

# Positive and negative externalities of the subway system economics essay



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(a) Negative externality. A negative externality may be defined as a cost arising from an economic activity which affects somebody other than the people engaged in the economic activity and is not fully reflected in prices.

A typical example would be of a steel mill which has been moved into a town which so far has clean air. In order to produce steel, it has paid for land, labour, capital and entrepreneurship. The price charged by the operator reflects only the costs incurred. The operator does not have to pay the cost of cleaning up the smoke given off by the mill but people in the community pay that cost in the form of dirtier clothes, dirtier cars and perhaps even more respiratory illnesses.

(b) Positive externality. Positive externalities are benefits which arise from economic activities which impact on parties that are not directly involved in the transaction. Prices do not reflect the full benefit in consumption of a product or service.

For instance, a beekeeper can collect honey from beehives, but the bees will also pollinate surrounding fields and thus aid farmers. Farmers do not pay anything to benefit from pollination.

(a) A subway system might create a negative externality in the form of noise pollution to residents. This will normally result since such areas attract commercial activity. However, if the subway system buys the property around the new stations, such negative externality will be reduced or eliminated as there will be less or no residential property and more commercial property in the area.

(b) Construction of a subway will raise the value of retail businesses located close to the subway stations as new business tend to be generated due to improved access. If the owners of property near the new stations buy shares in the subway system, negative externalities will be balanced since they will start receiving dividends as a result of such shareholding.

## Assignment Question 2

### **Our costs are very high because of the huge pensions of our retirees. Are the pensions of retired employees relevant for prospective business decisions?**

Retirees are living longer than anyone expected or accounted for. This is making liabilities look larger as companies recalculate their pension obligations. Since retirees are employees who are already retired, their pension costs are part of the organisation's sunk costs. Sunk costs are historical expenditures that are irrelevant for current or future decisions about what to exchange or produce. Pension costs are costs that have been created by a decision made in the past and that cannot be changed by any decision that will be made in the future.

Pension costs are irrelevant for decision-making since employers cannot walk away from their pension obligations.

Economists argue that pension costs should not be taken into account when making rational decisions. Organisations have pension obligations as a result of past decisions and such costs need not be considered when deciding about the organization's future strategies. However, potential investors who might be interested to acquire substantial shareholding or buy-out the

business need to consider pension obligations during a due diligence exercise in order to make an offer.

### Assignment Question 3

**Explain why the own-price elasticity is a pure number (with no units) and is negative.**

‘ The own-price elasticity of demand measures the responsiveness of the quantity demanded to changes in the price of the item’ (Png & Lehman, 2007: 53). Through this, managers can tell the extent to which buyers will respond to price decreases or increases. Own-price elasticity is calculated as follows:

percentage change in quantity demanded

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percentage change in price

Pure number

The percentage change in quantity demanded is the change in quantity demanded divided by the average quantity demanded. Such change is a pure number which does not depend on the units of measure. Therefore, if we consider matches as an example, the percentage change will be the same whether we measure quantity demanded in boxes or individual matches.

The percentage change in price is also a pure number being part of the same formula.

Negative number

Demand curves normally slope downward, which means that if the price of an item rises, the quantity demanded will fall. Thus, the own-price elasticity will be a negative number.

Some analysts report own-price elasticities without the negative sign (i. e. as an absolute value). Therefore, it is very important to keep in mind that the own-price elasticity is a negative number when this concept is being applied.

### **Assignment Question 4**

**Hospitals are the only large buyer of nursing services in many communities. These hospitals often report shortages of nurses – unfilled positions. Reconcile these two facts, using the theory of Monopsony (Note: A monopsony occurs when a market has only one buyer. A monopoly occurs when a market has only one seller.).**

The market for nurses employed by hospitals is a very typical example of a monopsony. Empirical literature however provides mixed conclusions. One strand focuses on empirical estimates of nurses labour supply elasticities facing hospitals. This research generally finds evidence of upward sloping labour supply curves and concludes that this result supports the existence of monopsony (Sullivan 1989, Staiger, Spetz, and Phibbs 1999). Another strand (eg Adamache and Sloan 1982; Hirsch and Schumacher 1995) investigates whether relative wage and/or employment outcomes vary with respect to hospital concentration, labour market size, and the like.

Hospitals have the market power to set the salaries paid to nurses in many communities. However, such hospitals are reporting shortages of nurses for various reasons. One reason is the retirement of old registered nurses who are retiring from the work force. Another reason is that thousands of well qualified nursing applicants are being turned away because nursing programs are not well funded and cannot afford the staff, laboratories, and clinical facilities required to fulfill the needs of more nursing students. It has been estimated that about two-thirds of nursing schools turned these qualified applicants away because of lack of staff and facilities to teach them.

Even though hospitals can increase the salaries being offered to fill the unfilled positions, the shortage will not be resolved. This will continue to exist unless appropriate funding will be provided to train the well qualified nursing applicants which are being turned away.

### **Assignment Question 5**

**Consider two markets, each of which is a duopoly where sellers compete on price. In one market, products are more differentiated. In that market, will prices be higher or lower?**

Duopoly may be defined as a type of market structure in which there are only two sellers/providers of a good or service.

Most firms, under duopoly, specialise their production and marketing activities in order to occupy definite segments of the market. A number of firms offer products or services to the market which are highly reliable. This

might also include valuable warranties. Some firms may decide to go for low reliability output and providing less valuable compensation terms or warranties. Firms offering a highly reliable product or service will normally charge higher prices than those offering low reliability output. A typical example is the non-luxury cars international market. Italian firms specialize in less reliable and less expensive cars with less valuable warranties when compared to Japanese firms. The latter promotes highly reliable and expensive cars with better warranty deals.

It is frequently observed that firms, under duopoly specialize their production. Some producers produce output with high reliability and include good warranty arrangements while other firms manufacture output with less reliability and less attractive warranty deals but at a lower price. This normally applies to markets for a few services, few intermediate goods and durable goods.

### **Assignment Question 6**

**Compare the following ways of paying a lawyer in terms of the incentive for effort:**

**Hourly rate in which the lawyer receives a fixed dollar amount for each hour of work on the case.**

**Contingency fee, in which the lawyer receives a proportion of the amount that the client recovers. If the client loses the legal action, the lawyer gets nothing.**

Consumers of legal services can pay their lawyer in various ways. However, it is important that before signing any agreements, consumers should

educate themselves about legal fees to keep the amount down and at the same time receive a quality service.

If a client enters into an agreement with his lawyer whereby an hourly fee will be charged for each hour spent on the case, this might lead to absorption of inefficiencies and inexperience by the client. Lawyers normally charge a standard hourly rate and such rate reflects the experience and reputation. The number of hours of work on the case depends on the amount in controversy, the nature and complexity of the matter and also client goals.

A contingency fee basis agreement demonstrates that the lawyer has enough faith in the case which gives more comfort to the client. Such agreements may be dependent upon a number of factors which includes the nature and complexity of the matter, the level of risk involved, the costs and the probability of being successful.

Most lawyers and clients are more accustomed to hourly billing rather than the contingency fee way of charging. Under a contingency fee agreement, clients will not have to pay large monthly amounts to the lawyer while the case is still making its way through the law courts.

Hourly billing transfers all risks except the risk of not getting paid on clients whereas under contingency fee billing the lawyer is normally bearing the risk. The lawyer will receive a lower fee irrespectively of the amount of time spent on the case if the case is unsuccessful or if the client accepts a reduced settlement offer.



## Assignment Question 7

### Contracts

**(a) Why do businesses enter into contracts that are deliberately incomplete?**

**(b) A property management business is considering whether to set up its own cleaning service to replace an outside contractor. What are the arguments for and against this proposal?**

(a) Contracts are sometimes left incomplete on purpose, because one or both parties withhold information required to finalise the contract. This will allow opportunistic behavior. In an incomplete contract, both parties will not normally be covered for every contingent event which might happen.

Incomplete contracts normally arise due to difficulties in specifying or measuring performance, bounded rationality and asymmetric information. Wording of contracts is oftenly left vague in circumstances where it is not easy to measure performance. Such contracts will not include an exact definition of any vague words used. Bounded rationality is a concept whereby decision-makers have to work under limited and unreliable information. The human mind has a limited capacity to evaluate and process information and the decision-maker has a limited amount of time to make a decision. If any party to the contract knows information which the other party doesn't know, this will lead to the creation of an incomplete contract.

(b)

Arguments for this proposal

By setting up its own cleaning service, the property management business will gain more managerial control. It is easier for a company to manager its own employees rather than managing service provider employees.

Continuity of service will not be guaranteed if the service provider goes out of business and through setting up an internal department this risk will be eliminated.

Keeping the service in-house is also cheaper when compared to outsourcing.

Arguments against this proposal

More capital will be required as a result of having its own cleaning services department. The company will have to buy cleaning equipment which previously was directly provided by the service provider.

The company will now have to incur administrative costs such as hiring costs and costs relating to the management of internal cleaning employees.

In addition to this, the company will lose focus on core competencies.

Outsourcing cleaning services will allow the business to focus on its core strengths and competencies, leading to the achievement of a competitive advantage.

## Assignment Question 8

**“ Successful firms are those that have developed resources and capabilities that are not available, transferable or imitable by other firms.” Does this imply that successful firms are monopolist? Explain your answer.**

This statement does not imply that successful firms are monopolists. A firm which has value-creating products, processes and services which cannot be transferred or imitated by its rival firms is said to possess a sustainable competitive advantage.

Having a sustainable competitive advantage does not necessarily mean that the firm or its customers are aware of it. This means that the company will need to position itself in the market to clearly state its competitive advantage.

“ Isolating mechanisms” refer to the ways through which a firm can create a barrier to imitation of resources and capabilities (Hooley and Greenley 2005, p 96). Such mechanisms can be divided into two groups: competitive isolating mechanism and customer-based isolating mechanisms. Competitive mechanisms relate to reducing the competitors’ abilities to imitate. On the other hand, customer-based isolating mechanisms are psychological and economic barriers related to customers’ brand selection decisions. Firms must design and develop effective mechanisms to achieve a better competitive position in the long run.

Sustainable competitive advantage occurs when despite the efforts by competitors to neutralize or duplicate the competitive advantage, such

advantage still persists. In order for this to happen, there must be ongoing asymmetries between firms.

The resource-based theory of the firm states that the competitive advantage of a firm is dependent on the valuable resources which it has at its disposal. Such resources and capabilities should be scarce and imperfectly mobile to lead to a sustainable competitive advantage.

### Assignment Question 9

**Neoclassical economics, effectively mainstream economics, underpins most of the economic literature in the last century. It does, however, have its critics. Use your understanding of this debate to explain and comment on the following statement. “ Large firms probably come close to behaving according to the neoclassical ideal of profit maximization, but is this a desirable outcome? Does it not come at the expense of wider social issues. The response to this is that neoclassical economics is descriptive and not normative. It addresses such problems with concepts of private versus social utility.”**

Neoclassical economics is ‘ an approach to economics that relates supply and demand to an individual’s rationality and his or her ability to maximize utility or profit’ (Investopedia, 2010).

Microeconomics is dominated by neoclassical economics. The latter together with Keynesian economics forms the neoclassical synthesis, which nowadays dominates mainstream economics. Mainstream economics combines the neoclassical approach to microeconomics with Keynesian approach to macroeconomics.

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Neoclassical economics can also be criticized for the fact that it relies heavily on complex mathematical models. Typical examples are those used in general equilibrium theory which raises doubts on whether the economy is really described.

Different views exist on whether neoclassical economics falls under the normative or the descriptive branch of economics. Many argue that it is normative as it tries to change the world by recommending policies to increase economic welfare as opposed to descriptive economics whereby economics tries to explain how the economy operates in reality. Some critics argue that in order to focus on individuals, neoclassical economists are missing to analyse whether the economic system is stable and desirable.

Important aspects of human behavior are ignored as a result of the assumption that individuals act rationally. This raises doubts on these views as to how real these views are. Neoclassical economics criticize firms for not being human and for the fact that in order to achieve profit-maximization, this has a social impact.

Neoclassical economists introduced the assumption of 'rational expectations' in modern neoclassical models. This theory is used to project expectations of future events. Rational expectations theory assumes that expectations do not differ systematically from actual outcomes and thus assumes that humans do not make errors. It is in fact highly criticized on the basis of realism.

Compatibility of the neoclassical 'general equilibrium theory' with

economies which develop over time and produce capital goods is  
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problematic. The Cambridge Capital Controversy debated this issue during the 1960s. Emphasis was made on the theory of growth, aggregate theory, capital and the marginal productivity theory of distribution.

Some critics have the opinion that such developments discovered fatal weaknesses in neoclassical economics. The continued use of mathematical models such as game theory, econometrics and linear programming does not reflect any difference from the other branches of economics.

Most criticism highlights that neoclassical economics makes many unrealistic assumptions which do not represent real situations. However, it is important to keep in mind that this branch of economics is extremely influential and still dominates microeconomics.