

Economics questions and answers economics essay



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The law of diminishing marginal returns states that when a firm introduces more variable inputs successively with one fixed factor of production, total returns would continuously increase, but marginal returns would diminish (Anderton, 1993). This can be explained with the help of graph given below.

It can be seen from the graph that when the firm was initially increasing the number of workers, total output was increasing at a greater rate every time; this is not because every new worker is more productive but merely because of the combined effect (Colander, 2007).

It can also be seen that total output is ultimately increasing at a decreasing rate. This basically is occurring because the proportion of inputs is continuously varying. The firm is facing scarcity of resources of capital (Lipsey, 2002). The ratio between capital and labour is continuously widening, which means that after a certain time, the capital is not enough for the increased workers, hence the returns started to diminish.

Since this situation would always be faced by every firm in the short run. That is why this fact is known as the law of variable proportions or diminishing returns.

E. g. if the firm is facing shortage of capital, then increasing the number of labourers would benefit it to the extent where by it can make 6 workers work at a machine at a time, rather than two. However when all the machines would be fully employed along with their operators, then the hiring up of new workers would only lead to increased costs, but no increased output or productivity.

In short, a firm faces diminishing returns when it increases its factor inputs with one factor fixed (i. e. the short run) and hence suffers diminishing productivities (Lipsey, 2002).

On the other hand, economies of scales are those cost saving advantages which occur when a firm increases its scale of production (Boyes, 2008). This might be inform of purchasing/bulk buying economies, technical economies, marketing, managerial, financial and risk bearing economies.

The decreasing economies of scale is the phenomenon which applies to the long run production of a firm. In fact this phenomenon even includes the theory of Diminishing Marginal Returns. It so happens that when the firm adopts an ever increasing production status (in the long run) its cost saving advantages tend to be more and more less (Lipsey, 2002). E. g. Bulk buying discounts may reach at a certain limit and then no longer discounts be offered. Similarly fixed costs might be at first spread at a higher proportion that this proportion might decline with time, since the addition of more units would tend to contribute lesser in bearing up fixed costs. The economies of scale which would have been showing increasing returns to scale would then start to show diminishing returns to scale. This is also known as Diseconomies of Scale (Anderton, 1993).

When the size of the organization becomes too big, the actual owner cannot control everything directly due to which de centralization occurs.

Organization structure widens horizontally and vertically. Chain of command becomes too long due to which communication gaps develop. The mangers are unable to coordinate across different departments. Due to these factors,

decision making is delayed. Apart from that, being away from centre, lower level managers do not remain efficient. In short due to large size of organization, it becomes difficult to manage, due to which per unit cost ultimately increases (Young, 1987).

Too many workers are appointed to handle large scale production, due to which supervision cost increases by more than proportionately. Workers are not handled properly by the management. Monetary and non monetary benefits are not in line with worker's productivity; therefore demotivation among many workers develops. These all factors contribute to an increase in total cost greater in proportion to output.

Question 2:

(a) Explain and illustrate using diagrams the difference between price and non price influences that affect the behaviour of a demand curve (3 marks);

Answer:

A demand curve shows the respective quantities of goods that consumers are willing and able to buy at different prices. The behaviour of a demand curve can be elastic, or inelastic.

Elasticity of demand is referred to as the responsiveness of demand towards a change in price. An inelastic behaviour of the demand curve would tell that consumers are irresponsive towards changes in price. Similarly an elastic behaviour of the demand curve would show that more consumers are responsive towards price changes (Anderton, 1993). It normally happens that consumers start buying more, or new consumers start buying the product, when its price falls and vice versa.

The price factor which determines the demand curve behaviour is its expensiveness or cheapness. When prices are set at higher levels, demand is said to be more elastic. The graph given below shows that at higher levels of demand curve, elasticity is said to be higher than 1. This means that an upward or downward change in price would cause the demand to decrease or increase by more than 10%. When people buy goods at high prices, and are aware of buying it expensive, then they tend to stop using the, or decrease its use considerably when the prices go further up. However, people would be highly attracted towards the product if it is high priced, and its price suddenly falls, other things constant (Lipsey, 2002)..

Demand curve would be inelastic at lower levels of price. This happens because since the price of the product would be set too low, consumers would not pay heed to any changes in price. Be it high or low. Similarly since nearly all the potential consumers would be consuming the product, there would be no intensity for increased demand. Higher prices (at low price level) would not affect the consumption too much (Lipsey, 2002).

Non price factors affecting the demand curve behaviour include the causes given below:

Direct Taxes High direct taxes mean lesser disposable incomes for consumers, and hence less willingness and ability to buy. Lower direct taxes would make consumers more responsive (Young, 1987).

Availability of Substitutes: Availability of substitutes would mean that demand would be more elastic. Consumers might switch towards other substitutes if price is increased.

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Degree of Necessity: FMCG's and daily purpose goods would face an inelastic demand curve since they are necessities and are demanded at any price level (Solomon, 2006).

Degree of Addictiveness: If goods are habit forming or addictive, than their demand would tend to be inelastic.

Proportion of Income Spent: The higher the proportion spent, the more elastic the demand (Boyes, 2008).

The Situation or location where the product is bought. E. g. a consumer won't pay 5 rupees extra for a bottle of Pepsi from a local shop. However, consumers would surely pay, and Do pay 100 rupees for the pitcher containing the same amount of Pepsi.

Elastic Demand (Non price Factor) Inelastic Demand (Non price Factor)

(b) Explain and illustrate using diagrams the difference between price and non price influences that affect the behaviour of a supply curve (3 marks);

Answer:

A supply curve shows the respective quantities of goods that producers are willing and able to buy at different prices (Parkin, 2000). The behaviour of a supply curve can be elastic, or inelastic.

Elasticity of supply is referred to as the responsiveness of supply towards a change in price. An inelastic behaviour of the supply curve would tell that producer is irresponsive towards changes in price. Similarly an elastic behaviour of the supply curve would show that the producer(s) is responsive towards price changes (Anderton, 1993). It normally happens that producer

starts supplying more goods in the market, or new producers enter the market, so its price falls and vice versa.

The price factor which determines the supply curve behaviour is its expensiveness or cheapness. When prices are set at higher levels, supply is said to be more elastic. The graph given below shows that at higher levels of supply curve, elasticity is said to be higher than 1 (Parkin, 2000). This means that an upward or downward change in price would cause the supply to decrease or increase by more than 10%. When producer sells the goods at high prices, then they tend to stop selling the product, or decrease its supply if offered a slightly lower price. However, producers would be highly attracted towards the product if it is high priced, and its price suddenly falls, other things constant (Solomon, 2006).

Supply curve would be inelastic at lower levels of price. This happens because since the price of the product would be set too low, producers would not pay heed to any changes in price be it high or low. Similarly since nearly all the potential producers would be producing the product, there would be no intensity for increased supply. Higher prices (at low price level) would not affect the production too much. Producers would only keep on producing.

Non price factors affecting the supply curve behaviour include the causes given below:

Time: Supply tends to be more elastic in the long run. Production decisions can be changed and firms or producers can react to price changes (Parkin, 2000).

Factors of Production: Supply can be elastic if FOP's are available such as trained labour, raw materials, etc.

Stock Levels: If there are high amounts of stock piled up in the warehouses, than the supply would tend to be more elastic as producers would try to get rid of old stock and accommodate newer stock (Lipse, 2002).

Number of Firms in the Industry: Supply will be more elastic if there are a lot of firms in the industry, because there will be greater chance of someone having available factors and stock. Low number of firms guarantees low inelasticity (Boyes, 2008).

Elastic Supply (Non price Factor) Inelastic Supply (Non price Factor)

(c) Explain and illustrate with diagrams how and why a marginal cost curve maps out a supply curve (4 marks).

Answer:

To maximize profit a firm would sell its output at a price where it equals to its marginal cost. I. e. the firm would keep on selling its output, until the price it starts to receive for its output equals to the cost of producing one extra unit. Hence a marginal cost curve maps out the supply curve of a firm. As long as the firm produces something, it will maximize its profits by producing " on the marginal cost curve."

Observing the graph above, we can say that if the firm sells its output at a price of P_0 , the producer would deem it profitable as long as the MC (Marginal Cost) is being covered by P (Price). In fact, MC determines how many units a firm will supply, because it is assumed when studying economic that all firms have a profit maximizing objective in general. Supply

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curves that are drawn by a common economics student are nothing more than Marginal Cost curves in cover.

Question 3:

If a government wishes to raise more sales tax revenue should they impose the tax on goods that show a higher or lower price elasticity of supply? Illustrate with diagrams and define the producer and producer incidence of this tax (10 marks).

Answer:

When an indirect tax is imposed on a good, the burden of tax is either borne by the producer or consumer. Who will bear the burden of tax actually depends on price elasticity of demand and supply.

In all the three cases, i. e. elastic, inelastic or unitary elastic, a tax of \$2 has been imposed. In the first case the supply curve is perfectly inelastic, in second case the supply is only elastic, and in the third case it is perfectly elastic.

It can be seen in the first case that when a tax of \$2 has been imposed, the price of the good has also increased by 2. It shows that all the burden of tax has been borne by the consumer only. The reason of this is that supply is perfectly elastic, and cannot be avoided. Producers are not willing to supply the product at any other price than the prevalent price.

In the 2nd case supply is inelastic, which means producer is irresponsive a change in the price, therefore any imposition of tax would cause a contraction in supply; hence, the tax burden is shared between the consumer and producers. It can be seen in the diagrams that imposition of a 2\$ tax is reflected in price only by \$1.

In the 3rd and last case, supply of the producer is perfectly inelastic which means firms would supply this product at any price. Therefore any tax imposed on the producer cannot be shifted on the consumer. Hence, after tax price is same.

It is obvious now that who will bear the tax depends on the price elasticity of supply. The more a supply curve is elastic, the more the burden on consumer and vice versa.

Question 4:

(a) Pick an industry that you believe satisfies the criteria of perfect competition and explain and illustrate with diagrams your case for picking this industry (5 marks);

Answer:

Perfect competition is a market structure where there are a large number of small firms producing a homogenous good. One such type of industry could be the farming industry. All the firms in the market (farms in this case) are so small that their output as compared to the output of the industry is so small that they are unable to cause any influences on the market supply and price, therefore all the farms are to be known as price takers. Price taker means that the price of the good is determined in the market place by the forces of demand & supply. Whatever the price is prevalent in the market, the firm would have to accept it (Boyes, 2008). There is no union of any kind representing the sellers, neither is there any government intervention. In a perfect competition firms can easily enter and exit the market. Same applies for farming, where an entrepreneur can easily set up a firm, and if deemed unprofitable, can easily leave it. This means that there are no barriers to entry and exit (Solomon, 2006). This also means that settings up costs are

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very small and there are almost no legal formalities required. This also indicates that resources are fully transformable, as is the case with farming. Land can be used for any other purpose, tractors be easily sold, and seeds cost very cheap. Knowledge about price and other market conditions on the part of consumers and firms is perfect. So is the case with farming where the consumer nearly knows everything about the agricultural product. E. g. consumers can commonly identify which types of signs are found in good fruits or vegetables. Similarly farmers do know about prevalent market rates and other conditions. Due to this, neither producer nor the consumer is able to exploit each other. All the firms in the industry are profit maximising firms, and so is the case with farmers, who tend to earn more and more from farming (Lipsey, 2002).

As we know that all the firms are price takers, an individual firm would sell its whole output at the price which is predetermined in the market. Farmers have no other choice than to sell their output at the price that is currently being quoted for their product. Demand curve faced by a firm perfect competition would be perfectly elastic.

(b) Explain and illustrate with diagrams how the profit maximising price and output is determined for (1) the individual firm within this industry and (2) this industry as a whole. (5 marks)

Answer:

The demand curve faced by the firm in this industry is perfectly elastic. Due to this, the demand curve is also the marginal revenue curve of the firm, because every unit is being sold at the same price. Plotting the cost structure of the firm we can find out the profit maximising level of output of the farm (Boyes, 2008).

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At quantity Q in the diagram, profits of the farm are maximised. At this quantity, the farm would be enjoying abnormal profits in the short run. As there are no barriers to entry or exit, these abnormal profits would attract new firms to enter into the industry, due to which prices would fall, and soon the farm would only be making normal profit.

As the farm would only be earning normal profits, it would expect that price would increase in the long run, and the farm would be making abnormal profits. If the price further falls and there is no positive contribution towards fixed costs, the firm would shut down.

Question 5:

(a) Explain and illustrate with diagrams the characteristics of oligopoly (5 marks);

Answer:

Oligopoly is a market structure about which no simple and straightforward explanation can be given because it is very diverse in nature (Boyes, 2008). Some oligopolies would have only few large firms and the others would have large number of firms but few dominant firms. On the other hand, some oligopolies would be producing a standardised good and some a highly differentiated good. In some oligopolies the firms would be highly competing against each other and some might be quite cooperative. There would be strong barriers to entry and the firms would be price makers. Knowledge about price and other market conditions is imperfect; firms would also be involved in creating barriers towards entry of new firms. In an oligopolistic market firms attempt to merge or takeover other firms in order to further reduce the competition. The behaviour of firms in an oligopoly would be

quite rivalrous. All firms would closely watch each others activities and would thus determine their own strategy. The firms create the following artificial barriers:

(i) Advertising (ii) R & D (iii) Branding (iv) Sales promotion & distribution

The Oligopoly is characterised by price wars, furious non price competitions, predatory pricing or limit pricing (Boyes, 2008).

Above the kink, demand is relatively elastic because all other firm's prices remain unchanged. Below the link, demand is relatively inelastic because all other firms will introduce a similar price cut, eventually leading to a price war. Therefore, the best option for the oligopolistic firm is to produce at point E which is the equilibrium point and the kink point. A profit maximizing producer with some market power will set marginal costs equal to marginal revenue.

(b) Illustrate and explain how the oligopolistic firms determines their collective profit maximising price and output levels when they collude and act like a cartel (monopoly) (5 marks);

Answer:

A cartel might be joined by oligopolistic firms to increase their individual market power, and the member firms work together to determine the combined level of output to be produced by each member and the relative price to be charged. By being one, the cartel members try to act like a monopoly and succeed. For e. g. if each member firm is the producer of an undifferentiated good, such as oil, the demand curve to be faced by it would be horizontal, that is perfectly elastic. However if these firms join a cartel, they will then face a joint demand curve, which would be downward sloping, <https://assignbuster.com/economics-questions-and-answers-economics-essay/>

just like a monopolist's. Actually the profit maximizing decisions of an oligopoly (in a joint cartel) are as the same of a monopoly as shown in the figure below. The cartel member firms would decide their joint output level, where their combined marginal cost would equal combined marginal revenue. The cartel's decided price would be determined by the market demand curve at the level of output chosen by the cartel. The cartel's profit would, then be equal to the area of rectangular box, labeled "abcd" in our Figure. A cartel would, just like a monopoly, try to produce or supply less output and charge a higher price than to find it self in a competitive market. Previously due to the elastic demand curve, the firms could not have individually charged a high price by altering their respective outputs individually.

(c) Illustrate and explain with diagrams how a cheating oligopolist would choose its profit maximising output level if attempting to increase its market share at the agreed original price (5 marks);

Answer:

Cartel members will try to cheat on their agreement to limit production. By producing more output than it has been agreed to a cartel member can increase its share of the cartel's profits. Before the cartel is formed produces output earns no profit. After joining the cartel it reduces its output and changes the price to the cartel price. The firm then earns profits of abcd . If a firm were to cheat on this agreement and produce an higher output instead of the existent one, providing the other members don't cheat then it can view its supply curve as horizontal at the cartel price. It cannot affect price by changing output, therefore it can produce and sell additional

outputs without changing the price. So if a firm cheats on a cartel it gains the greater profit instead of abcd.

(d) Illustrate and explain with diagrams how a cheating oligopolist would choose its profit maximising price and output levels if it attempted to undercut the price charged by the other oligopolistic firms (5 marks).

Answer:

One more way for members to cheat on the cartel is to lower prices. An undetected price cut will boost company's sales to grab the consumers from other sellers, as well as customers who are not buying the product at all. Some of these adjustments may be non financial, including better credit terms, faster delivery, or related free services. The firm has an incentive to cheat by lowering price because the demand curve facing each firm is more elastic than the market demand curve as shown below.

Since the earlier demand curve faced by the firm in the industry as whole would have been more inelastic, the form would not have been able to attract buyers. However once the cartel has decided on a price, and then the cheater tries to sell the output with a price cut, demand for the output of that particular producer would increase considerably. The firm would maximize its profit where $MR = MC$ by expanding output and lowering its price. An industry demand curve is drawn below.

It can be seen that lowering the price by the industry as a whole would not have benefited anyone. However, if a firm cheats, then it may take the advantage of the elastic demand curve it would face and grab market share.

Question 6:

(a) Outline a micro economic reform issue that is relevant to an economy of your choice (i. e home country or Australia) and explain why this market or industry reform has been implemented? (5 marks)

Answer:

Infrastructure and related industries form an essential part of the economy and have been characterised by a long tradition of government ownership and monopoly (Colander, 2007).. The operation, access and cost of infrastructure services affect all industries and play a significant role in their competitiveness and in the productivity of the economy (Solomon, 2006). Given the importance of these industries, they have been the subject of considerable reform effort in recent years.

Jurisdictions have pursued a wide variety of approaches in reforming their infrastructure industries. However, the reforms can be grouped into five broad categories: resolving specific problems (eg: 1983 rationalisation of the Queensland Electricity Commission);

- administrative (eg: Commonwealth 1988 GBE reforms);
- pricing (eg: implementing more appropriate cost reflective pricing systems);
- increased competition (eg: improving third party access); and
- Privatisation (eg: airlines, banks and electricity assets).

(b) How successful do you think these reform measures were and say why referring to some data or research that has been performed (5 marks)

While reforms gathered some momentum over time, there was not a seamless program of implementation. The enthusiasm for reform varied among governments, over time and across jurisdictions (Solomon, 2006). Reform in some areas could only be taken so far and had to be revisited when further problems were identified, lessons were learnt, or further pressures emerged. Moreover, not all policy changes introduced could be regarded as true reform in terms of bringing improvement in living standards. For example, some policy changes had more to do with governments managing short term fiscal constraints.

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