Sample essay questions

1. *Critically discuss the institutions that constitute capitalism.*

    - Private property is an ability to privately own property.
    - A market is an institution which allows people to voluntarily exchange products and services for their mutual benefit. It leads to competition if the following conditions are met: there are no hidden information, externalities and increasing returns to scale.
    - Capitalism has no inherent mechanism for dealing with market failure. Firms are organisations that use inputs, produce outputs, and sets prices to maximise their gains.
    - Firms require markets and ownership of private property.
    - Problems with capitalism
        - Capitalism does not deal with ownership of the "commons" like air and knowledge. Since capitalism does not inherently have any framework for social ownership, it has a tendency of bringing the commons under private ownership with inequitable results.
        - Capitalism does not inherently have any mechanism to protect society from the deleterious effect of firms that acquires power.
        - Capitalism does not inherently require a state which can enforce property right, correct market failures and protect the society from the excess of powerful firms.

2. *Explain why investment tends to be more volatile than consumption in a developed economy.*

   - Households choose to smooth their consumption. Hence any temporary income (output) shock is smoothed out by households by borrowing and saving. It is important to remember that access to financial services is key for smoothing out consumption.
   - A firm's investment decisions depend on firms expectations about future demand. If there is a positive income shock to the economy, demand for goods increase, this leads to higher capacity utilisation by the firms and higher profits. Firms invest and hire more labour and this in turns increase the income of the workers and purchasing capacity in the economy. Thus, investment has a feedback loop that amplifies the shocks to the economy.
   - A good answer could also describe the two firm investment game. The game is a coordination game with multiple-equilibria, which implies that a shock can switch firms from low-investment to high-investment equilibrium, thus amplifying the initial shock through the circular flow model.