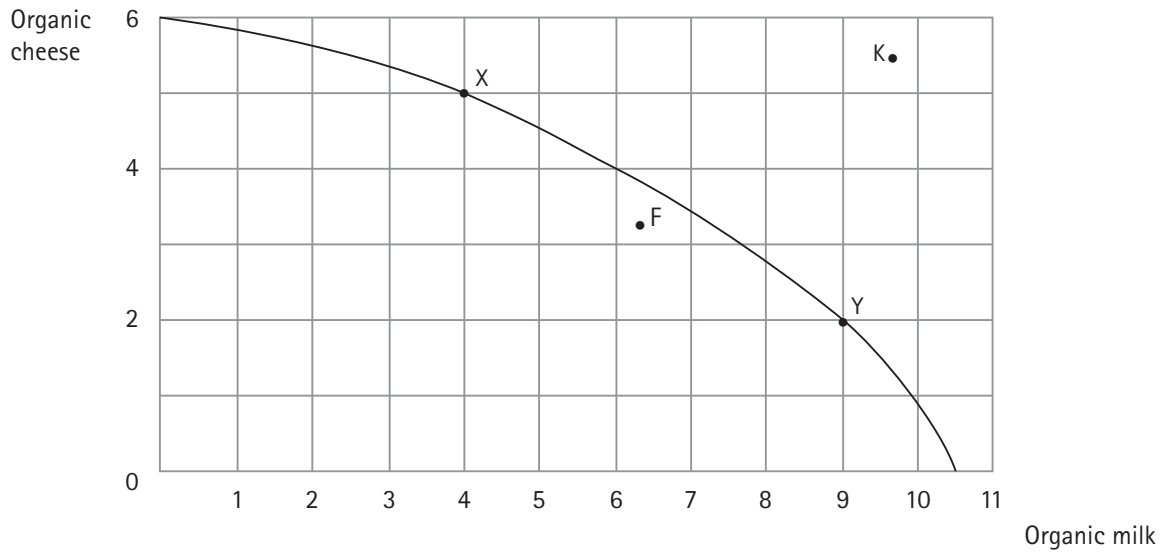




eLearneconomics: Allocative efficiency and market failure (1)

Student response _____

Use the graph to answer the questions that follow.



(a) What is the difference between production efficiency and allocative efficiency?

(b) If peoples' tastes have changed from organic milk to organic cheese. Explain how the market would move the economy from Point Y to Point X.

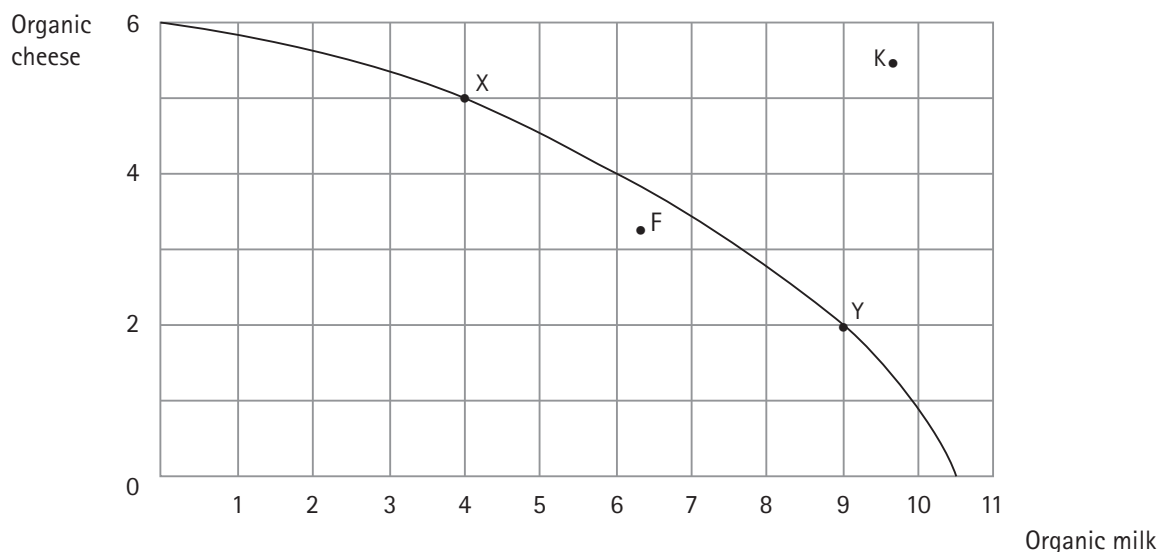
(c) Explain how the move from Point Y to Point X reflects a move from productive efficiency to allocative efficiency.

eLearneconomics: Allocative efficiency and market failure (1a)



Solution

Use the graph to answer the questions that follow.



(a) What is the difference between production efficiency and allocative efficiency?

Production efficiency is where resources are fully employed and put to their best use (goods are produced at least cost).

Allocative efficiency requires production efficiency as well as that combination of goods consumers actually want/or it is not possible to make someone better off without making someone else worse off.

(b) If peoples' tastes have changed from organic milk to organic cheese. Explain how the market would move the economy from Point Y to Point X.

How = Less demand for organic milk will lead to a fall in prices, and vice versa for organic cheese.

Explanation = these price signals will lead to producers moving resources from organic milk to organic cheese.

(c) Explain how the move from Point Y to Point X reflects a move from productive efficiency to allocative efficiency.

To remain at Point Y would mean that the economy is producing at productive efficiency, i.e., all available resources and technology are being used, and the output is being produced at the lowest possible cost for that level of output.

Moving to Point X means that allocative capacity is also being met, i.e., that productive efficiency is being met, and markets are in equilibrium, so that it is impossible to change the allocation of resources in such a way as to make someone better off without making someone else worse off, and the sum of consumer and producer surplus is maximised.