Economics revision notes for olevel

Econ Theory of Organztns (Tulane University)

ECONOMICS REVISION NOTES FOR GRADE 08, 09 & 10

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1.BASIC ECONOMIC PROBLEM:

LEARNING OUT COMES:

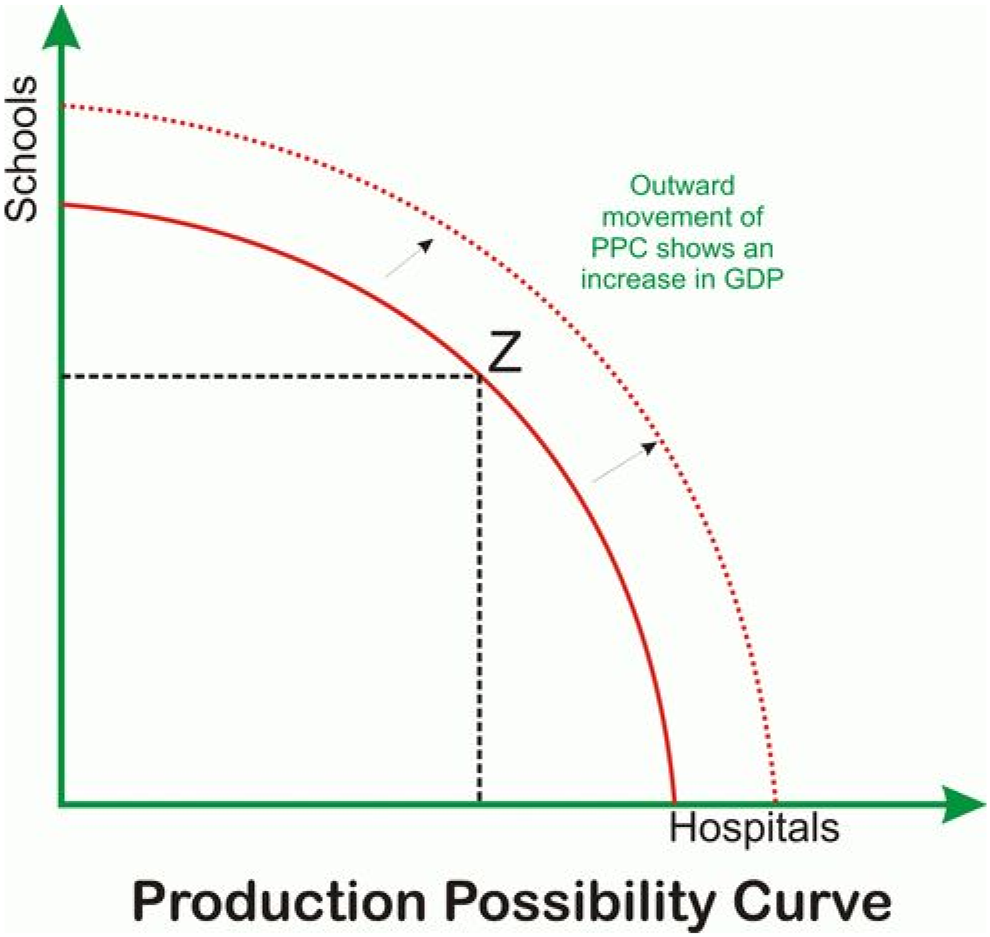
At the end of this unit students will be able to:

- define the nature of the economic problem (finite resources and unlimited wants);
- define the factors of production (land, labour, capital, enterprise);
- define opportunity cost and analyse particular circumstances to illustrate the concept;
- evaluate the implications of particular courses of action in terms of opportunity cost.

1.1Production Possibility Curve:

Production Possibility Curve/Production Possibility Boundary/Production Possibility Frontier

From the point of view of an Economy, there is an opportunity cost of using its resources. Production Possibility curve (PPC) shows the maximum combinations of goods and services that can be produced by an economy in a given time period with its limited resources.



In the graph, if all the resources are used to produce Schools then there will be no Hospitals. If you move to the other end then all the resources would be used to produce Hospitals and not Schools will be there in the economy. Government has to move along this curve and decide the best possible combination of goods to produce. For example Z, shows the possible combinations of School buildings and Hospitals. Thus, it is impossible to build more Schools without also building fewer Hospitals.

Resources have to be switched from building more Hosipitals to building more Schools. This is known as rellocation of resources. Before the rellocation of resources we will have to consider the costs of rellocating these resources between uses. This costs will include retraining cost of our workforce and the time consumed in this rellocation.

Any point outside the curve is unattainable unless there is an outward shift of the PPC. This can only be possible if there is an improvement in the quantity and/or quality of factors of production. This is known as economic growth. It is a process of increasing the economy's ability to produce goods and services

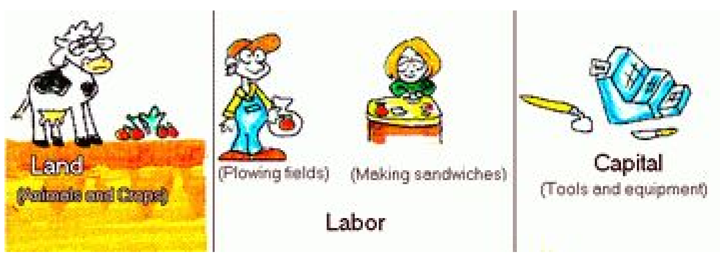
1.2 FACTORSOF PRODUCTION:

What are factors of Production?

Resources available on earth to make goods and services to satisfy our needs and want are limited.

In economics, **factors of production** (or productive **inputs**) are the resources employed to produce goods and services. These can be categorised as

- **Land**: All natural resources provided by nature such as fields, forests, oil, gas, metals and other mineral resources. The payment for land use and the received income of a land owner is rent.
- **Labour:**Human effort used in production which also includes technical and marketing expertise. The payment for someone else's labour and all income received from ones own labour is **wages**. Labour can also be classified as the physical and mental contribution of an employee to the production of the good(s).
- **Capital:** Human-made goods (or means of production) which are used in the production of other goods. These include machinery, tools and buildings.
- **Enterprise:** The skill and risk taking ability of the person who brings together all the other factors of production together to produce goods and services. Usually the owner or founder of a business.



1.3 **Scarcity, Choice and Opportunity cost:**

Unlimited Wants

Human beings, in order to survive need a lot of things. Some of these things are very important for our existence. For example, food, clothing, water, shelter and air. These things can be classified as **Needs**. Apart from this there are things which are needed by us but they are not important for our survival and we can live without them also. For example, going on an expensive holiday, owning a 57 inches Plasma TV. These are known as **Wants**. This list is never ending and is continuously increasing.

Limited Resources

On the other hand, we have limited resources to produce these goods and services we want. There are not enough car factories to provide cars to everybody on earth. Everything on this

planet has some limits except for our Wants.
When unlimited wants meet limited resources, it is known as Scarcity.

2.ALLOCATION OF RESOURCES / How the market and market failure:

LEARNING OUT COMES:

At the end of this unit students will be able to:

- describe the allocation of resources in market and mixed economic systems;
- demonstrate the principle of equilibrium price and analyse simple market situations with changes in demand and supply;
- describe the causes of changes in demand and supply conditions and analyse such changes to show effects in the market;
- define price elasticity of demand and supply and perform simple calculations;
- demonstrate the usefulness of price elasticity in particular situations such as revenue changes, consumer expenditure;
- describe the concept of market failure and explain the reasons for its occurrence;
- evaluate the merits of the market system;
- define private and social costs and benefits and discuss conflicts of interest in relation to these costs and benefits in the short term and long term through studies of the following issues:
  - conserving resources versus using resource
  - public expenditure versus private expenditure

2.1 What is demand?

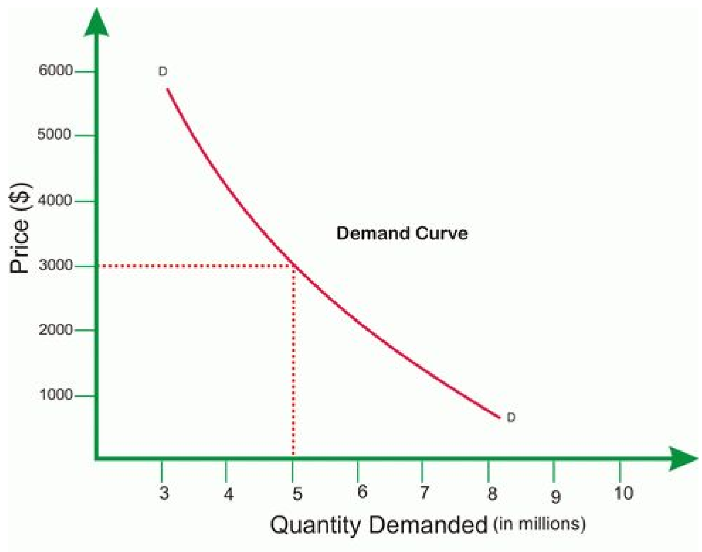
Demand is defined as want or willingness of consumers to buy goods and services. In economics willingness to buy goods and services should be accompanied by the ability to buy (purchasing power) and is referred to as effective demand.

Types of demand

Composite demand: It is when a good is demanded for two or more uses. For example oil may be used to run a car or as a fuel in a factory.
Joint demand: It is when two goods are bought together. Mouse is bought with a mouse pad.
Derived demand: It is when demand for one good occurs as a result of demand for another. Example, If more goods are made, more labour is needed. Hence demand for labour is derived demand.

Law of demand

It states that when price increases, the amount demanded will fall and when prices fall, the amount demanded will rise.
This phenomenon when plotted on a graph is known as Demand Curve.



Demand Curve

2.2 Changes in demand | extension, contraction, fall , rise:

Movement along the demand Curve

Extension of demand

Extension of demand is the increase in demand due to the fall in price, all other factors remaining constant.

Contraction of demand

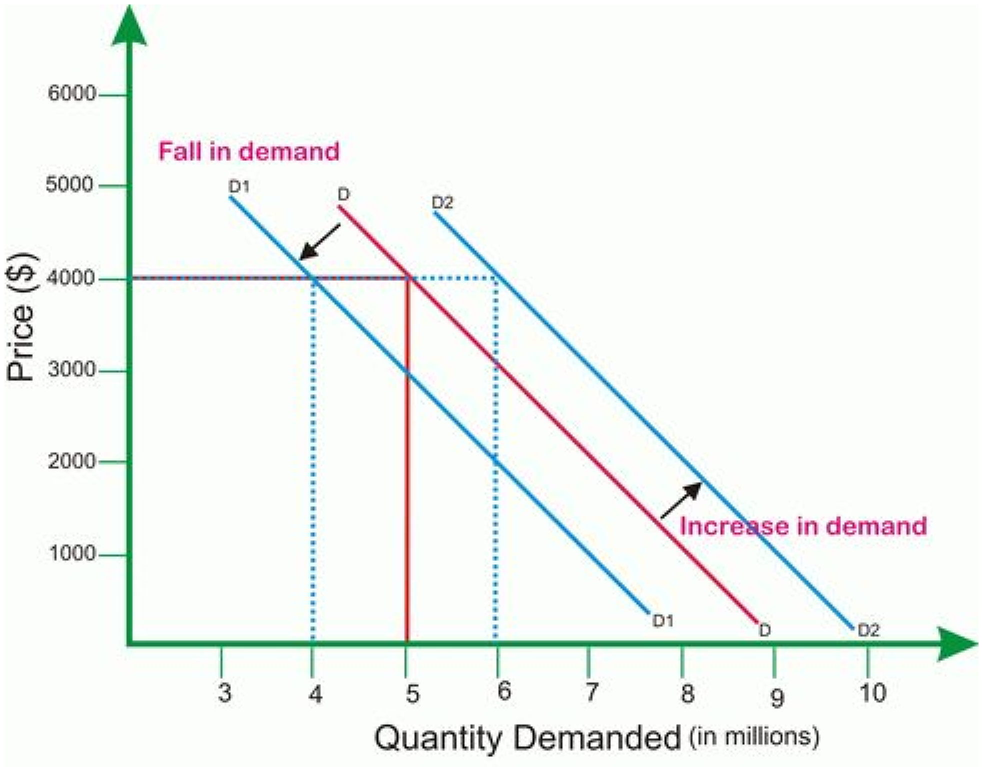
Contraction of demand is the fall in demand due to the rise in price, all other factors remaining constant.

Extension & Contraction of Demand

Shift in the demand curve

Usually demand curves are drawn based on the assumption except for price all other factors remain the same. But there might be instances when demand may be affected by factors other than price. This will result in the change in demand although the price will remain the same. This change in demand may cause the demand curve to SHIFT inwards or outwards.

- Shift of demand curve OUTWARDS shows an increase in demand at the same price level. It is known as INCREASE IN DEMAND.
- Shift of demand curve INWARDS shows that less is demanded at the same price level. It is known as a FALL IN DEMAND.



Shift in Demand Curve

2.3 Factors affecting demand:

Factors affecting demand:

Change in people's income: More the people earn the more they will spend and thus the demand will rise. A fall in income will see a fall in demand.
Changes in population: An increase in population will result in a rise in demand and vice versa.
Change in fashion and taste: Commodities or which the fashion is out are less in demand as compared to commodities which are in fashion. In the same way, change in taste of people affects the demand of a commodity.
Changes in Income Tax: An increase in income tax will see a fall in demand as people will have less money left in their pockets to spend whereas a decrease in income tax will result in increase of demand for products and services because people now have more disposable income.
Change in prices of Substitute goods: Substitute goods or services are those which can replace the want of another good or service. For example margarine is a substitute for butter. Thus a rise in butter prices will see a rise in demand for margarine and vice versa.
Change in price of Complementary goods: Complementary goods or services are demanded along with other goods and services or jointly demanded with other goods or services. Demand for cars is affected the change in price of petrol. Same way, demand for DVD players will rise if the prices of DVDs' fall.

Advertising: A successful advertising campaign may affect the demand for a product or service.
Climate: Changes in climate affects the demand for certain goods and services.
Interest rates: A fall in Interest rate will see a rise in demand for goods and services.

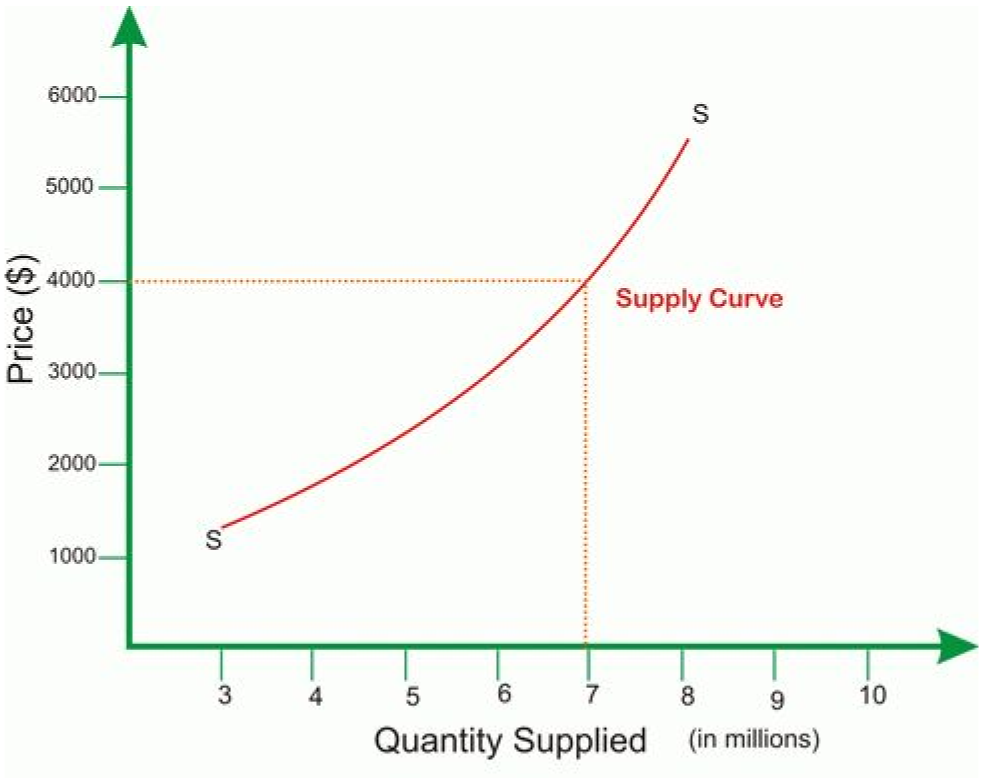
2.4 What is supply:

What is Supply?

Supply refers to the amount of goods and services firms or producers are willing and able to sell in the market at a possible price.

Law of Supply

It states that when the price of a commodity rises, the supply for it also increases.
The higher the price for the good or service the more it will be supplied in the market. The reason behind it is that more and more suppliers will be interested in supplying those good or service whose prices are rising.



Supply Curve

2.5 Changes in supply:

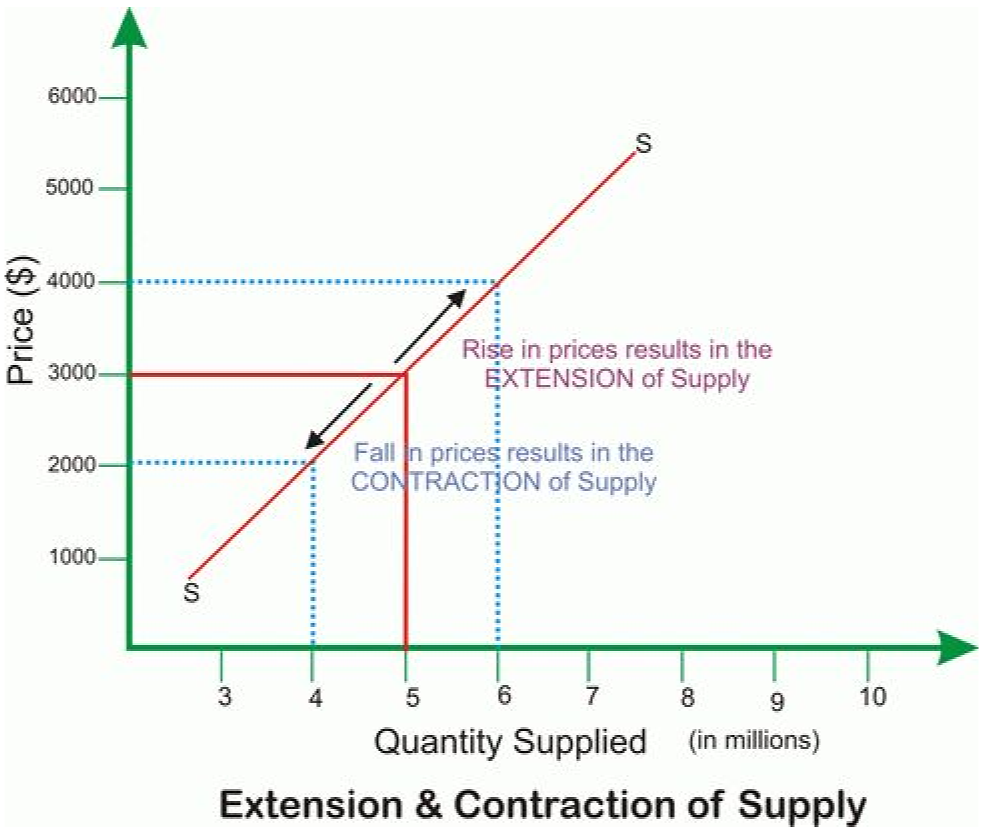
Movement along the Supply Curve

Extension of supply

It refers to the increase in supply of a commodity with the rise in price, other factors remaining unchanged.

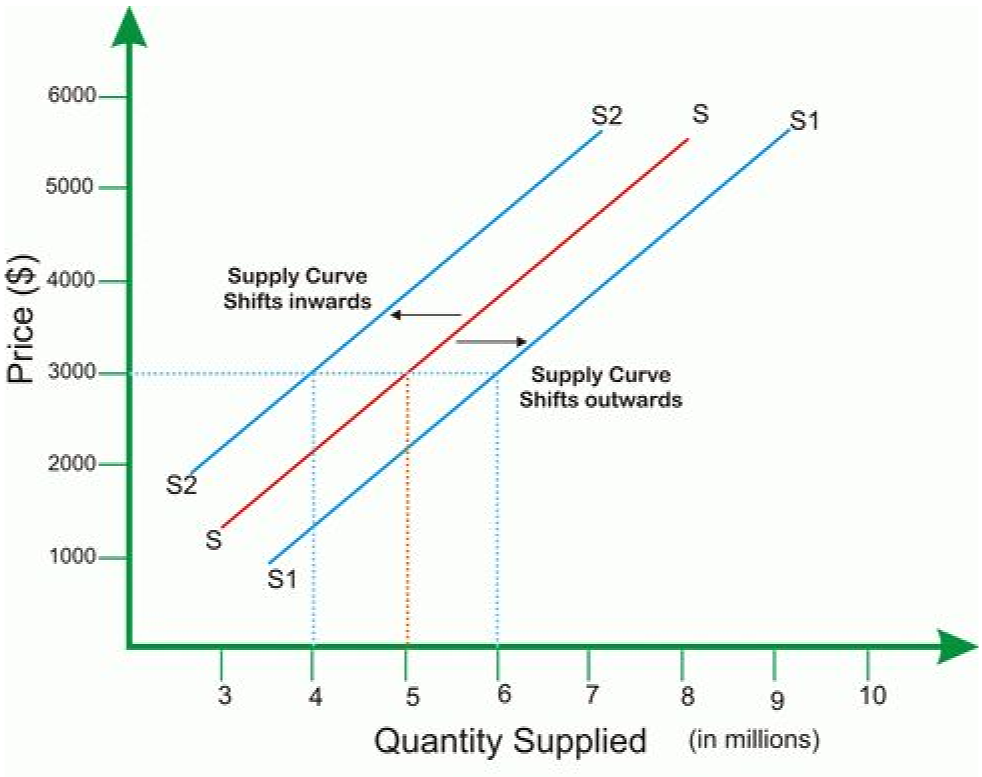
Contraction of supply

It refers to the fall in supply of a commodity when its prices fall, other factors remaining unchanged.



Shift in Supply Curve

When factors other than price affect the supply it results in the shift of supply curve. The supply curve may move inward or outward.
A shift of supply curve outwards to the right will mean an increase in supply at the same price level.
When the supply curve moves inwards to the left it means that less is being supplied at the same price level.



Shift in Supply Curve

2.6 Factors affecting supply:

Factors affecting Supply

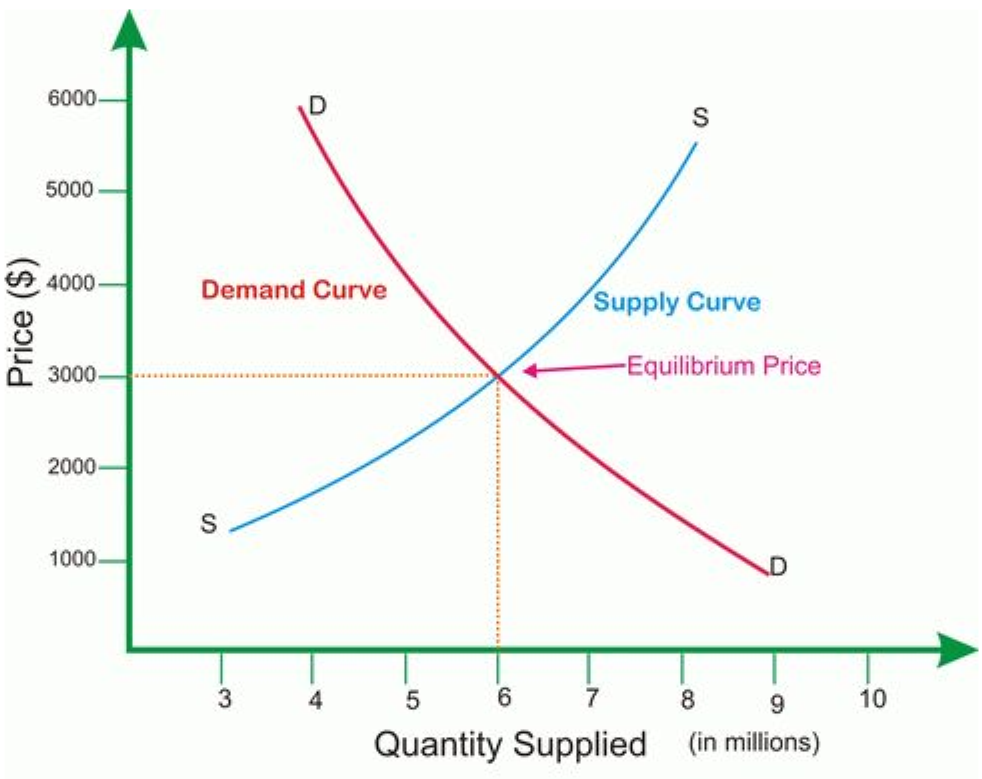
Price of the commodity: A rise in price will result in more of the commodity being supplied to the market and vice versa.
Prices of other commodities: For example if it is more profitable to produce LCD TVs then producers will produce more LCD TVs as compared to PLASMA TVs. Thus the supply curve for PLASMA TVs will shift inwards i.e. a fall in supply.
Change in cost of production: Increase in the cost of any factor of production may result in the decrease in supply as reduced profits might see producers less willing to produce that commodity.

Technological advancement: Improvement in technology results in lowering of cost of production and more profits for the producer and thus more supply of that commodity.
Climate: Climate and weather conditions affect the supply of commodities especially agricultural goods.

2.7 Market Equilibrium | price determination:

Market Price-Equilibrium Price

Equilibrium price can be defined as the price at which the quantity demanded is equal to the quantity supplied.
Market Price can be defined as the price prevailing in the market. Prices are determined by supply and demand forces.
It is not necessary that Market Price is equivalent to Equilibrium price.
In the graph below the point at which the demand curve meets the supply curve is the equilibrium price.



Price determination

Effect of change in Demand and Supply

Demand	Supply	Equilibrium price	Equilibrium quantity
Increase	Unchanged	Rise	Rise
Decrease	Unchanged	Fall	Fall
Unchanged	Increase	Rise	Rise
Unchanged	Decrease	Rise	Fall

2.8 Price Elasticity of demand:

Price Elasticity of demand

The responsiveness of quantity demanded, or how much quantity demanded changes, given a change in the price of goods or service is known as the price elasticity of demand.

Price Elasticity of demand (PED)= $\dfrac{\textbf{\% change in quantity demanded}}{\textbf{\% Change in price}}$

Negative sign

The mathematical value which is derived from the calculation is negative. A negative value indicates an inverse relationship between price and the quantity demanded. However, the negative sign is ignored.

Range of PED

The value of PED might range from 0 to ?

Lets take a look at various types of PED.

Perfectly Inelastic demand

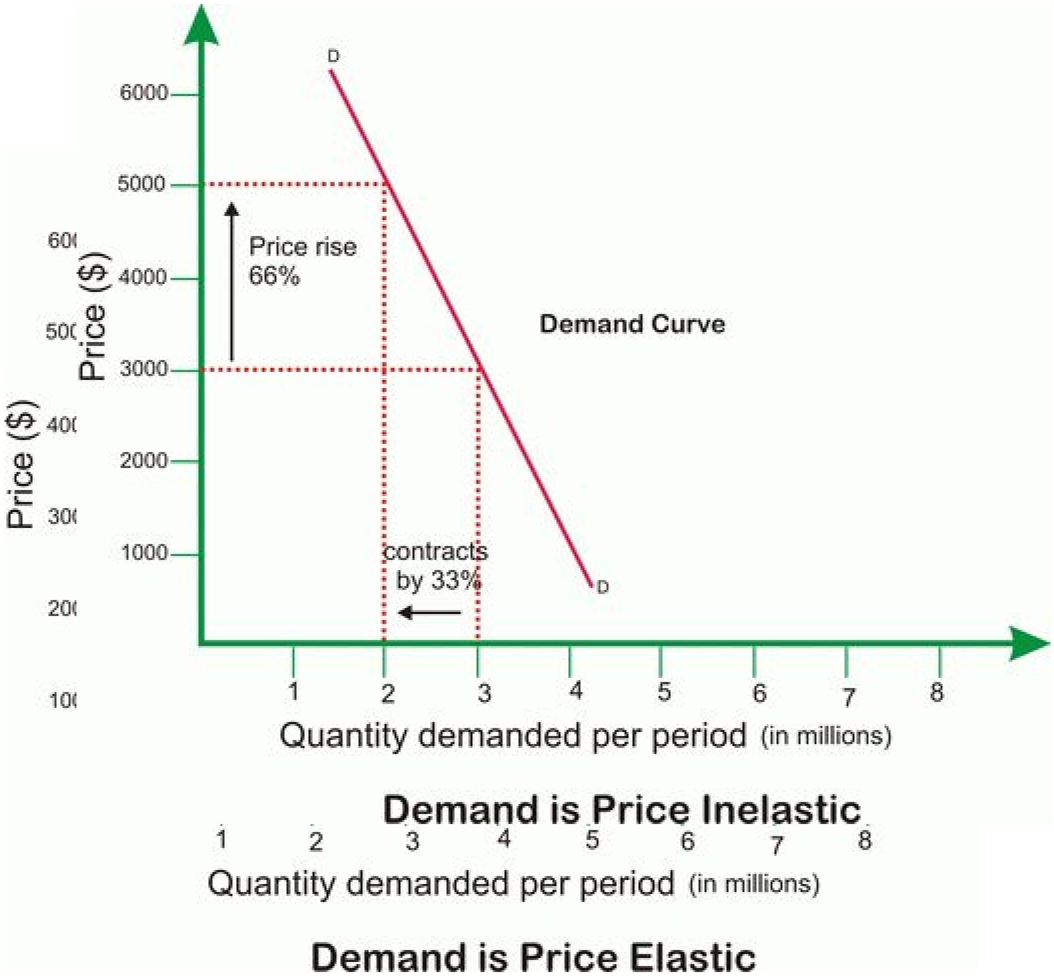
In this case the PED =0 That means, any change in price will not have any effect on the demand of the product. Or in other words, the percentage change in demand will be equal to zero. It is hypothetical situation and does not exist in real world.

Perfectly elastic demand In this case the PED =?

The demand changes infinitely at a particular price. Any change in price will lead to fall of demand to zero. It is hypothetical situation and does not exist in real world.

However Normal goods have value of PED between 0 and ?. These can be classified as Inelastic demand When a product has a PED less than 1 and greater than 0, it is said to be have an inelastic demand. The percentage change in demand is less than the percentage change in price of the product.

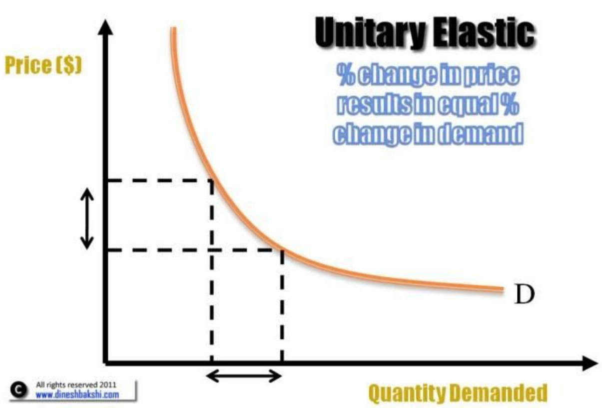
Demand for a product is said to be **ELASTIC** if the percentage change is demand is more than the percentage change in price.
The value of PED is more than 1.



When there is a smaller percentage change in quantity demanded as compared to the percentage change in its price, the product is said to price **INELASTIC**.
The value of PED is less than 1.

Unitary Elastic Demand

When the percentage change in demand is equal to the percentage change in price, the product is said to have Unitary Elastic demand. In short, PED=1



2.9 Cross elasticity of demand:

Cross price elasticity of demand (XED)

Cross elasticity of demand is

the effect on the change in demand of one good as a result of a change in price of related to another product.

In economics, it is denoted by the symbol XED.

The formula for cross elasticity of demand is

$$\textbf{Cross elasticity of demand} = \frac{\textbf{\% change in quantity demanded of good X}}{\textbf{\% Change in price of good Y}}$$

In XED it is important to have the positive/negative sign in front of the value.

If the value of XED is positive, this means that the two goods being considered are substitute goods.

Close substitutes have high positive value. Example: butter and margarine.

If two goods are complements, an increase in the price of one will lead to a reduction in the demand for the other—the XED is negative.

Very close complements have a lower negative value.

If two goods are unrelated, a change in the price of one will not affect the demand for the other—the XED is zero.

2.10 Income elasticity of demand:

The Income Elasticity of Demand (YED) measures the rate of response of quantity demand due to a raise (or lowering) in a consumers income.

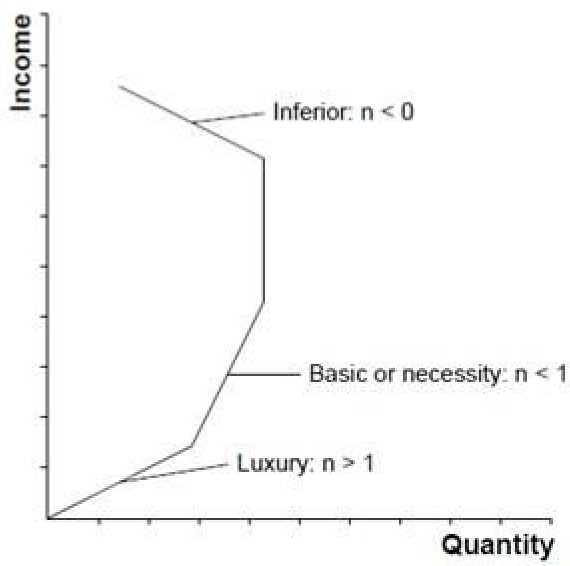
$$\textbf{Income elasticity of demand} = \frac{\textbf{\% change in quantity demanded}}{\textbf{\% Change in Income}}$$

Normal goods: an increase in income leads to an increase in consumption, demand shifts to the right. Thus YED is positive for normal goods.
Inferior goods: Income elasticity is actually negative for inferior goods, the demand curve shifts left as income rises. As income rises, the proportion spent on cheap goods will reduce as now they can afford to buy more expensive goods. For example demand for cheap/generic electronic goods will fall as people income rises and they will switch to expensive branded electronic goods.

{xtypo_info}Distinguish, with reference to YED, between necessity (income inelastic) goods and luxury (income elastic) goods.{xtypo_info}

Basic or necessity goods have a low income elasticity i.e., 0 < ? < 1. Quantity demanded will not increase much as income increases (income elasticity for food = 0.2)

Luxury goods have high income elasticity i.e. ? > 1. Quantity demanded rises faster than income. For restaurant meals income elasticity is higher than for food, because of the additional restaurant service.



In different types of economies, the demand for goods and services are determined by the income elasticity. As economies grow, firms will want to avoid producing inferior goods. The reason being as income increases more and more people will switch from inferior goods to superior goods.

2.11 What is an economic system:

What is an Economic System?

Because of the fact that there is scarcity of resources and unlimited wants, it is always a problem to allocate resources in an efficient manner. We are constantly facing three basic questions. These are:

- What to produce?
- How to produce?
- For whom do we produce?

Every community or country must choose and develop its own way of solving these problems. The way a country decides what to produce, how to produce and for whom to produce is called it Economic System.
The three Economic Systems existing are:

- Market Economic system
- Planned Economic System
- Mixed Economic System

Note:

- There are no PURE command economies
- There are no PURE market economies
- Instead there is a continuum of different characteristics

2.12 Market economic system | features, advantages and disadvantages:

The central thought of this system is that it should be the producers and consumers who decide how to utilise the resources. Thus, the market forces decide what to produce, how much to produce and for whom to produce.

Features

- All resources are privately owned by people and firms.
- Profit is the main motive of all businesses.

- There is no government interference in the business activities.
- Producers are free to produce what they want, how much they want and for whom they want to produce.
- Consumers are free to choose.
- Prices are decided by the Price mechanism i.e. the demand and supply of the good/service.

Advantages

- **Free market responds quickly to the people's wants**: Thus, firms will produce what people want because it is more profitable whereas anything which is not demanded will be taken out of production.
- **Wide Variety of goods and services:** There will be wide variety of goods and services available in the market to suit everybody's taste.
- **Efficient use of resources encouraged:** Profit being the sole motive, will drive the firms to produce goods and services at lower cost and more efficiently. This will lead to firms using latest technology to produce at lower costs.

Disadvantages

- **Unemployment:** Businesses in the market economy will only employ those factors of production which will be profitable and thus we may find a lot of unemployment as more machines and less labour will be used to cut cost.
- **Certain goods and services may not be provided:** There may be certain goods which might not be provided for by the Market economy. Those which people might want to use but don't want to pay may not be available because the firms may not find it profitable to produce. For example, Public goods, such as, street lighting.
- **Consumption of harmful goods may be encouraged:** Free market economy might find it profitable to provide goods which are in demand and ignore the fact that they might be harmful for the society.
- **Ignore Social cost:** In the desire to maximise profits businesses might not consider the social effects of their actions.

2.13 Planned economy | features, advantages and disadvantages:

In a planned economy, the **factors of production are owned and managed by the government**. Thus the Government decides what to produce, how much to produce and for whom to produce.

Features:

- All resources are owned and managed by the government.
- There is no Consumer or producer sovereignty.
- The market forces are not allowed to set the price of the goods and services.
- Profit in not the main objective, instead the government aims to provide goods and services to everybody.
- Government decides what to produce, how much to produce and for whom to produce.

Advantages

- Prices are kept under control and thus everybody can afford to consume goods and services.
- There is less inequality of wealth.
- There is no duplication as the allocation of resources is centrally planned.
- Low level of unemployment as the government aims to provide employment to everybody.
- Elimination of waste resulting from competition between firms.

Disadvantages

- Consumers cannot choose and only those goods and services are produced which are decided by the government.
- Lack of profit motive may lead to firms being inefficient.
- Lot of time and money is wasted in communicating instructions from the government to the firms.

Examples of Planned economies

- North Korea
- Cuba
- Turkmenistan
- Myanmar
- Belarus
- Laos
- Libya
- Iran
- Iraq (until 2003)

2.14 Mixed economy | features, advantages and disadvantages:

Mixed Economy

A **mixed economy** is an economic system that incorporates aspects of more than one economic system. This usually means an economy that contains both privately-owned and state-owned enterprises or that combines elements of capitalism and socialism, or a mix of market economy and planned economy characteristics. This system overcomes the disadvantages of both the market and planned economic systems.

Features

- Resources are owned both by the government as well as private individuals. i.e. co-existence of both public sector and private sector.
- Market forces prevail but are closely monitored by the government.

Advantages

- **Producers and consumer have sovereignty** to choose what to produce and what to consume but production and consumption of harmful goods and services may be stopped by the government.
- **Social cost of business activities may be reduced** by carrying out cost-benefit analysis by the government.
- As compared to Market economy, a mixed economy **may have less income inequality** due to the role played by the government.
- **Monopolies** may be existing but **under close supervision** of the government.

2.15 What is Market Failure:

What is Market Failure?

In a market where there is equilibrium, the resources are allocated in the best possible manner and there is 'allocative efficiency'.

Allocative efficiency is when situation where Marginal cost is equal to Marginal revenue.

However, this is not possible in the real world. Market failure exists when the resources are not allocated efficiently. Community surplus is not maximised and thus there is market failure. From a community's point of view, producer surplus is not equal to consumer surplus.

Market failure is thus caused by

- Abuse of monopoly power
- Lack of public goods
- Under provision of merit goods
- Overprovision of demerit goods
- Environmental degradation
- Inequality in distribution of wealth
- Immobility of factors of production
- Problems of information
- Short termism

2.16 Social cost and Social benefit:

Social Cost and benefits

Every business activity which takes place has some benefits and costs attached to it. The benefits go both to the owners of the firm as well as to external stakeholders. In the same way the owners and the external stakeholders have to pay a cost for the activities of the business.

Talking about…

Private cost

It is the cost of setting up the business. The owner(s) pay for the hire of machinery, buying of materials, payments of wages. This is termed as Private Cost.

Private benefit

The monetary benefits i.e. the revenue earned by the firm is a benefit for the owner and is termed as Private benefit.

External Cost

The problems that the external stakeholders have to bear due to the firm's activity are known as external cost. Example: cleaning a river which has been polluted by a firm's waste products. Private firms usually ignore external cost.

External benefits

Some firms can cause external benefits. These are the benefits to the external stakeholders due to the activity of firm. For example, a firm may train workers, which might get them better wages in other firms. These external benefits are free.

Social cost is the total cost paid for by the society due to the activities of a firm. It is the sum of all the external cost and private cost.

Social benefit is the total benefit arising due to the production of goods and services by a firm. This is equal to the total of private benefits and external benefits.

3. Individual as producer, consumer & brrower:

LEARNING OUT COMES:

- describe the functions of money and the need for exchange;

- describe the functions of central banks, stock exchanges, commercial banks;
- identify the factors affecting an individual's choice of occupation (wage factors and non-wage factors);
- describe likely changes in earnings over time for an individual;
- describe the differences in earnings between different occupational groups (male/female; skilled/unskilled; private/public; agricultural/manufacturing/services);
- describe trade unions and their role in an economy;
- describe the benefits and disadvantages of specialisation for the individual;
- analyse the different motives for spending, saving and borrowing;
- discuss how and why different income groups have different expenditure patterns (spending, saving and borrowing).

3.1 What is money?

Money *is anything that is generally accepted as payment for goods and services and repayment of debts.*

Functions of Money

A medium of exchange

Money overcomes the problem of needing a double coincidence of wants. It can be used to exchange and is therefore a comparative object, a **tertium comparationis** ("a third comparative unit").

A unit of account

Money acts as a measuring unit for value. Thus different commodities can be expressed in terms of money uniformly. This simplifies the comparison of the value of two products or services.

A store of value

Money can be used to store value. Unlike barter system where the commodities could not be saved over time, money can be stored as it does not lose value overtime.

A standard of deferred payment

Money can be used to pay over time for commodities. Goods and services can be paid for in instalments over a period of time e.g hire purchase. This was much more difficult and complicated in the barter system.

3.2 Qualities of good money:

Following are the qualities of good money:

General acceptance

The essential quality of good money is that it should be acceptable to all, without any hesitation in the exchange for goods and services.

Portability

It is also an important quality of good money that is should be easily transferable from one place to another for doing business and making payment. The paper money is easier to carry because it has minimum possible wait than metallic money.

Storability

Money should be storable and it should not be depreciate with time. If the money used is perishable it will lose its value in few days. Paper money has this quality of storability.

Divisibility

Good money is that which could be divided into small units without losing any value.

Durability

Money should be durable. It should not lose its value with the passage of time. The gold and silver coins do not wear out quickly and quality of money remains the same.

Economy

It is important quality of good money that it should be made economically. If there is heavy cost on issuing more money that is not good money. Good money is that has low cost and more supply. Paper money has this quality of economy.

3.3 Functions of Central Bank:

Central Banks

Central Banks are charged with regulating the size of a nation's money supply, the availability and cost of credit, and the foreign-exchange value of its currency. Regulation of the availability and cost of credit may be designed to influence the distribution of credit among competing uses. The principal objectives of a modern central bank in carrying out these functions are to maintain monetary and credit conditions conducive to a high level of employment and production, a reasonably stable level of domestic prices, and an adequate level of international reserves.

Function of a Central Bank

A central bank usually carries out the following responsibilities:

- Implementation of monetary policy.
- Controls the nation's entire money supply.
- The Government's banker and the bankers' bank ("Lender of Last Resort").
- Manages the country's foreign exchange and gold reserves and the Government's stock register;
- Regulation and supervision of the banking industry
- Setting the official interest rates- used to manage both inflation and the country's exchange rate - and ensuring that this rate takes effect via a variety of policy mechanisms

3.4 Video Series | Role of Central Bank:

The primary objective of the ECBs monetary policy is to maintain price stability. The ECB aims at inflation rates of below, but close to, 2% over the medium term.The operational framework of the Eurosystem consists of the following set of instruments:

Open market operations

Open market operations play an important role in steering interest rates, managing the liquidity situation in the market and signalling the monetary policy stance.

Click here on more information on Open market operations

Standing facilities

Standing facilities aim to provide and absorb overnight liquidity, signal the general monetary policy stance and bound overnight market interest rates. Two standing facilities, which are administered in a decentralised manner by the NCBs, are available to eligible counterparties on their own initiative.

More information on Standing facilities

Minimum reserve requirements

The intent of the minimum reserve system is to pursue the aims of stabilising money market interest rates, creating (or enlarging) a structural liquidity shortage and possibly contributing to the control of monetary expansion.

3.5 Commercial Bank:

Commercial banks provide banking services to businesses and consumers. These are profit motivated businesses with the power to make loans and accept deposits from customers.

The name commercial bank was first used to indicate that the loans extended were short-term loans to businesses, though loans later were extended to consumers, governments, and other non-business institutions as well. Most commercial banks offer a variety of services to their customers, including savings deposits, safe-deposit boxes, and trust services.

Functions of Commercial banks

Commercial banks are usually engaged in the following activities:

- processing of payments by way of telegraphic transfer, EFTPOS, internet banking or other means
- Issuing bank drafts and bank cheques.
- accepting money on term deposit
- lending money by way of overdraft, installment loan or otherwise
- providing documentary and standby letter of credit, guarantees, performance bonds, securities underwriting commitments and other forms of off balance sheet exposures

- safekeeping of documents and other items in safe deposit boxes
- Currency exchange.
- Sale, distribution or brokerage, with or without advice, of insurance, unit trusts and similar financial products as a “financial supermarket”.

3.6 Stock exchange | Its role in the economy:

Stock Exchange

It is an organized market for the sale and purchase of securities such as shares, stocks and bonds.

Stock exchanges are like markets where buyers and sellers of shares, stocks and bond meet.

These are known as secondary market.

Once shares are issued by companies, these can again be bought or sold through a Stock exchange.

Role of Stock exchanges

Stock exchanges have multiple roles in the economy, this may include the following:

Raising capital for businesses

The Stock Exchange provides companies with the facility to raise capital for expansion through selling shares to the investing public.

Mobilizing savings for investment

When people draw their savings and invest in shares, it leads to a more rational allocation of resources because funds, which could have been consumed, or kept in idle deposits with banks, are mobilized and redirected to promote business activity with benefits for several economic sectors such as agriculture, commerce and industry, resulting in a stronger economic growth and higher productivity levels and firms.

Facilitating company growth

Companies view acquisitions as an opportunity to expand product lines, increase distribution channels, hedge against volatility, increase its market share, or acquire other necessary business assets. A takeover bid or a merger agreement through the stock market is one of the simplest and most common ways for a company to grow by acquisition or fusion.

Redistribution of wealth

Stocks exchanges do not exist to redistribute wealth. However, both casual and professional stock investors, through dividends and stock price increases that may result in capital gains, will share in the wealth of profitable businesses.

Corporate governance

By having a wide and varied scope of owners, companies generally tend to improve on their management standards and efficiency in order to satisfy the demands of these shareholders and the more stringent rules for public corporations imposed by public stock exchanges and the government.

Creating investment opportunities for small investors

As opposed to other businesses that require huge capital outlay, investing in shares is open to both the large and small stock investors because a person buys the number of shares they can afford. Therefore the Stock Exchange provides the opportunity for small investors to own shares of the same companies as large investors.

Government capital-raising for development projects

Governments at various levels may decide to borrow money in order to finance infrastructure projects such as sewage and water treatment works or housing estates by selling another category of securities known as bonds. These bonds can be raised through the Stock Exchange whereby members of the public buy them, thus loaning money to the government.

Barometer of the economy

At the stock exchange, share prices rise and fall depending, largely, on market forces. Share prices tend to rise or remain stable when companies and the economy in general show signs of stability and growth. An economic recession, depression, or financial crisis could eventually lead to a stock market crash. Therefore the movement of share prices and in general of the stock indexes can be an indicator of the general trend in the economy.

3.7 Labour market | demand and supply of labour:

What are wages?

Wages are the reward to the factor of production – Labour. Wages are also regarded as the Price of labour. Wages are payments made to labour. Price of labour is determined by the market forces i.e. demand and supply.

Demand for labour

The demand for labour is a derived demand. It means that the demand for labour is linked with the products or services they produce. If the demand for those commodities rises the demand for labour also rises.

Factors affecting the demand for labour

Derived demand

The demand for labour is always derived from the demand for the good or service it produces. Thus if the demand for a particular goods or service increase it will lead to a rise in demand for labour used to produce those commodities. Recently there has been an increased demand for software professionals due to the increased demand for IT products.

Wage rates

A fall in wages will cause an extension in the demand for labour while a rise in wages paid to works will cause a contraction in demand.

Technology used

In industries where there is improved technology can be used, the demand for labour will tend to fall as producers will replace labour with sophisticated machinery.

Supply of labour

Supply of labour increases with the rise in wage rate. The supply curve of labour normally slopes upward to the right.

Factors affecting the supply of labour

Wage rate

In most cases the supply of labour will increase with the increase in wages. This is because more workers will be attracted by a higher wage rate and moreover the existing workforce may be willing to work overtime at a higher wage rate.

Size of the population

An increase in population will lead to an increase in supply of labour.

Social factors

With more and more women entering the labour market the supply of labour has increased in the recent times.

Working age

Lowering the working age of will increase the supply of labour. An increase in the retirement age will increase the supply of labour.

Educational requirement

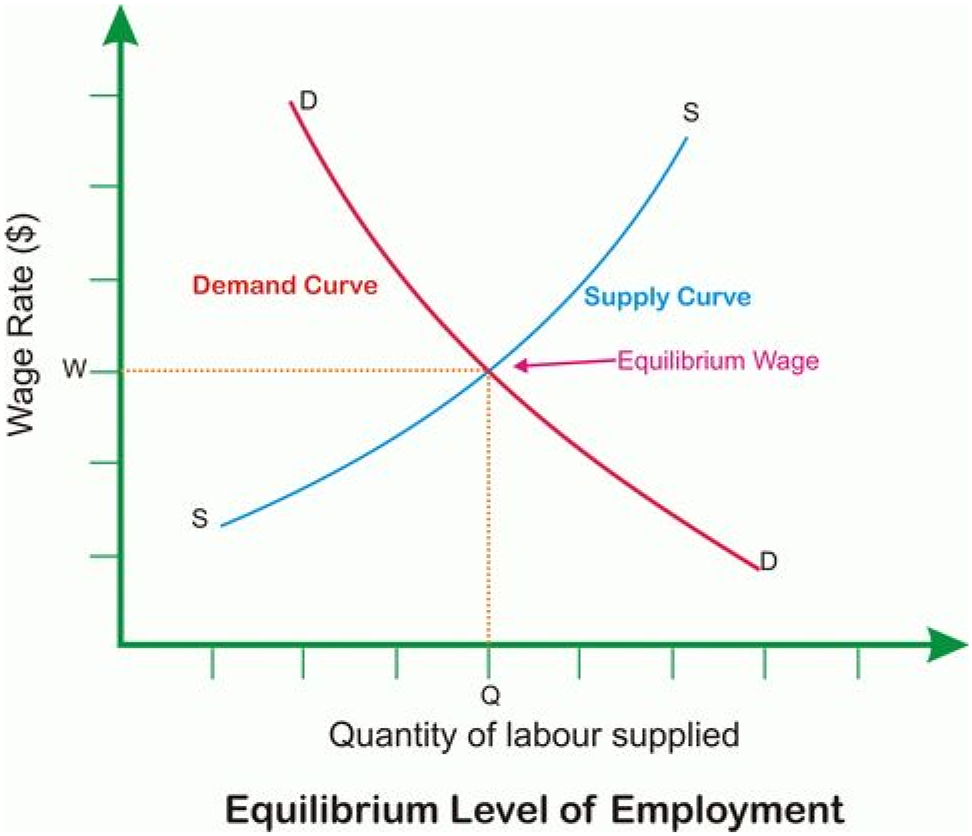
Jobs which need special training or educational qualifications will see less supply of labour as compared to jobs which don't need high level of educational qualification.

3.8 Wage rate determination:

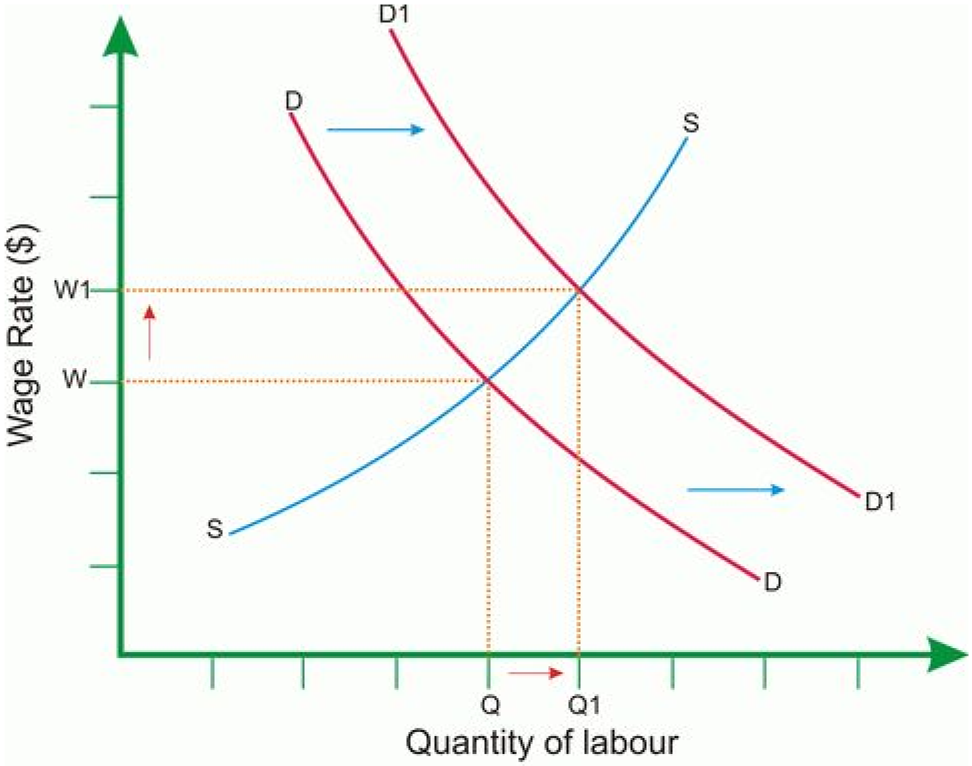
How to wage rate is determined?

The wage rate in a particular industry is determined by the market forces i.e. demand and supply.

The point at which the demand and supply of labour will intersect will determine the wage rate for that particular industry.

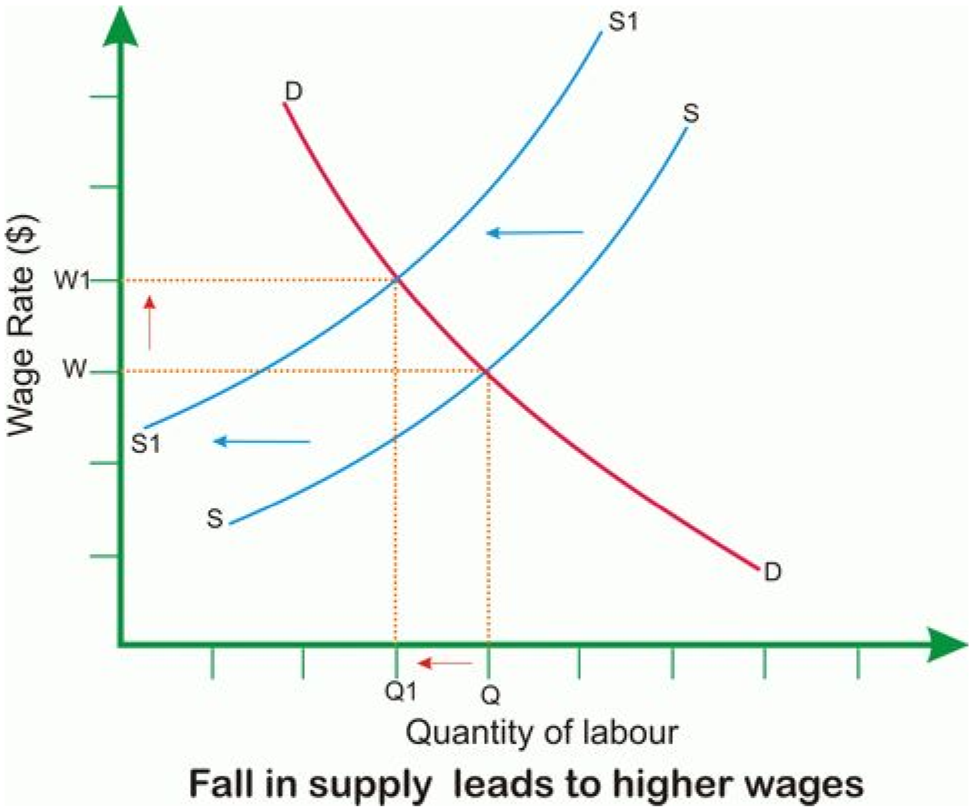


A rise in the demand for labour will lead to a rise in the equilibrium wage rate.



Rise in demand leads to higher wages

A fall in the supply of labour will result in a rise in the equilibrium wage rate.

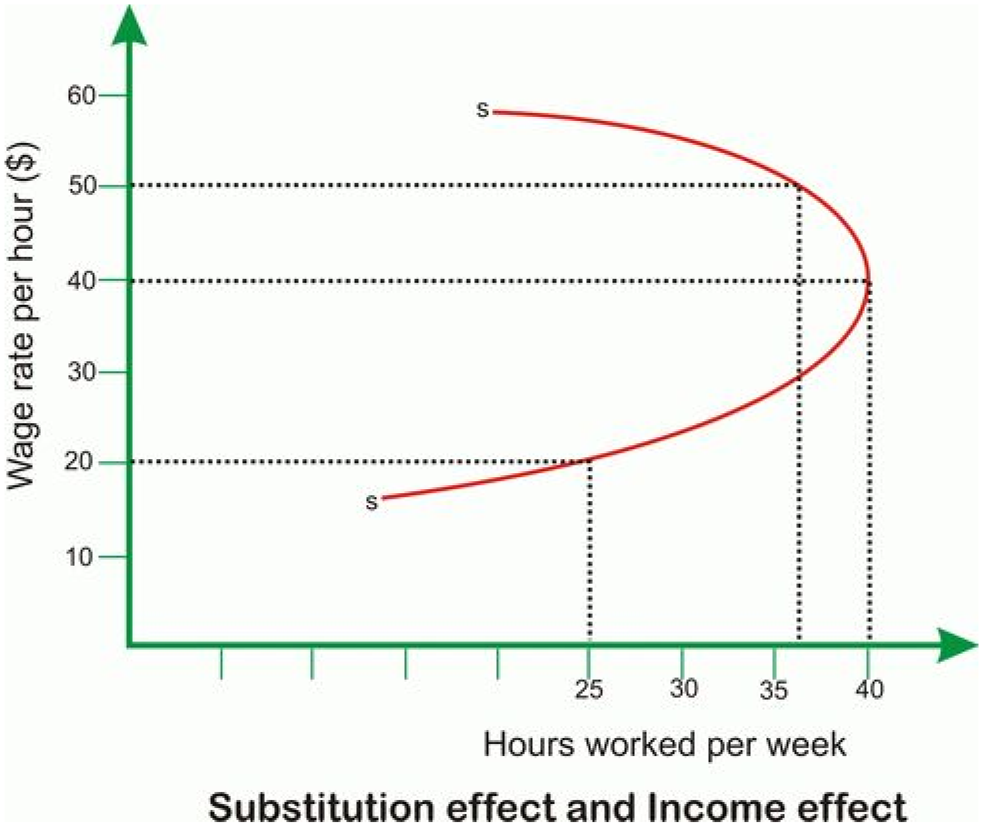


3.9 Substitution and Income effect:

Substitution and Income effect

As the price of a good is raised its supply also increases. Thus we get a normal upward sloping curve. In the same way, a higher wage rate will influence people to work for more hours. This would mean that the worker will spend less on leisure because the price of leisure has gone up, in terms of opportunity cost. This is known as **Substitution effect.**
As a result, the supply curve will be sloping upwards. But when the hourly rate rises above a certain level a worker may wish to work fewer hours per week, because he can earn higher income within a shorter period of time.This is known as**Income effect.** This will result in the supply curve bending backward.

This is illustrated in the diagram below.



3.10 Changing jobs at same wages:

Why workers change jobs at same wages?

There are many times when a worker decides to move to another job at the same rate of pay

The reasons might be:

- Sometimes workers move from one job to another at the same rate of pay because their working conditions are not good or acceptable to them and they prefer to change job even though they are not paid more.
- There may be times when the worker may find problems due to extreme weather conditions or geographical factors.
- Workers also change jobs in expectation of better prospects of promotion or professional development, though they are not getting higher wages.
- Many workers might find the journey to work very tiring and would prefer to work close to their homes.
- Some workers might relocate to a location which they personally like even though they might get the same wages.

- Working in large company is considered as a status symbol by many workers and they might change job to work in a large company.
- Many businesses don't pay high wages but care for their employees by providing Fringe benefits such as subsidised meals, health scheme, leisure activities. This may also influence a worker to move to these businesses.

3.11 Why work at low wages?

There may be times when a worker would be prepared to work for very low wages?

The reasons might be

- The worker might not be able to get another job and has to contend with low wages till he finds a better paying job.
- Low skilled jobs usually have low wages. The worker might not be trained to do skilled job and thus get low wages.
- The worker might choose to work part-time and does not mind low pay. For example, a student working doing a part time job to earn his pocket money may not negotiate too much for higher wages.
- In the same way, a worker might view the job as a temporary measure until a better job is available and may not negotiate for better wages.
- Lack of information is also an important factor. Workers who do not know of alternative jobs usually land up getting lower wages.
- Age may be a factor which limits the worker to get higher wages.

3.12 Factors affecting individual's choice of job:

Factors affecting individual's choice of job

An individual might be influenced by many factors while choosing a job. These factors are divided into wage factors and non wage factors.

Non-wage factors

Here are some of the non-wage factors which might influence an individual's choice.

- length/number of holidays
- working conditions/environment
- hours of work

- promotion/career prospects
- travelling distance
- size of company
- social/canteen facilities
- provision of insurance scheme
- company car.

3.13 Why wages differ?

Reasons for differences in remuneration:

- **Skills/training:** Jobs requiring higher level of skills and training usually fetch higher remuneration
- **Education/qualifications:** Again jobs requiring higher level of education/qualification are paid higher remunerations.
- **Experience:** People with vast experience will get higher remuneration as compared to a person with lesser experience.
- **Level of responsibility:** Jobs with greater responsibilities are usually paid more.
- **Geographical area:** Jobs located in urban areas are usually carrying higher remunerations because of higher living costs in cities. People working in trecherous geographical areas may get extra remuneration in the form of additional allowances.
- **Trade union membership:** Trade Union members might end up negotiating better remunerations then non-trade union members.
- **Demand factors:** Firms producing goods and services which are high in demand usually pay better remunerations to their workers.
- **Supply factors:** Industries where there is a shortage of workers will usually pay higher remuneration to attract workers.

3.14 Factors affecting individual expenditure

Factors affecting individual expenditure

Level of income/wealth

An individual with high income will usually spend more than a person whose income is less.

Family size and commitments

An individual with a large family will end up spending more from his income.

Rates of interest

When interest rates are high people usually spend less as saving are a more attractive option.

Availability of/knowledge about savings schemes

Availabiliy and knoweledge of saving schemes will result in individuals spending less and saving more.

Confidence in banking system

A strong banking system will attract more savings and hence less spending.

Personal needs/lifestyle

Lifestyle of an individual is a major determinent of how much is spent. Individuals following lavish lifestyles will end up saving less and spending more.

Health care

Individuals having health issues or paying heavy health insurance premium is ought to have more expenditure as compared to a person having less or no health issues or no health insurance premium liabilties.

Education

People usually with higher education will end up spending more compared to a less educated person. The prime reason being an educated person will have varied interests.

Future expectations

Individuals who feel more insecured about their future will save more for the 'rainy days' and hence have will spend less.

3.15 Savings | Factors affecting savings

Saving

Saving is income not spent, or deferred consumption.

Factors affecting savings

- **Interest rates:** Higher interest rates will encourage people to save more.
- **Availability of appropriate savings schemes:** With more options to save money people will be attracted to save more
- **Advertising** of/knowledge about what is available at financial institutions
- **Confidence**/trust in financial institutions
- **Size of real disposable income:** Disposable income is the income left after paying taxes. Thus more money left in pockets will encourage people to save more.
- **Rate of inflation:** when inflation is high people have less money left with them to save because a major part of their disposable income will be spent to satisfy their needs and wants.
- **Save for a future purchase:** People might save with the motive to carry out a future purchase e.g. a house
- **Precautionary factors:** People might be 'saving for a rainy day'
- **Tastes and preferences of consumers:** It also depends on a individuals preference. Some people save more than others.
- **Consumer confidence**/expectations about future changes in the economy, e.g. risk of unemployment may lead to people saving more

3.16 Specialisation | Divsion of labour

Through years, production has developed into a complicated process and thus broken down into a series of highly specialised task. Each task is then performed by a worker. This is known as Division of Labour.

Advantages of Division of Labour

- **Practise makes perfect:** Worker specialises in a particular task and gives in the best, thus producing goods faster and less wastage of material.
- **Use of machinery:** Specialised machinery can be used which is further increase the productivity.

- **Increased Output:** with improvement in efficiency and use of machinery output is increased.
- **Saves time:** There is no time wasted in switching of jobs and thus the momentum of production can be maintained which leads to less wastage of time.

Disadvantages of Division of Labour

- **Boredom:** Performing the same task over and over again may lead to boredom for the workers.
- **Lack of variety:** Though the number of goods produced increases but they are identical or standardized.
- **Low motivation for worker:** Repeatedly performing the same task may lead to low motivation level for the worker. The worker might not have the sense of fulfilling a complete task as he is performing only a part of the job.
- **Lack of mobility:** Due to specialisation workers might find it difficult to switch between occupations.

3.17 What is a trade union ?

A **trade union** or **labour union** is an organization of workers who have banded together to achieve common goals in key areas such as wages, hours, and working conditions. The trade union, through its leadership, bargains with the employer on behalf of union members and negotiates labour contracts with employers. This may include the negotiation of wages, work rules, complaint procedures, rules governing hiring, firing and promotion of workers, benefits, workplace safety and policies.

A rally of the trade union UNISON in Oxford during a strike *Copyright © 2006 Kaihsu Tai*

3.18 Why do workers join trade union?

Workers might join a trade union because

- They believe that there is strength in number and they will be listened to when they in a group.
- To negotiate a better pay, more holidays and less hours of work.
- To pressurise the employer to provide them with a healthier and safer working environment.
- Improved benefits for retrenched workers
- To get the benefits of advice, financial support and welfare activities carried out by Trade Unions.
- Many workers may also join a trade union because there is a closed shop policy.

Closed Shop

It is where all employees must be a member of the same trade union.

Single Union agreement

It is an agreement between the management and workers, where the management deals with only one trade union and no other.

Collective bargaining

It means the negotiations between one or more trade unions and one or more employers on pay and conditions of employment.

Productivity agreement

It is an agreement between the management and workers whereby the management agrees to increase the benefits for workers in return for an increase in productivity.

3.19 Types of industrial actions

- **Strike:** when employees refuse to work
- **Picketing:** When employees stand outside the workplace and prevent the smooth functioning of the firm. E.g. they may stop the movement of Lorries in and out of factory.
- **Work to Rule:** It is when workers purposely follow all the rules in order to delay the progress of work.
- **Go slow:** It is when the employees work at a very slow pace.
- **Non-cooperation:** It involves workers refusing to follow a new procedure or rule.
- **Overtime ban:** It is when the employees refuse to work overtime or for additional hours of work apart from their normal working hours.

4. Private firm as producer and employer:

Learning outcomes

At the end of this unit students will be able to:

- describe the type of business organisation in the public and private sectors: sole proprietors, partnerships, private companies, public companies, multi-nationals, co-operatives, public corporations;

- describe and evaluate the effects of changes in structure of business organisations;
- describe what determines the demand for factors of production;
- define total and average cost, fixed and variable cost and perform simple calculations;
- analyse particular situations to show changes in total and average cost as output changes;
- define total and average revenue and perform simple calculations;
- describe the principle of profit maximisation as a goal;
- describe pricing and output policies in perfect competition and monopoly;
- describe the main reasons for the different sizes of firms (size of market, capital, organisation);
- describe and evaluate integration, economies and diseconomies of scale;
- discuss the advantages and disadvantages of monopoly

4.1 What is a sole trader?

The sole trader iis the oldest and most popular type of business. It is a form of business where there is only one owner who manages and controls the business.

A sole proprietorship, is a type of business entity which legally has no separate existence from its owner. Hence, the limitations of liability enjoyed by a corporation and limited liability partnerships do not apply to sole proprietors. All debts of the business are debts of the owner. It is a "sole" proprietor in the sense that the owner has no partners.

A sole proprietorship essentially means a person does business in his or her own name and there is only one owner. A sole proprietorship is not a corporation; it does not pay corporate taxes, but rather the person who organized the business pays personal income taxes on the profits made, making accounting much simpler. A sole proprietorship need not worry about double taxation like a corporate entity would have to.

A sole proprietor may do business with a trade name other than his or her legal name. In some jurisdictions, for example the United States, the sole proprietor is required to register the trade name or "Doing Business As" with a government agency. This also allows the proprietor to open a business account with banking institutions.

Advantages to a Sole Proprietor

An entrepreneur may opt for the sole proprietorship legal structure because no additional work must be done to start the business. In most cases, there are no legal formalities to forming or dissolving a business.

A sole proprietor is not separate from the individual; what the business makes, so does the individual. At the same time, all of the individual's non-protected assets (e.g homestead or qualified retirement accounts) are at risk. There is not necessarily better control or business administration possible with a sole proprietorship, only increased risks. For example, a single member corporation or limited company still only has one owner, who can make decisions quickly without having to consult others, but has the advantage of limited liability.

Furthermore, in most jurisdictions, a sole proprietorship files simpler tax returns to report its business activity. Typically a sole proprietorship reports its income and deductions on the individual's personal tax returns. In comparison, an identical small business operating as a corporation or partnership would be required to prepare and submit a separate tax return.

A sole proprietorship often has the advantage of the least government regulation.

Disadvantages to a Sole Proprietor

A business organized as a sole trader will likely have a hard time raising capital since shares of the business cannot be sold, and there is a smaller sense of legitimacy relative to a business organized as a corporation or limited liability company.

It can also sometimes be more difficult to raise bank finance, as sole proprietorships cannot grant a floating charge which in many jurisdictions is required for bank financing.

Hiring employees may also be difficult.

This form of business will have unlimited liability, so that if the business is sued, the proprietor is personally liable.

The life span of the business is also uncertain. As soon as the owner decides not to have the business anymore, or the owner dies, the business ceases to exist.

In countries without universal health care, such as the United States, a sole proprietor is also responsible for his or her own health insurance, and may find difficulty finding any if one of the family members to be covered has a previous health issue.

Another disadvantage of a sole proprietorship is that as a business becomes successful, the risks accompanying the business tend to grow. To minimize those risks, a sole proprietor has the option of forming a corporation. In the United States, a sole proprietor could also form a limited liability company, or LLC, which would give the protection of limited liability but would still be treated as a sole proprietorship for income tax purposes.

4.2 Partnership | features, advantages, disadvantages:

What is a Partnership?

A **partnership** is a type of business entity in which **partners** (owners) share with each other the profits or losses of the business undertaking in which all have invested. Partnerships are often favored over corporations for taxation purposes, as the partnership structure does not generally incur a tax on profits before it is distributed to the partners (i.e. there is no dividend tax levied). However, depending on the partnership structure and the jurisdiction in which it operates, owners of a partnership may be exposed to greater personal liability than they would as shareholders of a corporation.

Advantages of Partnership

- **Easy** to set up

- **More capital** can be brought into the business.
- Partners bring **new skills** and ideas to a business
- **Decision making** can be much easier with more brains to think about a problem.
- Partners **share responsibilities** and duties of the business.
- **Division of labour** is possible as partners may have different skills.

Disadvantages of Partnership

- There is **unlimited liability**: All the partners are responsible for the debts of the firm and if the business goes bankrupt, all the partners will have to clear the debts even if they have to sell of their personal belongings.
- **Disagreement** among the partners can lead to problems for the business.
- There is a **limit to the capital** invested. Because of the fact that maximum 20 members are allowed, the business may find it difficult to expand after a certain limit.
- There is **no continuity** of existence. Partnership is dissolved if one of the partners die or resigns or becomes bankrupt.

4.3 Partnership Deed:

Before starting a partnership business, all the partners have to draw up a legal document called a **Partnership Deed of Agreement**.

It usually contains the following information:

- *Names of included parties* - includes all names of people participating in this contract
- *Commencement of partnership*- includes when the partnership should begin. The date of the contract is assumed as this date, if none is given.
- *Duration of partnership* - includes how long the partnership should last. It is automatically assumed that the death of one of the contracting parties breaks the contract, unless otherwise stated.
- *Business to be done* - includes exactly what will be done in this partnership. This section should be very particular to avoid confusion and loopholes.
- *Name of firm* - includes the name of the business entity.
- *Initial investments* - includes how much each partner will invest immediately or by installments.
- *Division of profits and losses* - includes what percentages of profits and losses each partner will receive. If it is not a limited partnership, then there is unlimited liability (each partner is responsible for all partners' debts, including their own).
- *Ending of the business* - includes what happens when the business winds down. Usually this includes three parts: 1) All assets are turned into cash and divided among the members in a certain proportion; 2) one partner may purchase the others' shares at their value; 3) all property is divided among the members in their proper proportions.
- *Date of writing* - includes simply the date that the contract was written.

4.4 Limited Companies | types, features and advantages

Also known as **Joint stock companies**. These are business where a number of owner(shareholder) pool in their resources to do a common business and to share the profits and losses proportionally.

In a limited company, the debts of the company are separate from those of the shareholders. As a result, should the company experience financial distress because of normal business activity, the personal assets of shareholders will not be at risk of being seized by creditors. Ownership in the limited company can be easily transferred, and many of these companies have been passed down through generations.

Difference between Limited companies and partnership

Limited companies can **issue shares** whereas partnership business cannot.

Shareholders enjoy **limited liability** in Limited companies. It means that if the company experience financial distress because of normal business activity, the personal assets of shareholders will not be at risk of being seized by creditors. Whereas partnership business does not have limited liability except for limited partnerships.

Separate Identity: Limited companies are considered as human beings in the eyes of the law. They are born and die in the eyes of law. They can sue and get sued on their own name.

Continuity: There is continuity of existence in limited companies and are their existence is not affected by the death, bankruptcy or sickness of their owner. This is not the case in Partnership or sole trader businesses.

There are two main types of Limited companies. These are:

- Private Limited Company
- Public Limited Company

4.5 Private limited company | features, advantages, disadvantages

Private limited Companies

These are closely held businesses usually by family, friends and relatives.
Private companies may issue stock and have shareholders. However, their shares do not trade on public exchanges and are not issued through an initial public offering.
Shareholders may not be able to sell their shares without the agreement of the other shareholders.

Advantages

Limited Liability: It means that if the company experience financial distress because of normal business activity, the personal assets of shareholders will not be at risk of being seized by creditors.
Continuity of existence: business not affected by the status of the owner.
Minimum number of shareholders need to start the business are only2.
More capital can be raised as the maximum number of shareholders allowed is 50.
Scope of expansion is higher because easy to raise capital from financial institutions and the advantage of limited liability.

Disadvantages

Growth may be limited because **maximum shareholders** allowed are only 50.
The shares in a private limited company **cannot be sold or transferred** to anyone else without the agreement of other shareholders.

4.6 Public Limited Companies and Stock Exchange

please visit this link to study more about 4.6 (https://youtu.be/GnJCOof2HJk)

4.7 Public Limited company | features, advantages, disadvantages

Limited companies which can sell share on the stock exchange are Public Limited companies. These companies usually write PLC after their names. Minimum value of shares to be issued (in UK) is £50,000.

Advantages

- There is **limited liability** for the shareholders.
- The business has **separate legal entity**. There is continuity even if any of the shareholders die.
- These businesses can **raise large capital** sum as there is no limit to the number of shareholders.
- The shares of the business are **freely transferable** providing more liquidity to its shareholders .

Disadvantages

- There are lot of **legal formalities** required for forming a public limited company. It is costly and time consuming.
- In order to protect the interest of the ordinary investor there are **strict controls and regulations** to comply. These companies have to publish their accounts.
- The original owners may **lose control**.
- Public Limited companies are huge in size and may face **management problems** such as slow decision making and industrial relations problems.

4.8 Franchsing | features, advantages, disadvantages

What is franchising?

The term "franchising" can describe some very different business arrangements. It is important to understand exactly what you're being offered.

Franchise occurs when the owner of a business (the franchisor) grants a licence to another person or business (the franchisee) to use their business idea - often in a specific geographical area.

The franchisee sells the franchisor's product or services, trades under the franchisor's trade mark or trade name and benefits from the franchisor's help and support.

In return, the franchisee usually pays an initial fee to the franchisor and then a percentage of the sales revenue.

The franchisee owns the outlet they run. But the franchisor keeps control over how products are marketed and sold and how their business idea is used.

Well-known businesses that offer franchises of this kind include Prontaprint, Dyno-Rod, McDonald's and Coffee Republic.

Advantages and disadvantages of franchising

Buying a franchise can be a quick way to set up your own business without starting from scratch. But there are also a number of drawbacks.

Advantages

- Your business is based on a **proven idea**. You can check how successful other franchises are before committing yourself.
- You can use a recognised **brand name** and **trade marks**. You benefit from any advertising or promotion by the owner of the franchise - the "franchisor".
- The franchisor gives you **support** - usually including training, help setting up the business, a manual telling you how to run the business and ongoing advice.
- You usually have **exclusive rights** in your territory. The franchisor won't sell any other franchises in the same region.
- **Financing** the business may be easier. Banks are sometimes more likely to lend money to buy a franchise with a good reputation.
- **Risk is reduced** and is shared by the franchisor.
- If you have an existing **customer base** you will not have to invest time looking to set one up.
- Relationships with **suppliers** have already been established.

Disadvantages

- **Costs** may be higher than you expect. As well as the initial costs of buying the franchise, you pay continuing royalties and you may have to agree to buy products from the franchisor.
- The franchise agreement usually includes **restrictions** on how you run the business. You might not be able to make changes to suit your local market.
- The franchisor might go **out of business**, or **change** the way they do things.

- Other franchisees could give the brand a **bad reputation**.
- You may find it difficult to **sell** your franchise - you can only sell it to someone approved by the franchisor.
- Reduced risk means you might **not generate large profits**.

4.9 Cooperatives | features, types, advantages, disadvantages

What is a Co-operative?

A cooperative is defined as an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.
A cooperative may also be defined as a business owned and controlled equally by the people who use its services or who work at it.

There are different types of co-operatives:

Housing cooperative

A housing cooperative is a legal mechanism for ownership of housing where residents either own shares reflecting their equity in the co-operative's real estate, or have membership and occupancy rights in a not-for-profit co-operative and they underwrite their housing through paying subscriptions or rent.

Building cooperative

Members of a building cooperative (in Britain known as a self-build housing co-operative) pool resources to build housing, normally using a high proportion of their own labour. When the building is finished, each member is the sole owner of a homestead, and the cooperative may be dissolved.

Retailers' cooperative

A retailers' cooperative (known as a secondary or marketing co-operative in some countries) is an organization which employs economies of scale on behalf of its members to get discounts from manufacturers and to pool marketing. It is common for locally-owned grocery stores, hardware stores and pharmacies. In this case the members of the cooperative are businesses rather than individuals.

Utility cooperative

A utility cooperative is a public utility that is owned by its customers. It is a type of consumers' cooperative. In the US, many such cooperatives were formed to provide rural electrical and telephone service.

Worker cooperative

A worker cooperative or producer cooperative is a cooperative that is owned and democratically controlled by its "worker-owners". There are no outside owners in a "pure" workers' cooperative, only the workers own shares of the business, though hybrid forms in which consumers, community members or capitalist investors also own some shares are not uncommon.
Membership is not compulsory for employees, but generally only employees can become members. However, in India there is a form of workers' cooperative which insists on compulsory membership for all employees and compulsory employment for all members. That is the form of the Indian Coffee Houses. This system was advocated by the Indian communist leader A. K. Gopalan.

Consumers' cooperative

A consumers' cooperative is a business owned by its customers. Employees can also generally become members. Members vote on major decisions, and elect the board of directors from amongst their own number. A well known example in the United States is the REI (Recreational Equipment Incorporated) co-op, and in Canada: Mountain Equipment Co-op.
The world's largest consumers' cooperative is the Co-operative Group in the United Kingdom, which offers a variety of retail and financial services. The UK also has a number of autonomous consumers' cooperative societies, such as the East of England Co-operative Society and Midcounties Co-operative.
Migros is the largest supermarket chain in Switzerland and keeps the cooperative society as its form of organization.
Coop is another Swiss cooperative which operates the second largest supermarket chain in Switzerland after Migros.

Agricultural cooperative

Agricultural cooperatives are widespread in rural areas.
In the United States, there are both marketing and supply cooperatives. Agricultural marketing cooperatives, some of which are government-sponsored, promote and may actually distribute specific comodities. There are also agricultural supply cooperatives, which provide inputs into the agricultural process.
In Europe, there are strong agricultural / agribusiness cooperatives, and agricultural cooperative banks. Most emerging countries are developing agricultural cooperatives.

4.10 Multinational businesses

What are Multinational Businesses?

Businesses which have their operations, factories and assembly plants in more than one country are known as Multinational Business. They are also known as Transnational businesses.

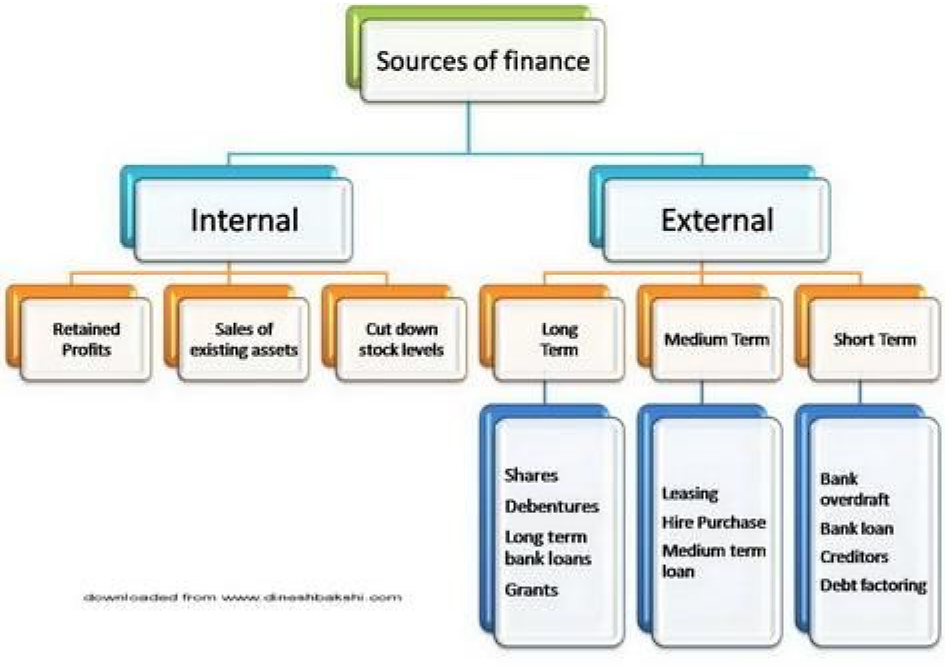
Advantages of being a Multinational

- Multinational can set up their business operations in countries where the **labour and raw material is cheaper**, which can give them cost advantage in the international market.
- Multinational have access to many markets which **spreads the risk of failure**. If any product may not be successful in a particular market, it might be successful in another.
- MNCs produce in large quantities thus achieving greater **economies of scales**.
- A multinational business is **less vulnerable to trade barriers**. MNCs set up their local operations in countries where there is potential market for them and get away with import duties and restrictions.
- MNCs can locate their operations near the potential market which results in **lower transportation cost**.

Advantages of Multinational to the host country

- Multinationals create **employment**.
- They bring **new technology and techniques** of production.
- MNCs usually provide **training** to their worker which results in better skills for the country's workforce.
- Multinational businesses usually produce in large quantities and export to other countries which can result in valuable**foreign exchange** for the host country.
- They pay huge **taxes to the government** which can be used for the development of the host country.

4.11 Sources of finance



A business might have access to various sources of financing its needs. These sources of finance can be classified as:

Internal and external

Internal: this is money raised from inside the business. It includes

- **Sales of assets**: Business might sell off old, obsolete assets which are no longer used by the business to raise additional cash for the business.

Advantage	Disadvantage
Better use of capital	A new business might not have any old or obsolete assets

- **Retained profits :** Businesses (especially limited companies) usually keep some part of the profit every year for future use. This is also known as ploughed back profit. Over a period of time it can total up to a huge amount which can be used for financing the business.

Advantage	Disadvantage

Does not increase liabilities No need to pay interest	Not available to new businesses

- **Reduction in working capital**: Cutting the stock levels can also help the business to raise additional cash.

Advantage	Disadvantage
Costs related to storage of stock is reduced	May lead to shortage of stock and loss of sales

4.12 External sources of finance | Long term, medium and short term

External sources of finance

External: This is the money raised from outside the business. It includes

Short Term

Bank overdraft: Bank overdraft is a facility given by banks to its business customers, people having current accounts. Through this facility the customers can overdraw their accounts to a greater value than the balance in the account. To overdrawn amount is agreed in advance with the bank manager. The bank assigns a limit to overdraw from the account and the business can meet its short term liabilities by writing cheques to the extent of limit allowed.

Advantage	Disadvantage
No need for collaterals or security.	Interest rates are usually variable and higher than bank loans
More flexible and the overdraft amount can be adjusted every month according to needs.	Cash flow problems can arise if the bank asks for the overdraft to be repaid at a short notice.

Trade Credit: Usually in business dealing supplier give a grace period to their customers to pay for the purchases. This can range from 1 week to 90 days depending upon the type of business and industry.

Advantage	Disadvantage

No interest has to be paid.	The business may not get cash discounts.

By delaying the payment of bills for goods or services received, a business is, in effect, obtaining finance which can be used for more important expenditures.

Factoring of debts: It involves the business selling its bills receivable to a debt factoring company at a discounted price. In this way the business get access to instant cash.

Medium Term

Hire purchase: It involves purchasing an asset paying for it over a period of time. Usually a percentage of the price is paid as down payment and the rest is paid in installments for the period of time agreed upon. The business has to pay an interest on these installments.
Leasing: Leasing involves using an asset, but the ownership does not pass to the user. Business can lease a building or machinery and a periodic payment is made as rent, till the time the business uses the assets. The business does not need to purchase the asset.

Advantage	Disadvantage
The business can benefit from the asset without purchasing it.	The total cost of leasing may end up higher than the purchasing of asset
Usually the maintenance of the asset is done by the leasing firm.	

Medium term bank loan: A bank loan for 1 year to 5 years.

Long term

Long term Bank loan: borrowing from bank for a limited period of time. The business has to pay an interest on the borrowing. This interest may be fixed or variable. Businesses taking loan will often have to provide security or collateral for the loan.
Issue of share: It is a permanent source of finance but only available to limited companies. Public limited companies can sell further shares up to the limit of their authorized share capital. Private limited companies can sell further shares to existing shareholders.

Advantage	Disadvantage
Permanent source of capital. In case of ordinary shares business will only pay dividends if there is a profit.	Dividends have to be paid to the shareholders.

Debentures: A **debenture** is defined as a certificate of acceptance of loans which is given under the company's stamp and carries an undertaking that the debenture holder will get a fixed return (fixed on the basis of interest rates) and the principal amount whenever the debenture matures. It is issued for a long periods of time. Debentures are generally freely transferrable by the debenture holder. Debenture holders have no voting rights and the interest given to them is a charge against profit.
Sales and lease back: this involves a firm selling its assets or property to an investment company and then leasing it back over a long period of time. The business thus can use the asset without purchasing it and can use the revenue earned from its sale for other purposes.

4.13 What are resources

Resources of an economy are the factors of production or the inputs which are used to produce an output i.e. goods and services. These can be classified into four categories.

Land

Land includes all resources found in the sea and on land. They are also known as natural resources. Land is said to be immobile and is limited in supply. Land is subject to the law of diminishing returns.

Law of diminishing returns states that given a fixed factor, variable factors added to it will eventually lead to a fall in marginal product.

Labour

Labour refers to input of human efforts, both physical and mental. However, only those human efforts are considered in economics as labour which has the sole purpose of receiving rewards. Any kind of labour done for pleasure is cannot be considered as labour.
Labour has greater mobility than land but is less mobile than capital and cannot be stored.

Mobility of labour

It refers to the movement of labour. There are two types of labour mobility. These are:

Geographical mobility

It is the movement of labour from place to another. But there are many barriers to geographical mobility which are as follows:

1. Workers may have insufficient information or unawareness of the opportunities existing in different places.
2. Sometimes age may be a factor. Older workers are more immobile than younger ones.
3. Social ties or sentimental reason may discourage workers to move to other places.

Occupational mobility

It refers to the willingness and mobility of worker to change from one occupation to another.

1. Labour may lack necessary skills and qualifications needed to relocate to another job.

2. Certain occupation may have entry requirements and restrictions.
3. Personal liking of the occupation may discourage a worker to move to other occupations.
4. Some workers may be too cautious in taking risk and moving to another occupation.

Capital

These are manmade resources which help to produce many other goods and services.
It can be classified as:

Fixed capital

These are physical assets which do not vary as the level of output varies and its form does not change in the course of production. Examples include factories, machines, and dockyards and so on.

Working capital

It consists of stocks of raw materials and stocks of semi-finished and finished goods awaiting purchase of consumers. It varies with the level of output. Thus, when output increases, the working capital also increases.

Entrepreneur

Entrepreneur is the person who brings all the factors of production together and organises them to produce goods and services. An entrepreneur decides what to produce, how to produce and for whom to produce.

4.14 Location decisions

Factors affecting the choice of location of a firm

Near to the Market

The most important factor affecting the location of a firm is the nearness to the market. Every business wants to be near to its customers. This is especially true for retail businesses.

Near to the raw materials

In case of manufacturing firm it is more economical to locate near to the source of raw material. This results in low transportation cost. If the output of the firms is more expensive to transport than its input, it is a bulk decreasing industry and is more likely to locate near to the market. For example, brewing industries locate near to the market because it is expensive to transport finished product.

On the other hand, if the raw material used by the firm is bulky and expensive to transport, it is a bulk decreasing industry. In this case, the firm would locate near to the raw material.

Supply of labour

If a firm requires skilled labour, than the location decision might be affected by availability of skilled, cheap labour. Many multinational firms are locating their production facilities in South East Asian countries just because the labour is cheap in these countries.

Availability of cheap land

Firms which need large areas of land might consider cost of land before locating. Automobile manufacturing plants need large chunks of land.

Traditional locations

Locating in an area that contains similar businesses, suppliers and markets may also be a considerable advantage. In Indonesia, most of the wood craft businesses prefer to locate in Bali because of its long reputation of producing excellent wood craft.

Amenities

Basic amenities such as gas, electricity, water, waste disposal and drainage may also be considered.

Climate

Many production processes may be affected by the climatic conditions also. Chip manufacturers prefer to locate in dry areas, e.g. Silicon Valley.

Safety requirements

Some products may be hazardous for the community and thus need to be located away from high density population. For example, Nuclear power plants, Chemical plants.

Management's Preference

In many cases the location of a firm may be influenced by the likes and dislikes of its management.

Government's Influence

Government also influences the location decisions of the firms. Government may give special incentives to firms which locate in underdeveloped or high unemployment areas of the country. These incentives may be in the form of Tax holidays, subsidies, cheap land etc. A firm in order to harness these incentives may locate in these regions.

4.15 Capital Intensive and Labour Intensive

Capital Intensive Vs. Labour Intensive

A business is **capital intensive** if it requires heavy capital investment in buying assets relative to the level of sales or profits that those assets can generate.
A capital intensive business will typically have some mixture of the following characteristics:

- high depreciation costs
- high barriers to entry
- large amounts of fixed assets on the balance sheet.

A **labour intensive business** is one in which the main cost is that of labour, and it is high compared to sales or value added.

Just a capital intensive business may attempt to reduce operational gearing by, for example, leasing or renting assets, a labour intensive one may try to reduce operational gearing by outsourcing or automation.

4.16 Meaning of Productivity

What is meant by Productivity?

Productivity is the ratio of outputs to inputs. It refers to the volume of output produced from a given volume of inputs or resources. If the firm becomes more productive, then it has become more efficient, since productivity is an efficiency measure. Productivity can be:

Labour productivity

$$\frac{\text{Total output in a given time period}}{\text{Quantity of labour employed}} = \text{Output per worker}$$

Capital productivity

<u>Total output in a given time period</u> = Output per capital input

Quantity or Value of Capital employed

How to improve productivity?

Productivity can be improved by:

- Raising the skill level of the workers through training
- Using more technologically advanced equipment in the production process.
- Improving the motivation level of the employees
- By managing the available resource in a more efficient way.

4.17 Types of cost | Fixed, variable, average, marginal cost

What is Cost?

All payments made by a firm in the production of a good or service are called the cost of production. These costs can be classified in different ways.

Types of costs

Fixed Cost and Variable cost

Fixed costs are expenses that do not change in proportion to the activity of a business, *within the relevant period or scale of production*. For example, a retailer must pay rent and utility bills irrespective of sales.
Variable costs by contrast change in relation to the activity of a business such as sales or production volume. In the example of the retailer, variable costs may primarily be composed of inventory (goods purchased for sale), and the *cost of goods* is therefore almost entirely variable.

In manufacturing, direct material costs are an example of a variable cost. An example of variable costs is the prices of the supplies needed to produce a product.

A company will pay for line rental and maintenance fees each period regardless of how much power gets used. And some electrical equipment (air conditioning or lighting) may be kept running even in periods of low activity. These expenses can be regarded as fixed. But beyond this, the company will use electricity to run plant and machinery as required. The busier the company, the more the plant will be run, and so the more electricity gets used. This extra spending can therefore be regarded as variable.

Along with variable costs, fixed costs make up one of the two components of total cost. In the most simple production function, total cost is equal to fixed costs plus variable costs.

It is important to understand that fixed costs are "fixed" only within a certain range of activity or over a certain period of time. If enough time passes, all costs become variable.

In retail the cost of goods is almost entirely a variable cost; this is not true of manufacturing where many fixed costs, such as depreciation, are included in the cost of goods.

Although taxation usually varies with profit, which in turn varies with sales volume, it is not normally considered a variable cost.

Variable costs are expenses that change in proportion to the activity of a business. Along with fixed costs, variable costs make up the two components of total cost. **Direct Costs**, however, are costs that can be associated with a particular cost object. Not all variable costs are direct costs, however; for example, variable manufacturing overhead costs are variable costs that are not a direct costs, but indirect costs.
For example, a manufacturing firm pays for raw materials. When activity is decreased, less raw material is used, and so the spending for raw materials falls. When activity is increased, more raw materials is used and spending therefore rises.

Average cost per unit

Average cost is equal to total cost divided by the number of goods produced.

Total cost/output

It is also equal to the sum of average variable costs (total variable costs divided by Output)

Marginal cost

Marginal cost is the change in total cost that arises when the quantity produced changes by one unit. In general terms, marginal cost at each level of production includes any additional costs required to produce the next unit. So, the marginal costs involved in making one more wooden table are the additional materials and labour cost incurred.

4.18 Production in Short run

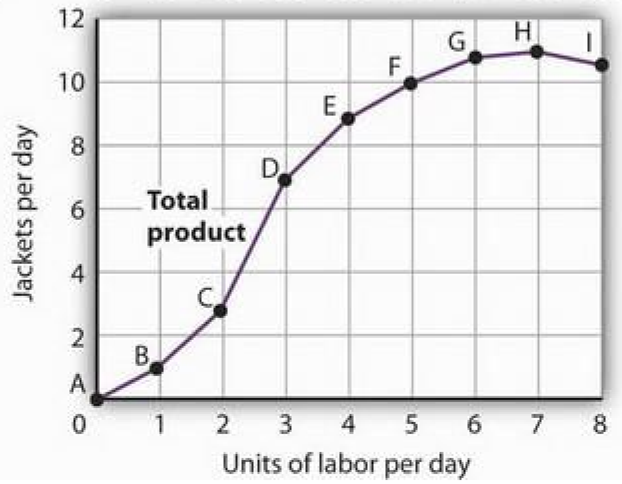
Short run is a period of time when at least one of the factors of production is fixed. Usually labour is the easiest factor to change. Thus in short run a firm can increase production only by employing more labour because no more land or capital is available. Thus, labour is the variable factor in the short run.

'Short run' for various firms is different. It may be few days for some industries and may be years for some industries.

Production function

It is the equation that expresses the relationship between the quantities of productive factors (such as labour and capital) used and the amount of product obtained. It states the amount of product that can be obtained from every combination of factors, assuming that the most efficient available methods of production are used.

Point on graph	A	B	C	D	E	F	G	H	I
Units of labor per day	0	1	2	3	4	5	6	7	8
Jackets per day	0.0	1.0	3.0	7.0	9.0	10.0	10.7	11.0	10.5

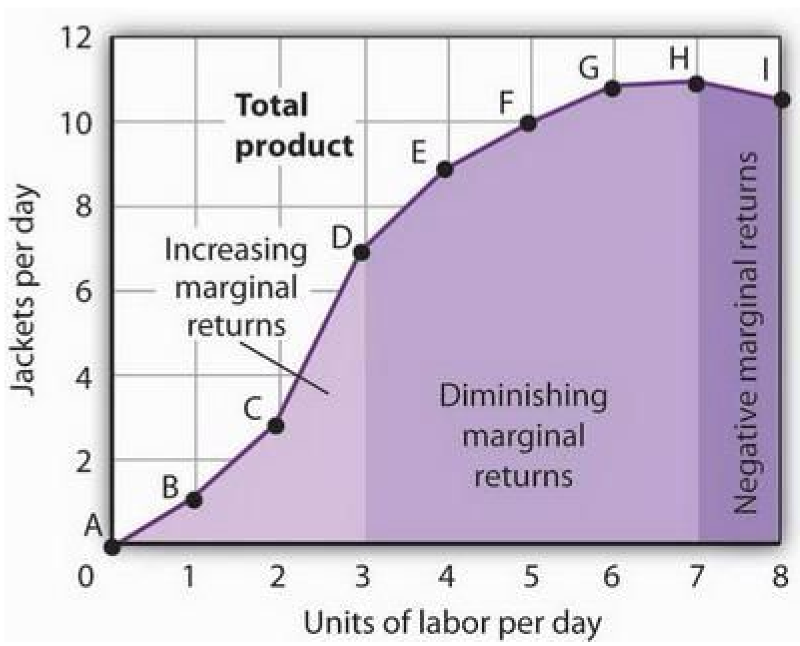


Law of increasing returns

This states that as more units of variable factor are added to a fixed factor, output will first rise more than proportionately. Thus, the firm experiences increasing returns.

Law of diminishing returns

The law states that as more units of a variable factor are added to a fixed factor, there will come a point when output will rise less than proportionately. The firm experiences diminishing returns.



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This graph shows firm's total product curve with the ranges of increasing marginal returns, diminishing marginal returns, and negative marginal returns marked. This firm experiences increasing marginal returns between 0 and 3 units of labor per day, diminishing marginal returns between 3 and 7 units of labor per day, and negative marginal returns beyond the 7th unit of labor.

Marginal product

Marginal product of labour is the change in total output when one more worker is employed.
It can be calculated as

$$\frac{\text{Change in total product}}{\text{Change in number of workers}}$$

Average product

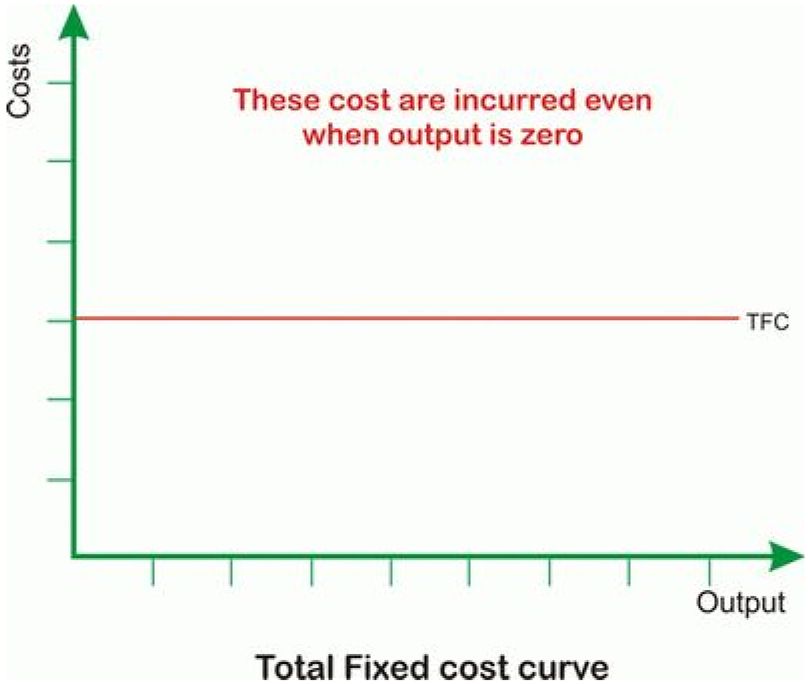
Average product of labour is the total product divided by the number of workers producing it. In other words, output each worker.

Total product
Number of workers

4.19 Diagrams |Cost curves in short run

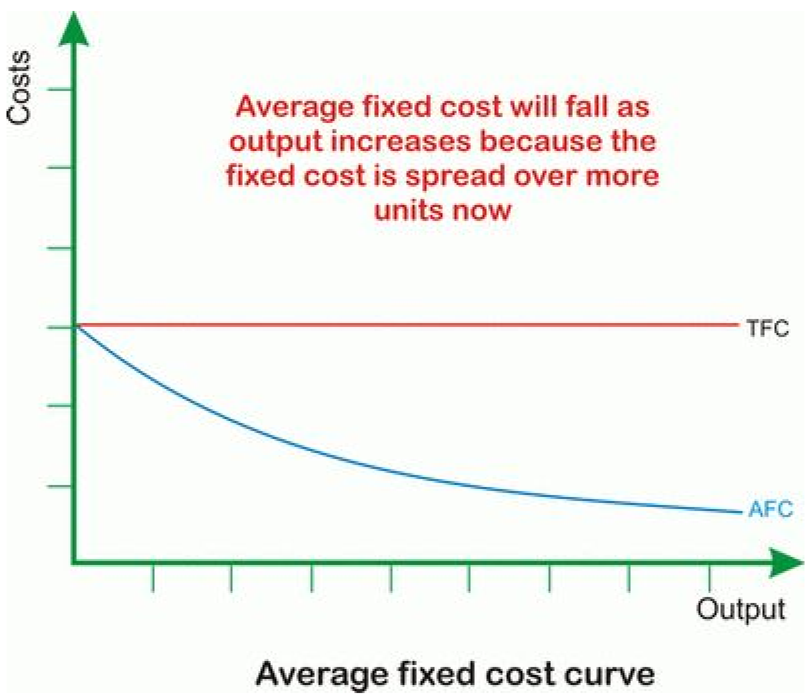
Total Fixed Cost

Total fixed cost will remain constant even though output changes.



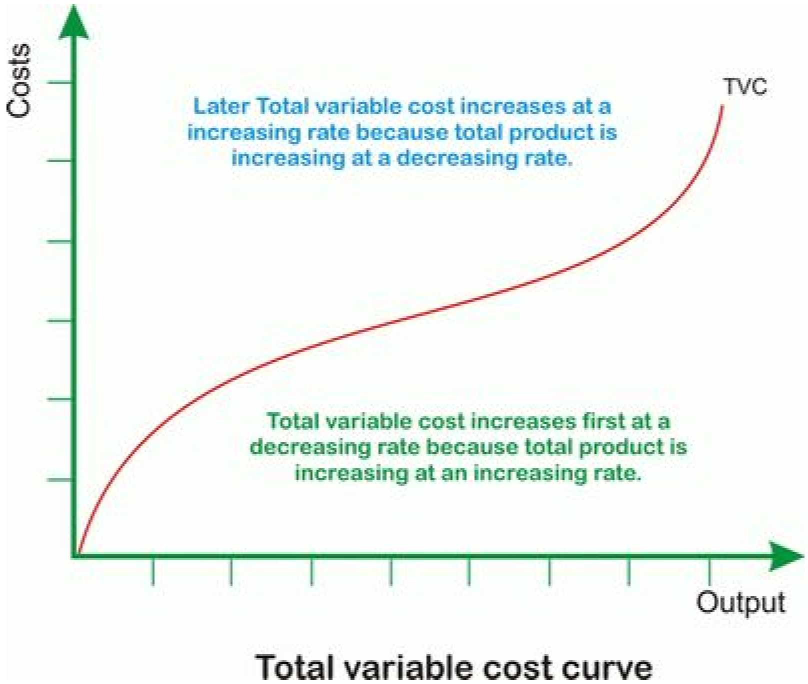
Average Fixed Cost

Average fixed cost will fall as output increases.



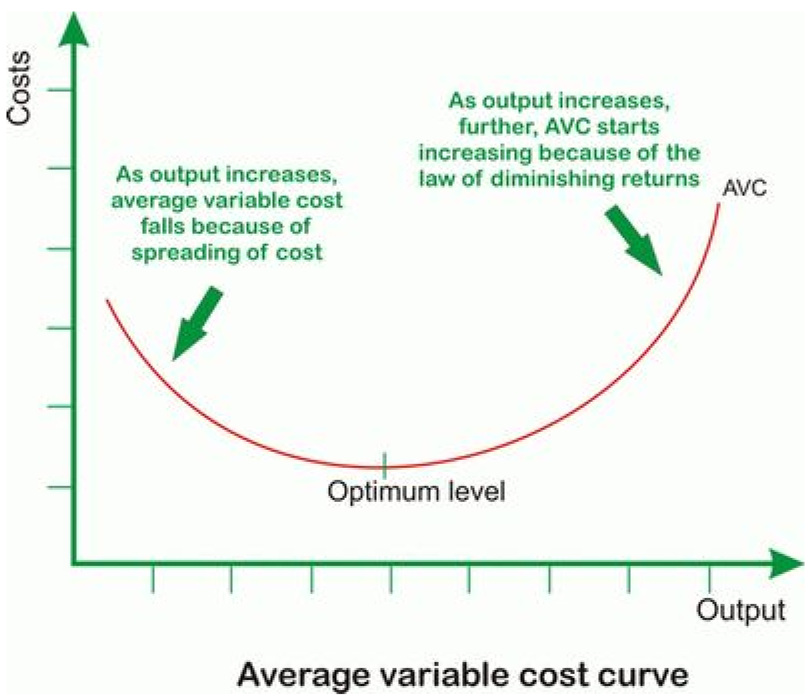
Total Variable cost

As output increases, total variable cost will increases.



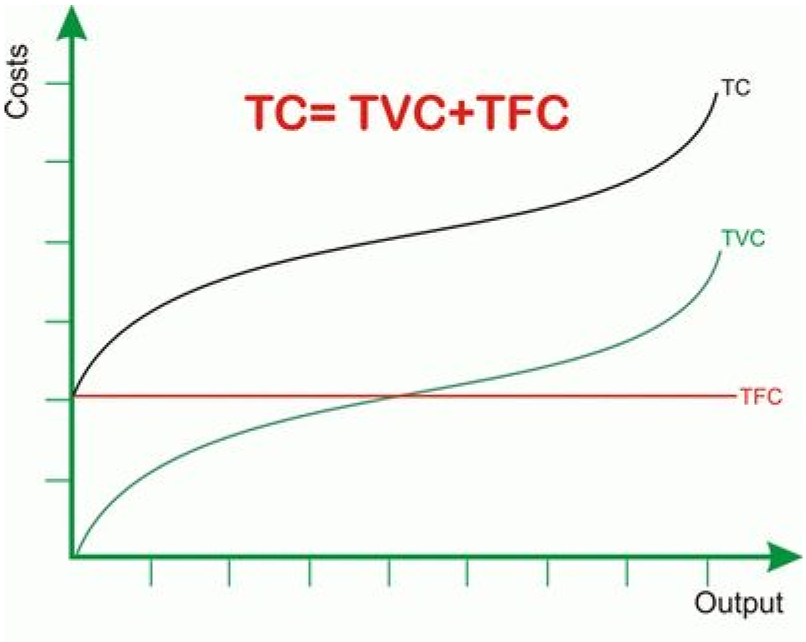
Average Variable Cost

The average cost curve is U-shaped. As output increases, average variable cost falls because of spreading of cost.



Total Cost

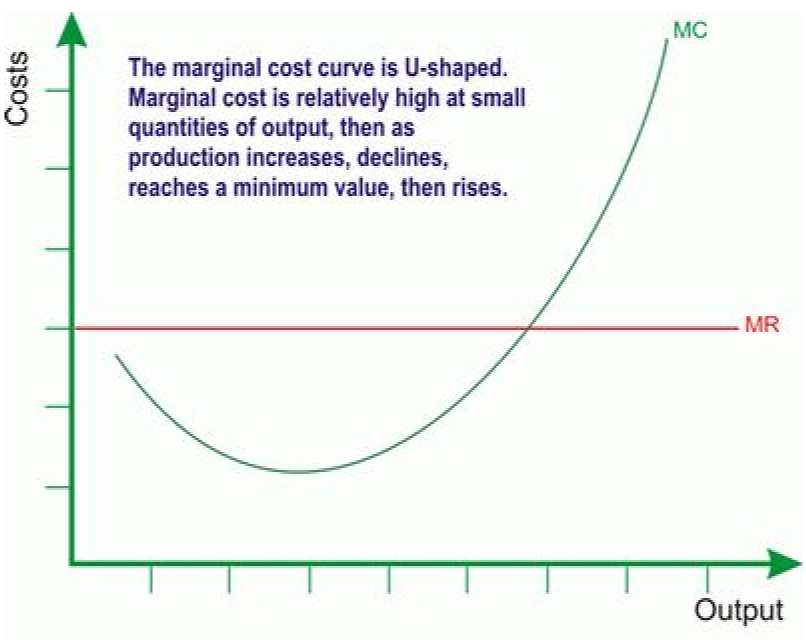
It can be defined as total variable cost plus total fixed cost.



Total cost curve

Marginal Cost

Marginal cost will initially fall, reach the minimum and finally rise.



Marginal Cost curve

4.20 Production in the Long run | Cost curves

Production in the Long run

In the long run there are no fixed factors of production. All factors are variable, and firms are therefore able to adjust their input of all factors of production. The process of change of input of all factors of production is the change in the **scale of production**.

When a firm changes it inputs but the change in output is more than the change input, the firms is said to be experiencing**increasing returns to scale**. On the other hand, when a firm's output experiences a less proportionate increase as compared to the increase in input, it is said to be **diminishing returns to scale**.

A firm experiencing an increased return to scale will find its average costs falling. This is termed as **economies of scale**. Whereas, a rise in average cost of production due to diminishing return to scale are termed as **diseconomies of scale**.

Long run cost curves

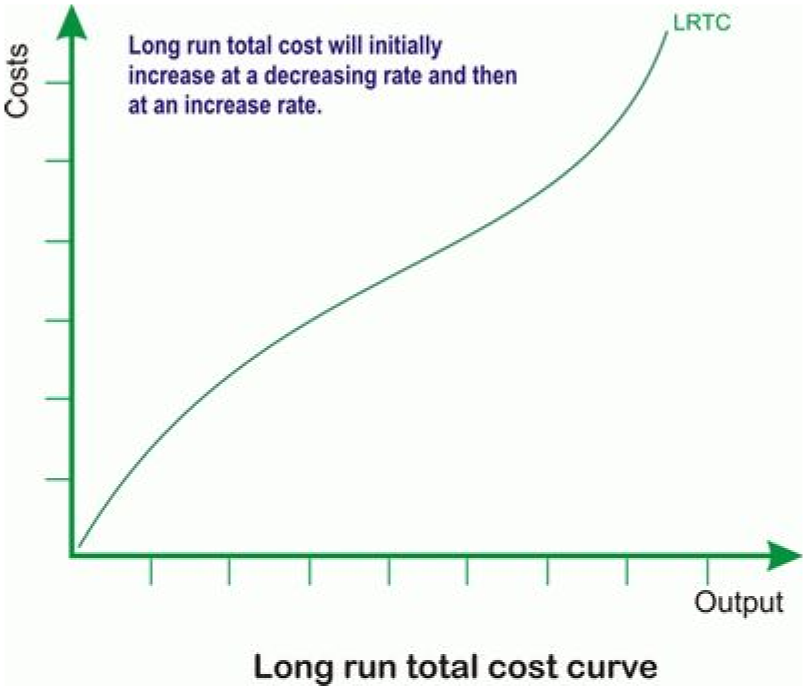
In the long run all the factors of production are Variable and a firm can expand or decrease the level of output by varying its variable factors.

There is no time dimension as to determine whether it is short run or long run. When the firm can alter it fixed factors, it is said to be a long run.

Long run Total Cost (LRTC)

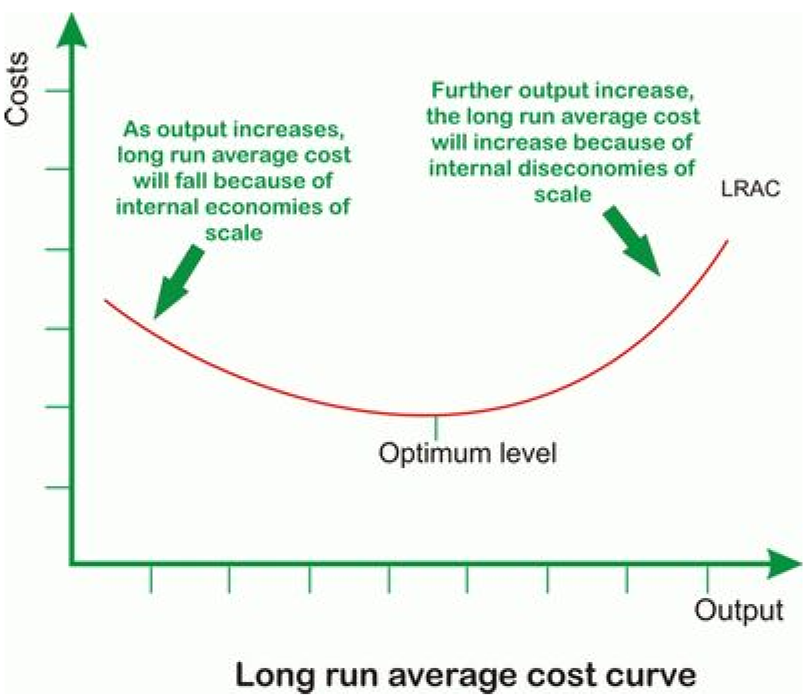
It is the total cost incurred as a result of producing a commodity in the long run. It can start from 0 as there is not fixed cost.

Long run total cost will initially increase at a decreasing rate and then at an increasing rate due to law of return to scale.



Long run Average Cost (LRAC)

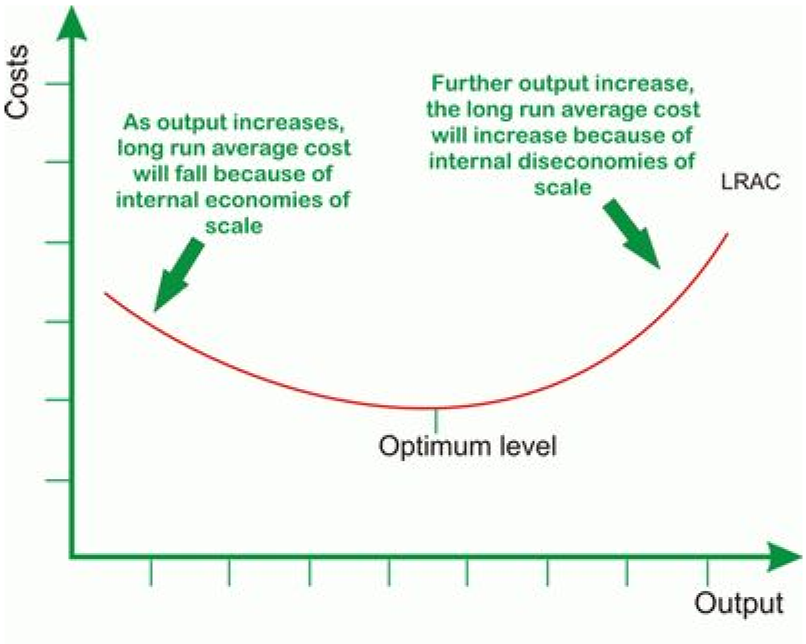
It is U shaped. In the long run, as output increase, the average cost will fall due to internal economies of scale. As output increases further, average cost will remain constant and if the output is increased further, the average cost will increase again due to internal diseconomies of scale.



4.21 Economies of scale

What are economies of scale?

Economies of scale are the cost advantages that enterprises obtain due to size, with cost per unit of output generally decreasing with increasing scale as fixed costs are spread out over more units of output.



Type of economies of scale

These can be classified into five categories:

Purchasing economies:

When business buys in large quantities, they are able to get discounts and special prices because of buying in bulk. This reduces the unit cost of raw materials and a firm gets an advantage over other smaller firms.

Marketing economies:

The cost of advertising and distribution rises at a lower rate than rises in output and sales. In proportion to sales, large firms can advertise more cheaply and more effectively than their smaller rivals.

Financial economies:

A larger company tends to present a more secure investment; they find it easier to raise finance.Banks and other lending institutions treat large firms more favorably and these firms are in a position to negotiate loans with preferential interest rates. Further, large companies can issue shares and raise additional capital.

Managerial economies:

A large company benefits from the services of specialist functional managers. These firms can employ a number of highly specialized members on its management team, such as accountants, marketing managers which results in better decision being taken and reduction in overall unit costs.

Technical economies:

In large scale plants there are advantages in terms of the availability and use of specialist, indivisible equipment which are not available to small firms. Large manufacturing firms often use flow production methods and apply the principle of the division of labour. This use of flow production and the latest equipment will reduce the average costs of the large manufacturing businesses.

4.22 Diseconomies of Scale

Diseconomies of Scale

These are the drawbacks of being a big business. In other words, all the factors those lead to an increase in average costs as a business grows.
Diseconomies include the following:

Human relations

It is difficult to organize large number of employees. The business might find itself spending too much on communication. There might be long chains of command and instructions will take a long to reach the desired destination. Moreover there might be distortion in the message. There will be less personal contact between decision makers and staff, which can lead to low level of morale, lack of motivation and ultimately industrial relations problems.

Decisions and co-ordinations

There could be coordination problems. With a larger hierarchy, both the quality of information reaching from the management to the workers and vice versa could lead to poor decision making. There would be considerable paperwork and many meetings.

External diseconomies

Recently, consumers have become more conscious of the activities carried out by big firms. Therefore, big firms have to spend a lot of money on environmental issues and social responsibility act. These ultimately lead to higher average cost per unit.

4.23 What is revenue ?

What is revenue?

It is the value of sales of a firm's products. It is the income from sales of goods and services.

Quantity sold X Price
Total Revenue is also known as turnover.
Average revenue refers to the revenue of the firm by selling per unit commodity. It is calculated as:
Total revenue/number of products sold
Marginal Revenue is the change in the total revenue from the sale of an additional unit.

It is calculated as

Change in total revenue/change in quantity

4.24 Perfect Competition | Characteristics, Merits and Demerits

Perfect Competition

A situation where there are many firms competing in the market, there is lot of competition and the firm producing the best quality goods and services at lowest price will be successful.

Characteristics of Perfect Competition

Homogeneous products

All firms produce the identical products.

Many buyers in the market

Though there are many buyers in the market they cannot control the prices. They are price takers. The prices are set through the price mechanism.

Many sellers in the market

There are many sellers in the market. There is no dominating firm. All firms are usually small and are price takers.

Perfect information

All buyers and sellers have perfect knowledge about the prices in the market.

Freedom of entry and exit

There are no barriers to entry and exit for firms. Firms are free to enter or exit the market at their discretion. If a firm is making profit other firms may enter the market tempted by the profits.

No preferential treatment

There is no preference given to any firm by government or anybody. All firms are equally treated.

Merits of Perfect Competition

- There is optimal allocation of resources in the long run.
- Maximum economic efficiency as no single firm can control prices. There is no wasteful excess capacity.
- Advertising and promotional expenses are eliminated because product is homogeneous and there is perfect knowledge among the consumers.

Demerits of Perfect Competition

- No Research and Development undertaken as the products are homogeneous.
- Prices in perfect competition are controlled by the price mechanism. It may lead to instable income and prices due to frequent change in equilibrium prices.

4.25 Monopoly | features, advantages, disadvantages

Monopoly

Monopoly means a market where there is only one seller of a particular good or service.

Characteristics

- Only one single seller in the market. There is no competition.
- There are many buyers in the market.
- The firm enjoys abnormal profits.
- The seller controls the prices in that particular product or service and is the price maker.
- Consumers don't have perfect information.
- There are barriers to entry. These barriers many be natural or artificial.
- The product does not have close substitutes.

Advantages of monopoly

- Monopoly avoids duplication and hence wastage of resources.
- A monopoly enjoys economics of scale as it is the only supplier of product or service in the market. The benefits can be passed on to the consumers.
- Due to the fact that monopolies make lot of profits, it can be used for research and development and to maintain their status as a monopoly.
- Monopolies may use price discrimination which benefits the economically weaker sections of the society. For example, Indian railways provide discounts to students travelling through its network.
- Monopolies can afford to invest in latest technology and machinery in order to be efficient and to avoid competition.

Disadvantages of monopoly

- Poor level of service.
- No consumer sovereignty.
- Consumers may be charged high prices for low quality of goods and services.
- Lack of competition may lead to low quality and out dated goods and services.

5. Role of government in an economy

Learning Outcomes

At the end of this unit students will be able to

- describe the government as a producer of goods and services and as an employer;

- describe the aims of government policies, such as full employment, price stability, economic growth, redistribution of income, balance of payments stability;
- discuss the possible conflicts between government aims;
- describe the types of taxation (direct, indirect, progressive, regressive, proportional) and the impact of taxation;
- discuss the government's influence (regulation, subsidies, taxes) on private producers.

5.1 Economics objectives of Government

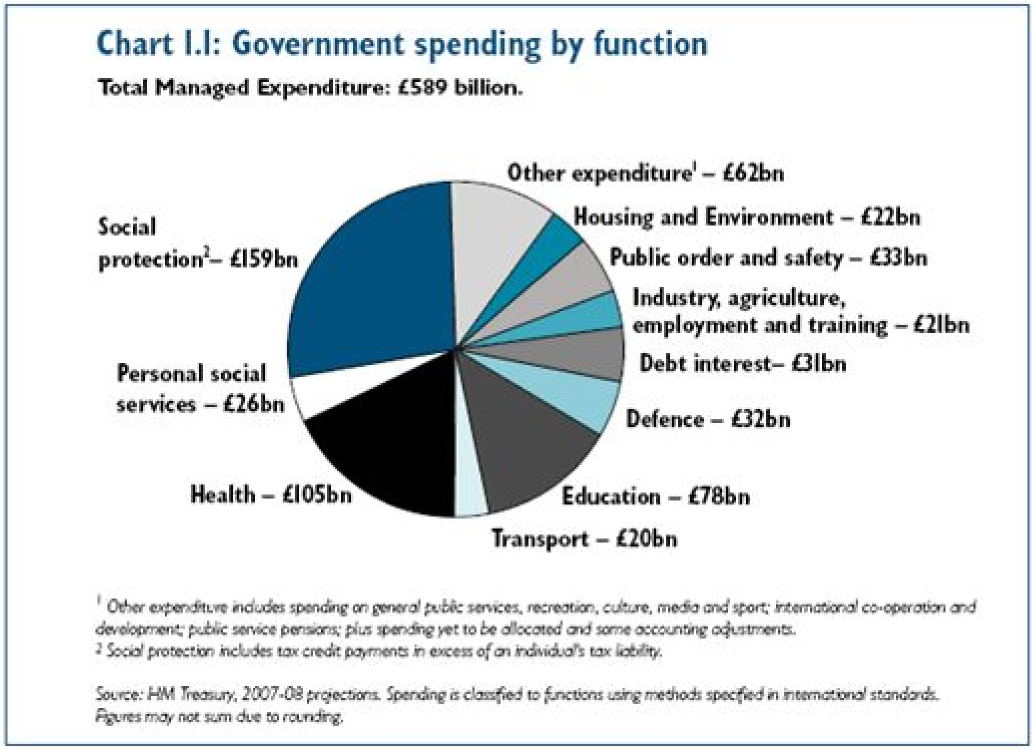
Most of the governments round the world have four main objectives. These are

- Keep inflation under control
- Maintain a low level of unemployment
- Achieve a high level of economic growth rate
- Maintain a healthy balance of payments.

5.2 Government spending or expenditure

Government spending or **government expenditure** is classified by economists into three main types.

- Government purchases of goods and services for current use are classed as **government** consumption.
- Government purchases of goods and services intended to create future benefits, such as infrastructure investment or research spending, are classed as **government investment**.
- Government expenditures that are not purchases of goods and services, and instead just represent transfers of money, such as social security payments, are called **transfer payments**.



5.3 Why do government spend

There are many reasons for government spending. These can be

To Provide Public goods

Public good is that good, consumption by one individual does not reduce availability of the good for consumption by others; and that no one can be effectively excluded from using the good. These goods are of importance to the general public and hence are provided by the government. Example defence, street lighting etc.

To provide Merit goods

A **merit good** is a commodity which is judged that an individual or society should have on the basis of a norm. The government feels that everybody should enjoy these goods irrespective of their incomeFor example, health and education. In most of the economies, governments spend a major part of their expenditure on health and education.

To maintain and promote economic growth

Public spending has an important role to play in **maintain and promoting economic growth** in the economy. Increases in government spending on state provided goods and services add to total domestic demand and can have multiplier effects on the final level of equilibrium national income.

Ensure welfare of the state

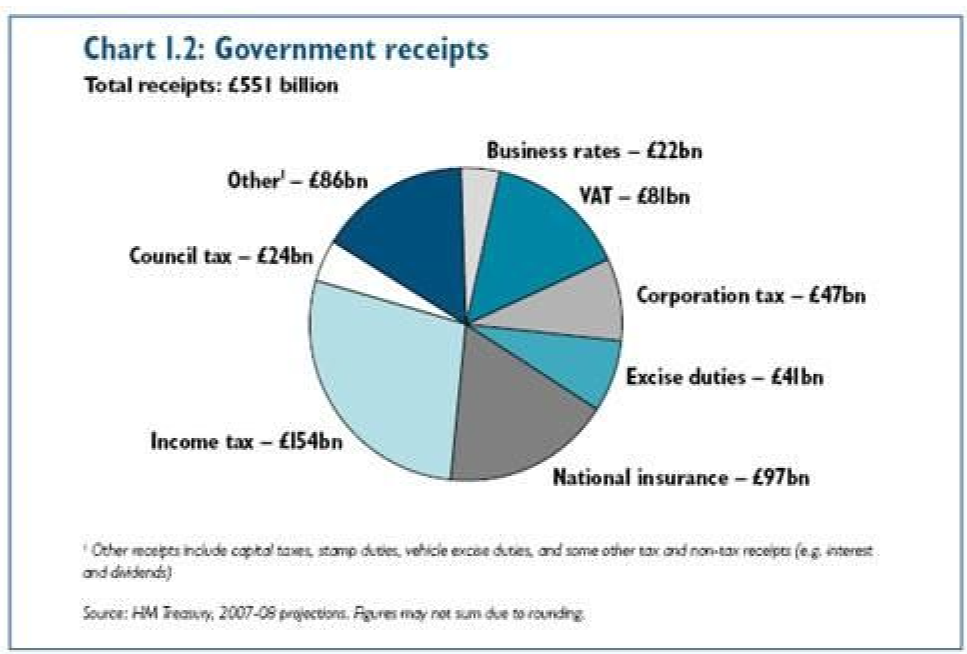
One of the government's main objective is to provide reduce the gap between rich and poor and thus government provides services like health and education to the economically weaker sections of the society free of cost or at a subsidised rates. The **social security system** also tries to provide a **safety-net** for those who suffer unexpected falls in income arising from unemployment, separation and bereavement.

5.4 Taxation | Purpose of taxation

Taxation

A Tax is a financial charge or other levy imposed on an individual or a legal entity by a state or a functional equivalent of a state.Taxes consist of direct tax or indirect tax.

A tax may be defined as a "pecuniary burden laid upon individuals or property to support the government […] a payment exacted by legislative authority."



Purposes of Taxation

Financing government spending:

Taxes are justified as they fund government expenditure and activities that are necessary and beneficial to society.

Reduce gap between rich and poor

Progressive taxation can be used to reduce inequality in a society. According to this view, taxation in modern nation-states benefits the majority of the population and social development. Progressive tax system where higher income groups have to pay more tax is an effective way of reducing inequality of income.

Reduce consumption of demerit Goods

Taxes can be used as an effective tool to reduce the consumption of demerit goods like alcohol and tobacco. Higher taxes on these goods reduce the consumption. Examples include cigarette tax and excise duty.

Control Inflation

One of the causes of inflation is *'too much money chasing too few goods'*. Government can take away the extra disposable income of the people through higher taxes and thus reduce the aggregate demand in the economy and resulting in low inflation rate.

Balance of payments

Tariffs are taxes on imports. Government can correct an unfavourable balance of payment situation by increasing the tariffs. This will result in imports becoming expensive and will cause a fall in demand for the imported goods.

Protecting local industries

Government uses taxes as a mean to protect local/infant industries. Increasing tariffs on imports and charging lower taxes to local/infant industries may boost the demand for goods and services produced by domestic industry.

5.5 Classification of taxes | progressive, regressive, proportional

Classification of taxes

Progressive taxes

A **progressive tax** is a tax imposed so that the tax rate increases as the amount subject to taxation increases. In simple terms, it imposes a greater burden (relative to resources) on the rich than on the poor. It can be applied to individual taxes or to a tax system as a whole. Progressive taxes attempt to reduce the tax incidence of people with a lower ability-to-pay, as they shift the incidence disproportionately to those with a higher ability-to-pay. The result is people with more disposable income pay a higher percentage of that income in tax than do those with less income.

Example of Progressive tax in New Zealand

Income (New Zealand Dollar)	Tax rate (%)
Up to 38,000	19.5
38001-60,000	33
Above 60,001	49

Example of Progressive tax in Australia

Income (Australian Dollar)	Tax rate (%)
Up to 6000	0
6001-25000	15
25001-75000	30
75001-150000	40
Above 150000	45

Regressive Tax

The opposite of a progressive tax is a **regressive tax**, where the tax rate decreases as the amount subject to taxation increases. It imposes a greater burden (relative to resources) on the poor than on the rich. Regressive taxes attempt to reduce the tax incidence of people with higher ability-to-pay, as they shift the incidence disproportionately to those with lower ability-to-pay.

For example, if Jane has $10 and John has $5, a tax of $1 on a purchase would result in a different percentage of total income applied to taxation, 20% for John and 10% for Jane. Thus, a tax that is fixed to the value of the good/service would likely, in effect, result in a higher burden of taxation to people with less money.

Proportional Tax

A proportional tax is one that imposes the same relative burden on all taxpayers—i.e., where tax liability and income grow in equal proportion. In simple terms, it imposes an equal burden (relative to resources) on the rich and poor. Proportional taxes maintain equal tax incidence regardless of the ability-to-pay and do not shift the incidence disproportionately to those with a higher or lower economic well-being.

5.6 Direct taxes | types of direct taxes

Direct taxes

Taxes which are collected directly from income and wealth are known as direct taxes.

Types of Direct taxes

Income tax

Income tax is collected on all incomes received by private individuals after certain allowances are made. In most of the economies Income tax is a major source of Government revenue.

Corporation tax

This tax is levied on profits earned by companies. It is a proportional tax which is levied at the constant rate.

Petroleum revenue tax

It is a tax levied on the profits of companies involved in drilling of oil and gas. This tax may or may not exist in other countries.

Capital gains tax

Capital gains tax is charged on the profit realized on the sale of a non-inventory asset that was purchased at a lower price. The most common capital gains are realized from the sale of stocks, bonds, precious metals and property. Not all countries implement a capital gains tax and most have different rates of taxation for individuals and corporations.

Property Tax

Many countries have Property tax, or millage tax. It is the tax which the owner pays on the value of the property being taxed.
The taxing authority requires and/or performs an appraisal of the monetary value of the property, and tax is assessed in proportion to that value. Forms of property tax used vary between countries and jurisdictions.

Stamp duty

Stamp duty is a form of tax that is levied on documents relating to immovable property, stocks and shares. Apart from transfers of shares and securities, stamp duties are also charged on the issue of bearer instruments and certain transactions involving partnerships.

5.7 Indirect taxes | Value added tax, excise duty

Indirect Taxes

Indirect tax (such as sales tax, **value added tax (VAT)**, or **goods and services tax (GST)**) is a tax collected by an intermediary (such as a retail store) from the person who bears the ultimate economic burden of the tax (such as the customer). The intermediary later files a tax return and forwards the tax proceeds to government with the return.An indirect tax may increase the price of a good so that consumers are actually paying the tax by paying more for the products.

Examples would be fuel, liquor, and cigarette taxes. An excise duty on motor cars is paid in the first instance by the manufacturer of the cars; ultimately the manufacturer transfers the burden of this duty to the buyer of the car in form of a higher price. Thus, an indirect tax is such which can be shifted or passed on.

All Indirect Taxes are regressive in nature. The poor will feel the pinch more than the rich.

Types of Indirect Taxes

Value added Tax

Value added tax (VAT), or goods and services tax (GST), is a consumption tax levied on *value added*. In contrast to sales tax, VAT is neutral with respect to the number of passages that there are between the producer and the final consumer; where sales tax is levied on total value at each stage, the result is a cascade (downstream taxes levied on upstream taxes).

Exports are consumed abroad and are usually not subject to VAT; VAT charged under such circumstances is usually refundable. This avoids downward pressure on exports and ultimately export derived revenue.

A VAT is an indirect tax, in that the tax is collected from someone who does not bear the entire cost of the tax.

Excise duties

Excise duty is a type of indirect tax charged on goods produced within the country. *Lists* of such goods are readily provided by governments.

5.8 Fiscal policy and how it works

Fiscal policy refers to government policy that attempts to influence the direction of the economy through changes in government taxes or through some spending.
The two main instruments of fiscal policy are **government spending** and **taxation**.

Changes in the level and composition of taxation and government spending can impact on the following variables in the economy:

- Aggregate demand and the level of economic activity.
- The pattern of resource allocation.
- The distribution of income.

How Fiscal Policy works?

Scenario one: High rate of Inflation

High rate of inflation is caused by too much aggregate demand in the economy. Government will use deflationary fiscal policy. Government will try to influence aggregate demand by reducing its public spending. The government will spend less on construction of roads, bridges and other public spending and thus aggregate demand will fall. On the other hand, Government may increase the tax rates. An increase in tax rates will take away the extra disposable income out people's pocket resulting in a lower demand.

Scenario two: Low rate of Inflation

In an economic recession, aggregate demand, output and employment all tend to fall. Now the Government wants to increase employment in the economy, it can attempt to do so by increasing aggregate demand. The Government will increase the public spending resulting in a rise in aggregate demand. Government may reduce the tax rates so that people have more disposable income to spend and instigate demand in the economy.

5.9 Problems with Fiscal Policy

Reduce incentive to work

Raising taxes on income and profits reduce work incentives, employment and economic growth. An effort to reduce aggregate demand may cause disincentives to work, if this occurs there will be a fall in productivity and Aggregate supply could fall.

Adverse effect of lowering Public Spending

Reduced govt spending to Increase Aggregate demand could adversely affect public services such as public transport and education causing market failure and social inefficiency.

‘Crowding out’ effect

With an increase in government expenditure, there will be greater competition for limited resources. This will offset private investments resulting in shrinking of the private sector.

Inaccurate forecasting

If the Government’s estimate or forecasting is wrong or inaccurate the Fiscal policy will suffer. For example, if a recession is expected and the government practises deficit budget, and yet the recession turns out to be a boom, this will cause inflation.

Implementation of the Policy

Planning for the spending is done once by most of the governments. If there is a delay in the implementation of the fiscal policy, it might reduce the effectiveness of the policy. Thus the time lag is important.

5.10 Monetary Policy

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls

1. the supply of money,
2. Availability of money, and
3. Cost of money or rate of interest,

in order to attain growth and stability of the economy.

Monetary policy is generally referred to as either being an expansionary policy, or a contractionary policy.

An **expansionary policy** increases the total supply of money in the economy and is traditionally used to combat unemployment in a recession by lowering interest rates.
Contractionary policy decreases the total money supply and involves raising interest rates in order to combat inflation.
It is argued that an increase in the money supply causes an increase in the rate of inflation. Maintaining a low and stable inflation is one of the main macroeconomic objectives of the Government. Government does so by controlling the supply of money to the economy. This policy is known as **monetary policy.**

Monetary policy is concerned with controlling the supply of money and the interest rates in the economy. The government cannot control both the supply of money and interest rates at the same time.

Monetary policy in any country is usually controlled by the Central Bank of that country. The Central bank alters the interest rates in the economy after assessing the inflationary pressures in the market.

Evaluation of Monetary Policy

Monetary policy is considered to be more successful during inflationary times because an increase in interest rates reduces the borrowings and thus stabilises the prices. Whereas, during deflation, Monetary policy may not be as effective. During deflation or recession, there is uncertainty in the market which discourages entrepreneurs and producers to take risk.

5.11 Interest rates affect on economy

How a change in Interest rates affects economy?

Controlling the interest rates affects the aggregate demand, inflation rate and the exchange rate.

Scenario one: Increasing the interest rates

An increase in the interest rates will reduce the demand for borrowing from customers and firms. If they borrow less money, they will have less money to spend and the aggregate demand will fall or rise more slowly. Moreover, individuals will be encouraged to save more due to high interest rates.

Higher interest rate will also raise the value of the country's exchange rate as more international investors will be interested in investing their money in the country, to get better interest rates.

Scenario one: Reducing the interest rates

Reducing the interest rates will encourage people and firms to spend more money. As loans become cheaper, more people will be interested in taking loans and purchasing houses and cars. Even firms will be encouraged to expand as the cost of capital is cheap, they will find it easier to raise funds. This will fuel the aggregate demand in the economy.

5.12 How the supply of money affects the economy

How the supply of money affects the economy?

If the Government reduces the supply of money, banks and money lenders will find they have less money to lend to people and firms. This shortage of the supply of money will lead them to charge higher interest rate. Moreover, in order to obtain more money they will increase the interest rates to attract savers to put money in deposit accounts. All these actions will lead to lowering the aggregate demand and the prices will come down.

On the other hand, if the Government increases the supply of money to banks, they will lower the interest rates in order to encourage people and firms to borrow more. More individuals and firms will borrow thus boosting the aggregate demand and the output of the economy. But if the increase in supply is not calculated properly it can result in inflation.

5.13 How government controls the money supply

Money supply includes all the notes and coins in circulation with the public plus the money with banks. It also includes the deposits in banks and building societies. The later is more significant supply of money and is usually the target of Governments monetary policy. The ways through which Government controls the money supply are:

Open market operations

Government usually sells treasury bills and bonds to raise money. Private individuals invest in these bonds and bills in order to get a healthy rate of interest. This reduces the deposits with banks and the money supply.

Variation of legal reserve requirements

Usually, the commercial banks have to maintain a certain percentage of their assets as deposit with the Central Bank. When the Central Bank wants to reduce money supply it will increase the limit of the deposit kept by the banks. The commercial banks are left with less money to lend to their customers.

5.14 Supply side policies

Most supply side policies aim to enable the free market to work more efficiently and attempt to promote employment, low inflation and economic growth. The main idea behind Supply side policies is to reduce Government interference.

Supply side policies include

Privatisation

Privatisation is the selling of state owned businesses to private individuals and groups. This increases the efficiency of these organisations as they face more competition. Profit motive increases the incentive to utilise the resources in the best possible way.

Deregulation

Deregulation involves reducing barriers to entry in order to make the market more competitive. It does away with unnecessary rules and regulations on business which results in reduced cost, increased output and lower prices. Moreover, it increases the competition in the economy, leading to higher efficiency for businesses.

Increased education and training

Improving the level of education, training and skills of the workforce will raise the labour productivity and increase the aggregate supply. Governments usually give a lot of importance to education and encourage more and more people to attend universities and colleges and enhance the skills of the workforce.

Labour Markets reforms

By controlling the actions of the trade unions the Government can ensure that there is least disruption in the business activities.

6. Economic indicators:

Learning outcomes

At the end of this Unit students will be able to

With regards to prices

- describe how the retail price index is calculated;

- discuss the causes and consequences of inflation.

With regards to employment

- describe the changing patterns and levels of employment;
- discuss the causes and consequences of unemployment.

With regards to output

- define Gross Domestic Product (GDP);
- describe simple measures and indicators of comparative living standards, such as GDP per head, Human Development Index (HDI).

6.1 Inflation:

Measuring Inflation

<u>The Retail price Index (RPI)</u>

- This is a price index that shows the general change in prices over time as a %.
- A hypothetical basket of goods and services which represents a normal households spending.
- The items are 'weighted' to reflect the % of income spent on them.
- Each month the prices of the goods & household spending patterns are monitored and the RPI is calculated.
- The index has a 'base year' and the % change is measured from this.

Causes of Inflation

<u>Cost-Push Inflation</u>

- Increases in wages & raw material costs push production costs up and result in higher prices.

- If increases in wages are matched by an increase in worker productivity then unit costs should not rise.
- A 'wage spiral' may occur when workers demand higher wages leading to higher prices & so workers then demand higher wages again & so on.

Demand-Pull Inflation

- Excess demand (an increase in demand without an equal increase in supply) pulls prices higher.
- Usually output can be increased to match demand but if there is full employment then extra workers cannot be employed to increase output. It could also be a shortage of a raw material that limits supply.

Monetary

- Increases in the money supply that are greater than increases in output (more money chasing same output).
- Can be classed as demand-pull inflation.

Effects of Inflation

- The value of money falls (each $ buys less). Hyperinflation may lead to loss in confidence of the currency.
- Redistribution of income:
    - savers lose out as their savings lose 'real' value & borrowers gain as they repay less in 'real terms' than they borrowed.
    - People on fixed incomes (pensioners, students) see their real income fall unless it is 'index-linked' (linked to the changes in the rate of inflation).
- Increased costs for firms: changing prices, labels, working out future costs.

- Balance of Payments: increased prices make a country's exports less desirable & imports seem comparatively cheaper. This can lead to further issues such as unemployment.

6.2 Unemployment:

Measuring Unemployment

Measured as the % of the labour force who are willing & able to work and looking for a job.

Methods for measuring unemployment vary & generally the official rate is lower than the actual number of people looking for work.

Types of Unemployment

- **Frictional unemployment**: people between jobs - tends to be short term.
- **Structural unemployment**: industrial change over the long term can leave sectors of the labour force with skills that the economy no longer demands.
- **Seasonal unemployment**: labour only demanded at certain times of the year (fruit pickers/ tour guides).
- **Cyclical unemployment**: high unemployment in times of recession.
- **Immobility of labour**: workers are generally fairly immobile (home, family) & only seek work in their region.
- **Technology**: increases in technology have replaced some jobs and reduced number of workers in others.
- **Minimum wage**: increased labour costs may force employers to hire less workers.

Effects of Unemployment

- Increases in unemployment lead to higher costs for the Government (support & benefits) & at the same time less income for the Government (income tax). This could mean higher taxes for the working population or reduced spending on schools/hospitals/emergency services etc.

- Increased unemployment means less output & so less goods and services for people to share.
- Increased costs to society through higher crime rates, higher health bills (alcoholism/depression), increased rates of divorce.

6.3 Economic Growth:

Measuring Output

Gross Domestic Product (GDP)

Definition: The total value of the goods and services produced in an economy over a given time period.

This is the standard measurement but there are several variations that are used to provide a clearer picture of what is happening in the economy.

- **Nominal GDP**: GDP valued using the current prices (no inflation consideration).
- **Real GDP**: GDP that has had the effect of inflation removed.
- **Real GDP per capita**: average Real GDP per person in the country. This allows any changes in the population size to be reflected.

Measuring Quality of Life

Human Development Index (HDI)

This is an index that takes into account 3 factors (each is an index itself):

- Life expectancy index
- Education index
- Income index

It generates a score between 0 and 1. The closer to 1 the higher the quality of life.

It is considered a better measure of overall development then GNI or GDP because it takes into account social factors aswell as purely economic ones.

7. Developed and developing economies

Learning outcomes

At the end of this Unit students will be able to

- describe why some countries are classified as developed and others are not;
- recognise and discuss policies to alleviate poverty;
- describe the factors that affect population growth (birth rate, death rate, fertility rate, net migration) and discuss reasons for the different rates of growth in different countries;
- analyse the problems and consequences of these population changes for countries at different stages of development;
- describe the effects of changing size and structure of population on an economy;
- discuss differences in living standards within countries and between countries, both developed and developing.

7.1 Difference between developed and developing economy

Difference between developed economy and less developed economy

Developed economy	Less developed economy

Population	low birth rate higher life expectancy low death rate due to better medical facilities aging population	Developing countries have higher rate of natural increase. Death rates have fallen faster than birth rates; birth rates are significantly higher than in developed countries, whereas death rates are only somewhat higher than in developed countries. Tradition, lack of contraception, poverty and lack of education are the main causes of high population growth rate.
Education	High level of literary, Highly trained workforce. Workers are paid high rates of wages.	Low level of literacy with low skill levels of the workforce results in low wages of the workforce. Government is the main provider of education services and have low percentage of public expenditure allocated for education.
Economic structure	These economies usually have a larger tertiary sector and most of the workforce is engaged in service industries. The country produces and exports high technology products or high value added goods.	Primary sector is the major contributor to the GDP of the country. Low GDP per capita is there. Usually exports agricultural goods or natural resources and imports value added goods from developed countries.

7.2 Characteristics of a less developed economy

What are developing countries?

The development of a country is measured with statistical indexes such as income per capita (per person) (GDP), life expectancy, the rate of literacy. Countries are categorised as less developed because of their poverty and low average incomes, their lack of good human resources and their low level of economic diversification.

HOT QUESTION: Explain what is likely to be the occupational distribution of the population in a less developed country?
SUGGESTED ANSWER: Most of the workforce is engaged in agriculture and other primary industries, with some in manufacturing and some in service industries. Many of these jobs will be poorly paid.

Developing countries are in general countries which have not achieved a significant degree of industrialization relative to their populations, and which have, in most cases a medium to low standard of living. There is a strong correlation between low income and high population growth. Other terms sometimes used are less developed countries (LDCs), least economically developed countries (LEDCs)

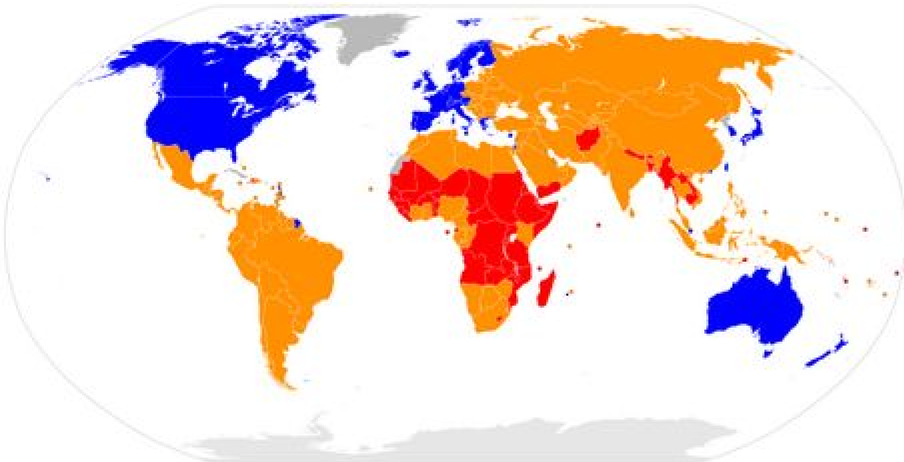
Characteristics of a less developed economy

These economies are marked by a

- high birth rate,
- relatively high death rate and
- a low life expectancy
- high population growth
- High dependency ratio
- Low GDP per capita.
- Lower proportion of population is enrolled in education
- Low level of living standard
- Poor health due to poor nutrition, lack of access to facilities such as clean water and proper sanitation.
- Health care provisions are of often poor.

Structure of the Economy

These economies are more reliant on primary sector.
They export certain primary commodities, agricultural goods and low technology products.



Advanced economies

Emerging and developing economies (not least developed)

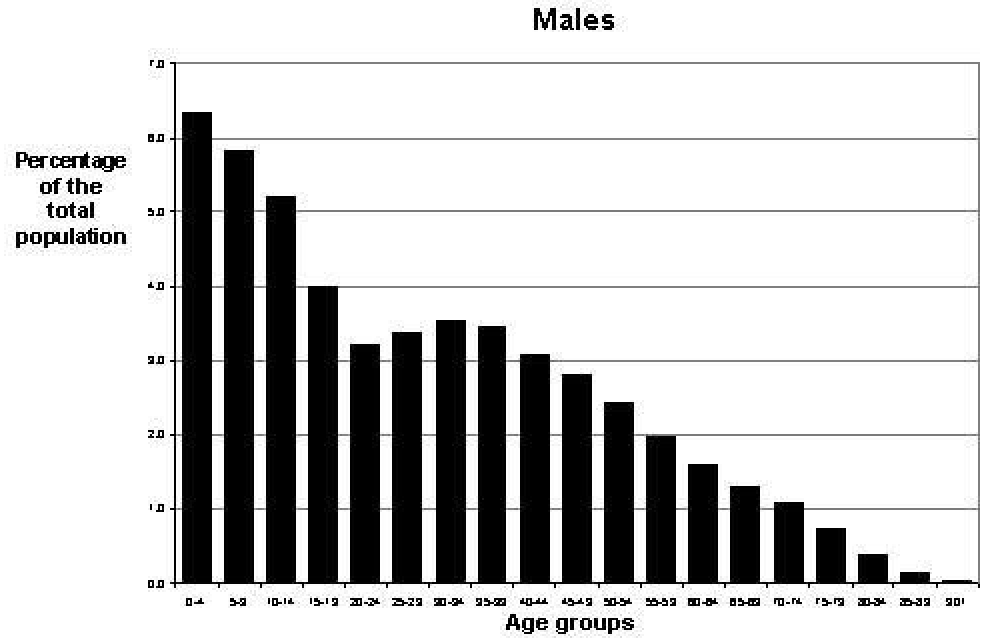
Emerging and developing economies (least developed)

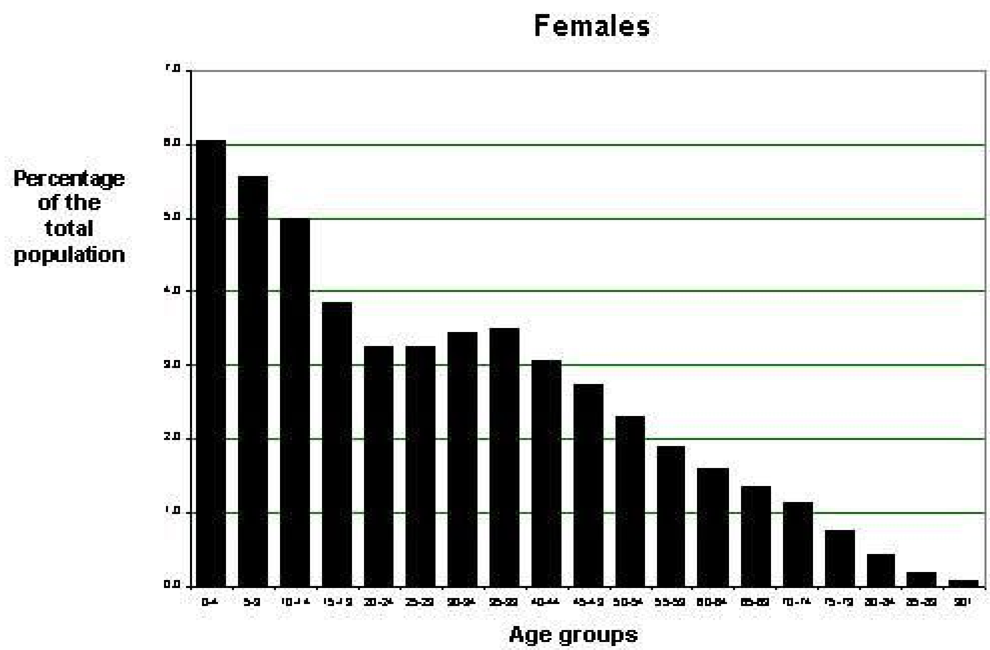
7.3 Example of Population Pyramid

The Population Pyramid—what it is and how it works

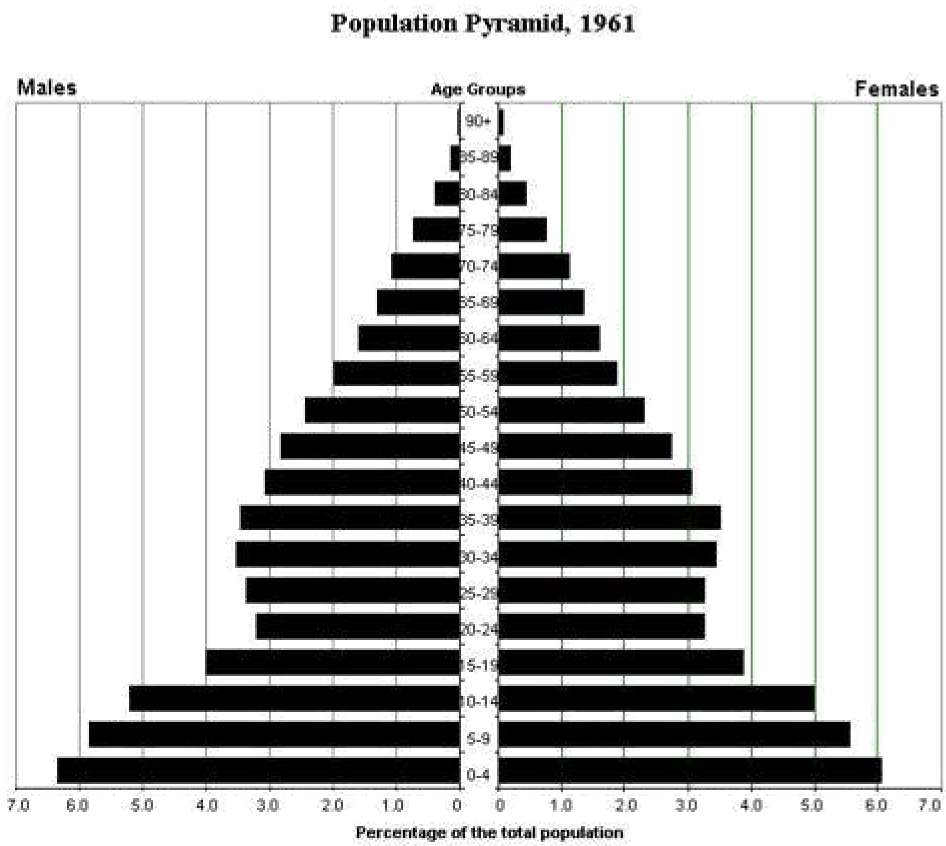
Bar graphs are a handy way to illustrate numbers. For example, if we were to graph the number of males and females in Canada for various age groups according to the 1961 Census, the result would be the illustrations below.

(Click on image to enlarge)





If we were to display these graphs horizontally, make a mirror image of the one for women, and then join them together, we would have a **population pyramid**—exactly as seen below.



This population pyramid shows at a glance the distribution of the Canadian population in 1961.

You can see that the pyramid narrows toward the top. This is because the death rate is higher among older people than among younger people.

There are also a few bulges and narrower parts in the middle part of the pyramid. For example, there are not as many people in their 20s as in their 30s in Canada in 1961. The people in their 20s in 1961 were born during the Depression, a time of economic hardship in Canada when people were having fewer children.

In 1961, the pyramid had a wide base. In fact, when we add the percentages for the three lowest age groups, we find that 35% of the population was under 15. These are the "baby boomers," a large group of people born between 1947 and 1966 when the economy was growing and prospering.

By analysing population pyramids and identifying trends, we can learn a lot about our society. These statistics give governments and others one of the tools they need to make informed decisions that will affect our lives today and in the future.

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What is a developed economy?

Countries with economies in which the tertiary and quaternary sectors of industry dominate are known as developed economies. This level of economic development is usually determined on the following factors:

High income per capita

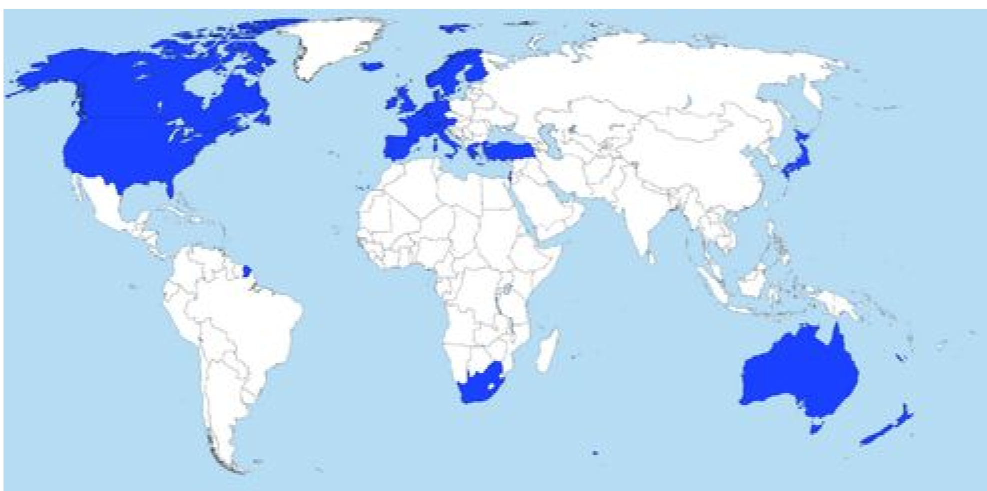
"**High income economies**" are defined by the World Bank as countries with a Gross National Income per capita of $11,456 or more. According to the United Nations definition some high income countries may also be developing countries. Thus, a high income country may be classified as either **developed** or **developing**.

High Human Development Index (HDI)

The **Human Development Index** (**HDI**) is an index combining normalized measures of life expectancy, literacy, educational attainment, and GDP per capita for countries worldwide. The basic use of HDI is to rank countries by level of "human development", which usually also implies to determine whether a country is a developed, developing, or underdeveloped country.

High gross domestic product (GDP) per capita

Traditionally, Canada and the United States in North America, Japan in Asia, Australia and New Zealand and most countries in Northern Europe and Western Europe have been considered "developed countries". These economies generally have a per capita GDP in excess of $10,000.



Map of Developed Countries according to the CIA World Factbook 2008

7.4 Population Pyramid

What is a Population pyramid?

A **population pyramid**, also called **age-sex pyramid** and **age structure diagram**, is a graphical illustration that shows the distribution of various age groups in a population (typically that of a country or region of the world), which normally forms the shape of a pyramid.

It typically consists of two back-to-back bar graphs, with the population plotted on the X-axis and age on the Y-axis, one showing the number of males and one showing females in a particular population in five-year age groups (also called cohorts). Males are conventionally shown on the left and females on the right, and they may be measured by raw number or as a percentage of the total population.

Young population

Generally a population pyramid that displays a population percentage of ages 1–14 over 30% and ages 75 and above under 6% is considered a "young population".

This pattern generally occurs in developing countries, with a high agricultural workforce.

Ageing population

A population pyramid that displays a population percentage of ages 1–14 under 30% and ages 75 and above over 6% is considered an "aging population".
Usually found in developed countries with adequate health services, e.g. Australia).

A country that displays all or none of these characteristics is considered neither.

Uses of Population pyramid

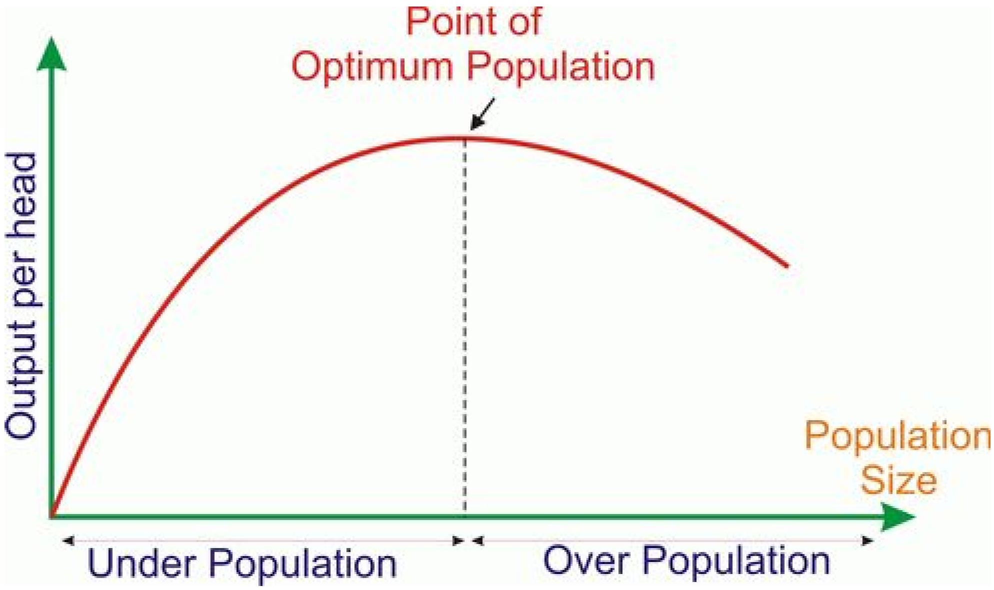
- Population pyramids can be used to find the number of economic 'dependents' being supported in a particular population.
- Population pyramids can be used to observe the natural increase, birth, and death rate.

7.5 Optimum Population

Optimum Population

It is the number of people that will produce the highest per capita economic return given the resources available, and their full utilization. Should the population rise or fall from the optimum the output per capita, and standard of living, will fall.

A country is said to be under populated if it has insufficient people to make full use of the resources available. On the other hand a country is overpopulated if there are too many people and few resources. There will be diminishing returns.



7.6 Factors affecting population | Birth rate, death rate, net migration

Factors affecting the population

The Birth Rate

It is the average number of the children born in a country compared to the rest of the population. In other words, it is the number of births for every 1000 people in the country.

$$\text{Birth rate} = \frac{\text{Number of live births}}{\text{Total population}} \times 1000$$

Factors affecting the birth rate in a country

- Existing age-sex structure
- Availability of family planning services
- Social and religious beliefs - especially in relation to contraception and abortion
- Female employment
- Economic prosperity (although in theory when the economy is doing well families can afford to have more children in practice the higher the economic prosperity the lower the birth rate).
- Poverty levels – children can be seen as an economic resource in developing countries as they can earn money
- Infant Mortality Rate – a family may have more children if a country's IMR is high as it is likely some of those children will die.
- Conflicts
- Typical age of marriage

The Death Rate

The number of people who die each year compared to every 1000 people in the population is known as death rate.

$$\text{Death rate} = \frac{\text{number of deaths}}{\text{Total population}} \times 1000$$

Factors affecting Death rate in a country

- Medical facilities and health care
- Nutrition levels
- Living standard
- Access to clean drinking water
- Hygiene levels
- Levels of infectious diseases
- Social factors such as conflicts and levels of violent crime

Net Migration

Emigration is when a person moves out of the country.
Immigration is when a person moves into a country.
Net Migration is the difference between emigration and immigration.

If net immigration is positive it will lead to a population increase, a negative net immigration will lead to a fall in population of the country.

Dependency Ratios

It is the number of people in work with the total population of the country.

$$\text{Dependency ratio} = \frac{\text{Total Population}}{\text{Number of people in work}}$$

Dependent Population usually consists of children, students, housewives, the unemployed and old age pensioners.

Affects of increase in dependent population

Lower standard of living

An increase in the dependent population will mean that people in work have more people to support and thus the living standard of the country will fall.

Balance of trade

If the people in work cannot produce enough goods and services to satisfy the need of the growing dependent population then the country has to spend its income on importing these goods and services, which will lead to an unfavourable balance of trade.

Changes in Population pattern as a country becomes more developed

As an economy becomes more developed the following characterisitics might be noticed in its population stucture.

Change in Occupational structure

- primary sector will continue to fall
- secondary sector will first rise, and then fall
- tertiary sector will continue to rise.

Age structure

- average age of the population will rise
- there will be an ageing population
- Birth rate and Death rate will fall

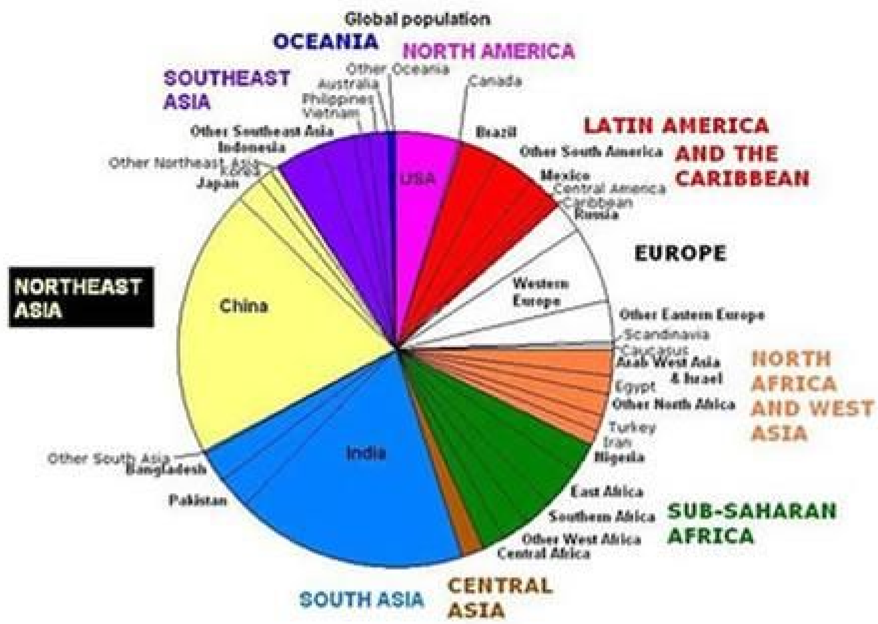
Geographical structure

- there will be a movement out of the rural areas and into the urban areas.

7.7 Introduction to population

Changes in world Population

The **world population** is the total number of living humans on Earth at a given time. As of July 2008, the world's population is estimated to be just over **6.684 billion**. In line with population projections, this figure continues to grow at rates that were unprecedented before the 20th century, although the rate of increase has almost halved since its peak of 2.2 percent per year, which was reached in 1963. The world's population, on its current growth trajectory, is expected to reach nearly 9 billion by the year 2042.



Further Research

- World Population Prospects
- Year-by-Year World Population Estimates: 10,000 B.C. to 2007 A.D.
- World Population
- The Population Project
- Optimum Population Trust
- State of World Population 2007 report

7.8 Barriers to growth

Barriers to growth of less developed economies

Rapid population growth neutralises growth in GDP. The ultimate effect is that GDP per capita remains the same or comes down.

Human resources: Lack of training and high level skills makes the workforce less productive.
Lack of natural resources: If the country is lacking in natural resources, growth can be difficult. Moreover, if the country has good natural resources, but they are not managed properly then there will be less development.

Inefficient use of resources: If there is no optimum utilisation of workforce, or if the firms are inefficient due to lack of competition.
Too much dependence on agricultural products: Developed countries which import these products from less developed countries usually pay very low prices for it. Moreover, they further process these products and sell it for higher prices to LDCs.
Poor infrastructure: Lack of infrastructure such as poor transport and communication is another reason which hinders growth for LDCs.

8. International aspects

Learning outcomes

At the end of this unit students will be able to

- describe the benefits and disadvantages of specialisation at regional and national levels;
- describe the structure of the current account of the balance of payments;
- define exchange rates;
- discuss the causes and consequences of exchange rate fluctuations;
- describe methods of protection;
- discuss the merits of free trade and protection

8.1 Exchange rate | revaluation, devaluation, appreciation, depreciation

Exchange Rate

Exchange rate is the rate at which one country's currency can be exchanged for another country's currency.

How is exchange rate determined?

Fixed Exchange Rate

A fixed exchange rate system refers to the case where the exchange rate is set and maintained at same level by the government irrespective of the market forces.

Floating Exchange Rate

Floating exchange rate system means that the exchange rate is allowed to fluctuate according to the market forces without the intervention of the Central bank or the government.

Appreciation and Depreciation

The exchange rate for any currency usually fluctuates. When the value of the currency goes up as compared to other currency it is known as **appreciation**. When the value of currency falls as compared to other currency it is known as**depreciation**.

Usually the exchange rates are determined by the demand and supply of that currency in the international market.

Demand for any country's currency on the foreign exchange market is determined by demand for that country's exports of goods and services and by changes in foreign investment in that country. This is because when foreigners buy another country's exports of goods or services they must pay for these in the currency of the exporting country.

In the same way Supply of any country's currency on the foreign exchange market is determined by that country's imports of goods and services and by its investment in other countries.
Thus when the demand for a currency rises its price goes up and it becomes costlier.

Revaluation and Devaluation

It refers to official changes in the price of a currency in a fixed exchange rate system.

Devaluation is when the price of the currency is officially decreased in a fixed exchange rate system.
Revaluation is the official increase in the price of the currency within a fixed exchange rate system.

What causes the fluctuation in currency value?

Changes in the imports and exports of the country

An increase in exports of a country will lead to an increase in demand for the currency and thus the value rises.

Changes in Interest rate

Higher interest rate will attract more foreign investors to invest in the country and thus the demand for currency will rise, resulting in appreciation in value of the currency.

Changes in Inflation rate

Higher inflation rate will make the country uncompetitive in the international market. The exports will fall resulting in decreased demand for the currency and hence lower value.

8.2 Balance of Payment | Current, Capital and financial account

Balance of Payments

It shows all the payments and receipts between one country and all the other countries it trades with. Balance of Payment is classified into three categories. These are:

The current account

It includes

- All the visible and invisible trade of the country
- Wages received by countries citizens working outside in other countries or paid to foreign workers working in the country.
- Interest payments, profits and dividends on shares
- Taxes received and paid by the government from foreign sources.

The Capital account

It includes flow of money in and out of the country because of:

- Change of ownership of fixed assets
- Sale of fixed assets

The financial account

It records the flow of money in and out of a country because of:

- Investment in capital, shares and loans.
- Direct inward investment.
- Portfolio investments

Balance of Payment can be favourable or unfavourable (deficit).

8.3 Exports and Imports | Visible trade and invisible trade

Exports & Imports

Exports are the movement of goods or commodities out of the country.
Imports are the movement of goods or commodities into the country.

Visible Trade

Visible trade involves trading of goods which can be touched and weighed. Examples include trade in goods such as Oil, machinery, food, clothes etc.
Visible Trade consists of

- **Visible exports:** Selling of tangible goods which can be touched and weighed to other countries.
- **Visible imports:** Buying of tangible goods which can be touched and weighed from other countries.

Balance of trade

It is the difference between the value of visible exports and value of visible imports of a country.
If the value of visible exports is more than visible imports the country will have a Surplus balance of trade.
If the value of visible imports is more than visible exports the country will have an Unfavourable balance of trade.

Invisible trade

Invisible trade involves the import and export of services rather than goods. Example include services such as insurance, banking, tourism, education.

If a UK student comes to Singapore to study, it would be invisible export for Singapore as it is earning foreign exchange by providing educational services.
If a Singapore citizen travels to UK for a holiday. It will be invisible import for Singapore and invisible export for UK.

Balance of invisible trade

It is the difference between the value of invisible exports and value of invisible imports of a country.

8.4 Comparative advantage | Theory and example

The theory of comparative advantage states that a country should specialise in the production of good or service in which it has lower opportunity cost and it should import commodities which have a higher opportunity cost of production.

Example

Suppose for example we have two countries *of equal size*, **Northland** and **Southland**. Both produce and consume two goods, **Food** and **Clothes**. The productive capacities and efficiencies of the countries are such that if both countries devoted all their resources to Food production, output would be as follows:

- Northland: 100 tonnes
- Southland: 200 tonnes

If all the resources of the countries were allocated to the production of clothes, output would be:

- Northland: 100 tonnes
- Southland: 100 tonnes

Assuming each has *constant opportunity costs of production* between the two products and both economies have full employment *at all times*. All factors of production *are mobile within the countries* between clothing and food industries, but are *immobile between the countries*. *The price mechanism must be working to provide perfect competition*.
Southland has an absolute advantage over Northland in the production of Food. Both countries are equally efficient in the production of clothes. There seems to be no mutual benefit in trade between the economies. The **opportunity costs** shows otherwise. Northland's opportunity cost of producing one tonne of Food is one tonne of Clothes and vice versa. Southland's opportunity cost of one tonne of Food is 0.5 tonne of Clothes. The opportunity cost of one tonne of Clothes is 2 tonnes of Food. Southland has a comparative advantage in food production, because of its lower opportunity cost of production with respect to Northland. Northland has a comparative advantage over Southland in the production of clothes, the opportunity cost of which is higher in Southland with respect to Food than in Northland.
To show these different opportunity costs lead to mutual benefit if the countries specialize production and trade, consider the countries produce and consume only domestically. The volumes are:

	Food	Clothes

Northland	50	50
Southland	100	50
World total	150	100

Production and consumption before trade

This example includes no formulation of the preferences of consumers in the two economies which would allow the determination of the international exchange rate of Clothes and Food. Given the production capabilities of each country, in order for trade to be worthwhile Northland requires a price of at least one tonne of Food in exchange for one tonne of Clothes; and Southland requires at least one tonne of Clothes for two tonnes of Food. The exchange price will be somewhere between the two. The remainder of the example works with an international trading price of one tonne of Food for 2/3 tonne of Clothes.
If both specialize in the goods in which they have comparative advantage, their outputs will be:

	Food	Clothes
Northland	0	100
Southland	200	0
World total	200	100

Production after trade

World production of food increased. Clothing production remained the same. Using the exchange rate of one tonne of Food for 2/3 tonne of Clothes, Northland and Southland are able to trade to yield the following level of consumption:

	Food	Clothes
Northland	75	50
Southland	125	50
World total	200	100

Consumption after trade
Northland traded 50 tonnes of Clothing for 75 tonnes of Food. Both benefited, and now consume at points outside their production possibility frontiers.
Assumptions in Example 2

- **Two countries, two goods** - the theory is no different for larger numbers of countries and goods, but the principles are clearer and the argument easier to follow in this simpler case.
- **Equal size economies** - again, this is a simplification to produce a clearer example.

- **Full employment** - if one or other of the economies has less than full employment of factors of production, then this excess capacity must usually be used up before the comparative advantage reasoning can be applied.
- **Constant opportunity costs** - a more realistic treatment of opportunity costs the reasoning is broadly the same, but specialization of production can only be taken to the point at which the opportunity costs in the two countries become equal. This does not invalidate the principles of comparative advantage, but it does limit the magnitude of the benefit.
- **Perfect mobility of factors of production within countries** - this is necessary to allow production to be switched*without cost*. In real economies this cost will be incurred: capital will be tied up in plant (sewing machines are not sowing machines) and labour will need to be retrained and relocated. This is why it is sometimes argued that 'nascent industries' should be protected from fully liberalised international trade during the period in which a high cost of entry into the market (capital equipment, training) is being paid for.
- **Immobility of factors of production between countries** - why are there different rates of productivity? The modern version of comparative advantage (developed in the early twentieth century by the Swedish economists Eli Heckscher and Bertil Ohlin) attributes these differences to differences in nations' factor endowments. A nation will have comparative advantage in producing the good that uses intensively the factor it produces abundantly. For example: suppose the US has a relative abundance of capital and India has a relative abundance of labor. Suppose further that cars are capital intensive to produce, while cloth is labor intensive. Then the US will have a comparative advantage in making cars, and India will have a comparative advantage in making cloth. If there is international factor mobility this can change nations' relative factor abundance. The principle of comparative advantage still applies, but who has the advantage in what can change.
- **Negligible Transport Cost** - Cost is not a cause of concern when countries decided to trade. It is ignored and not factored in.
- **Assume that half the resources are used to produce each good in each country.** This takes place before specialization
- **Perfect competition** - this is a standard assumption that allows perfectly efficient allocation of productive resources in an idealized free market.

8.5 Absolute advantage | definition and Examples

A country has an **absolute advantage** over another in producing a good, if it can produce that good using fewer resources than another country.

For example if one unit of labor in Australia can produce 80 units of wool or 20 units of wine; while in France one unit of labor makes 50 units of wool or 75 units of wine, then Australia has an absolute advantage in producing wool and France has an absolute advantage in producing wine.

Australia can get more wine with its labor by specializing in wool and trading the wool for French wine, while France can benefit by trading wine for wool.

Example

Example 1

Country A can produce one widget using one unit of labour.
Country B can produce one widget using two units of labour.
Country A has an absolute advantage over Country B in producing widgets.

Example 2

Country A has 100 units of labor. It uses 20 to produce 80 units of Parachutes, and 80 to produce 20 units of Barbie dolls.
Country B has 100 units of labor. It uses 40 to produce 100 units of Barbie dolls, and 60 to produce 20 units of Parachutes.
If the countries maximized their potential, Country A could produce 400 units of Parachutes, and country B could produce 250 units of Barbie dolls. Through trade, the two countries would achieve a more efficient allocation of resources and increase their prosperity.

8.6 Free trade | Benefits of free trade

What is Free Trade?

Free trade is a system of trade policy that allows traders to trade across national boundaries without interference from the respective governments.

Reasons for Free Trade

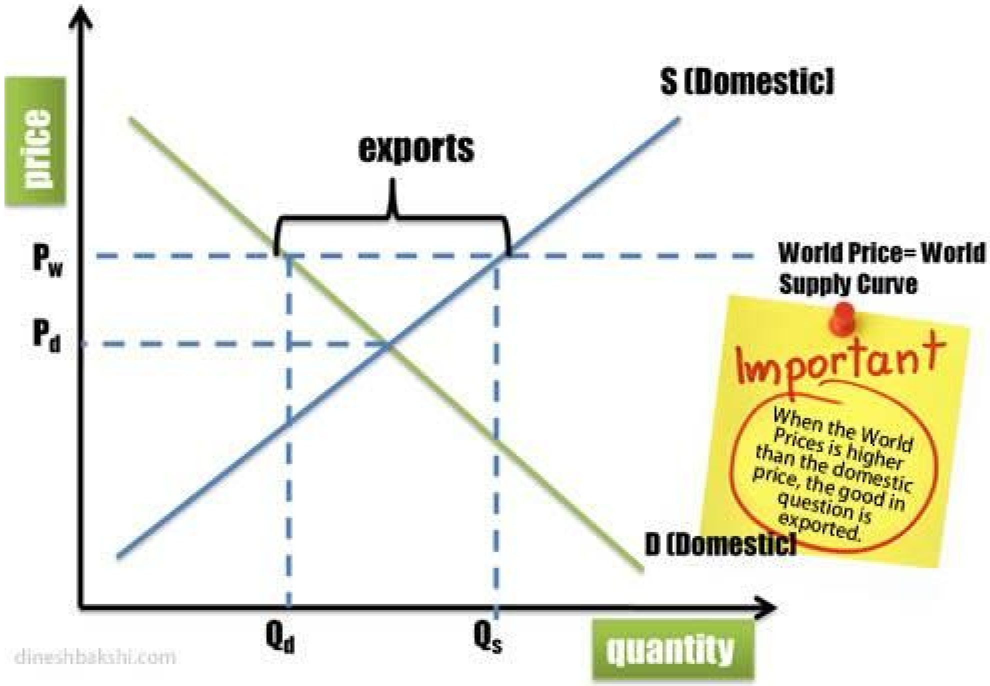
Domestic Non-availability: A nation trades because it lacks the raw materials, climate, specialist labour, capital or technology needed to manufacture a particular good. Trade allows a greater variety of goods and services.

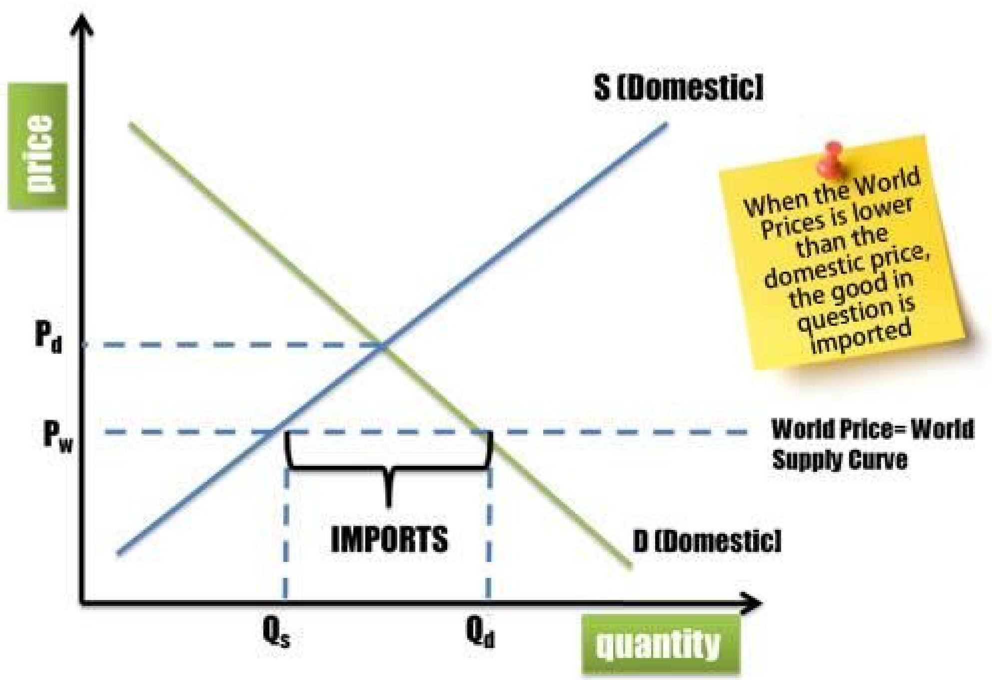
Cost effectiveness: It is cheaper to buy from other countries rather than producing themselves.

Benefits of Trade

Lower prices for consumers: When there is free trade, consumers can free to buy goods from the producer who is willing to sell at the lowest prices. Hence consumers gain from lower prices.
Greater choice for consumers: With free trade, consumers have access to variety of goods and services from different producers across the globe. This means more choice.
Ability of producers to **benefit from economies of scale:** Producers have access to a larger market thus they can produce more at lower cost and benefit from economies of scale.
Ability to **acquire needed resources:** Through free trade producers can not only sell in a large market but also gain from purchasing from suppliers across the world.
More **efficient allocation of resources:** When there is free trade, the most efficient producers get the opportunity to produce due to their cost efficiency. This leads to productive efficiency.
Increased competition: In free trade producers from different regions can compete with each other in terms of price, quality and variety. Increased competition leads to efficient allocation of resources.
Source of foreign exchange: Free trade involves the transaction of goods and services between nations. In order to purchase goods from abroad (imports), we need foreign currency. This is possible through exporting of goods to other countries.

Free Trade diagrams





8.7 Protectionism | Meaning and Methods

Protectionism

Policy of protecting domestic industries against foreign competition by means of tariffs, subsidies, import quotas, or other handicaps placed on imports. The chief protectionist measures, government-levied tariffs, raise the price of imported articles, making them less attractive to consumers than cheaper domestic products. Import quotas, which limit the quantities of goods that can be imported, are another protectionist device.

Methods of Protectionism

Tariffs

A tariff is a tax on foreign goods upon importation. Tariff rates vary according to the type of goods imported. Import tariffs will increase the cost to importers, and increase the price of imported goods in the local markets, thus lowering the quantity of goods imported.

Quotas

An **import quota** is a type of protectionist that sets a physical limit on the quantity of a good that can be imported into a country in a given period of time. This leads to a reduction in the quantity imported and therefore increases the market price of imported goods. Quotas, like other trade restrictions, are used to benefit the producers of a good in a domestic economy at the expense of all consumers of the good in that economy.

Administrative Barriers

Countries are sometimes accused of using their various administrative rules (eg. regarding food safety, environmental standards, electrical safety, etc.) as a way to introduce barriers to imports.

Embargo

An **embargo** is the prohibition of commerce and trade with a certain country, in order to isolate it and to put its government into a difficult internal situation, given that the effects of the embargo are often able to make its economy suffer from the initiative.

Subsidies

Government subsidies (in the form of lump-sum payments or cheap loans) are sometimes given to local firms that cannot compete well against foreign imports. These subsidies are purported to "protect" local jobs, and to help local firms adjust to the world markets.

Anti-dumping legislation

Supporters of anti-dumping laws argue that they prevent "dumping" of cheaper foreign goods that would cause local firms to close down. However, in practice, anti-dumping laws are usually used to impose trade tariffs on foreign exporters.