economic problem. {10}

b) Discuss the benefits of changing from a command economy to a market economy. {15}

2 a) Analyse the factors influencing price elasticity of demand for cement in your country. {10}

b) To what extent are elasticity of demand concepts useful to the housing construction industry ? {15}

9a) Explain

i. demand –pull inflation,
ii. cost-push inflation. {12}

10.a) Analyse factors influencing economic growth in your country. {12}

b) Discuss the benefits of economic growth to an economy. {13}

11a) Analyse the effects of unemployment in an economy. {10}

b) Discuss the effectiveness of measures meant to reduce unemployment in your country. {15}

JUNE 2014/3

1a) Explain how the basic economic questions are answered in a free market economy. {12}

b) Discuss the benefits to a society of a command economy changing to a market economy. {13}

2a) Explain

i. Price elasticity of demand
ii. Income elasticity of demand
iii. Cross elasticity of demand {12}

b) Discuss the relevance of elasticity of demand concepts to holiday resorts in Zimbabwe. {13}

6a) Explain how the price index of measuring the value of money is constructed. {12}

b) Assess the effects of inflation in an economy. {13}

11a) With reference to Zimbabwe, explain

i. structural unemployment
ii. demand-deficiency unemployment
iii. real wage unemployment. {12}

b) Discuss the effectiveness of the measures a government may use to reduce unemployment in an economy. {13}

12.a) Explain the differences between economic growth and economic development. {10}

b) Evaluate the benefits of international financial institutions such as the International Monetary Fund and World Bank in the growth and development of a developing country. {15}

NOVEMBER 2014/3

1a) Explain how the basic economic questions are answered in a free market economy. {12}

b) Discuss the benefits to a society of a command economy changing to a market economy. {13}

2a) Explain

i. Price elasticity of demand
ii. Income elasticity of demand
iii. Cross elasticity of demand {12}

b) Discuss the relevance of elasticity of demand concepts to holiday resorts in Zimbabwe. {13}

6a) Explain how the price index of measuring the value of money is constructed. {12}

b) Assess the effects of inflation in an economy. {13}

NOVEMBER 2015/3

1. Discuss how government may address the problems of a free market economy. {25}

2a) Using the substitution and income effects, explain

i. Normal good,
ii. Inferior good. {10}

b) Discuss the practical applicability of demand elasticity concepts to a firm exporting clothes. {15}

9a) Explain how the following contribute to the growth of money supply in an economy:

i. Central bank,
ii. Budget deficit financing, and

iii. International currency flows. {12}

b) Discuss the effects of high inflation in an economy. {13}

10a) Explain what is meant by economic growth and economic development. {12}

b) Discuss the view that economic growth enhances economic development. {13}

11a) Explain the causes of unemployment in your country. {12}

b) Should the government of your country give priority to solving unemployment? Justify your answer. {13}

JUNE 2016/3

1.Discuss whether a free market economic system improves the standard of living. {25}

2a) Explain the income and substitution effects of a fall in price of

i. Normal good,

ii. Inferior good. {12}

b) Discuss the usefulness of income elasticity of demand to oligopolistic firms {13}

9 a) Explain the causes of

i. demand-pull inflation,

ii. cost-push inflation. {10}

b) Discuss the effectiveness of price controls and supply side policies in reducing inflation in an economy. {15}

11a) Explain the difficulties involved in measuring unemployment. {10}

b) Discuss the effectiveness of policies that government can use to reduce unemployment in your country. {15}

12a) Explain the relationship between

i. internal and external value of money

ii. economic development and growth. {10}

b) Discuss the reasons why government of your country may give priority to high economic growth. {15}

NOVEMBER 2016/3

1a) Explain

i. Productive efficiency, and

ii. Allocative efficiency {10}

b) Discuss the efficiency implications of a country changing from a planned economy to a market economy. {15}

2a) Using the marginal utility theory, derive the demand curve for a product. {12}

b) To what extent does the marginal utility theory explain consumers' demand patterns for a good? {13}

9 a) Explain the causes of

iii. demand-pull inflation,

iv. cost-push inflation. {10}

b) Discuss the effectiveness of price controls and supply side policies in reducing inflation in an economy. {15}

11 a) Explain the difficulties involved in measuring unemployment. {10}

b) Discuss the effectiveness of policies that government can use to reduce unemployment in your country. {15}

12a) Explain the factors that influence investment in your country. {10}

b) Discuss the benefits of economic growth to an economy. {15}

JUNE 2017/3

1a) Explain how the basic economic questions are answered in

i. a planned economy

ii. a market economy {12}

b) Discuss the benefits to a country of changing from a command economy to a market economy.

2a) Using the income and substitution effects, explain the differences between a normal good and an inferior good. {12}

b) Examine the effects of an increase in income on the consumption of

i. beer

ii. beef in an economy {13}

10 a) Analyse the problems encountered when constructing the Consumer Price Index (CPI). {12}

b) Discuss the consequences of inflation in an economy. {13}

11a) Distinguish between economic growth and economic development. {10}

b) "High economic growth ensures attainment of economic development in an economy." Discuss. {15}

12 a) Analyse the causes of unemployment. {10}

b) Discuss the effectiveness of measures which can be used to reduce unemployment in your country. {15}

Tinofamba nevanofamba

0774-453126{hotline calls}……………………….0783-727157{whatsapp only}

0774 880751 Senzere the hunter