

Theme 1: Markets and Market Failure

Economics Y1 Study Guide Summary

Shape of the PPF

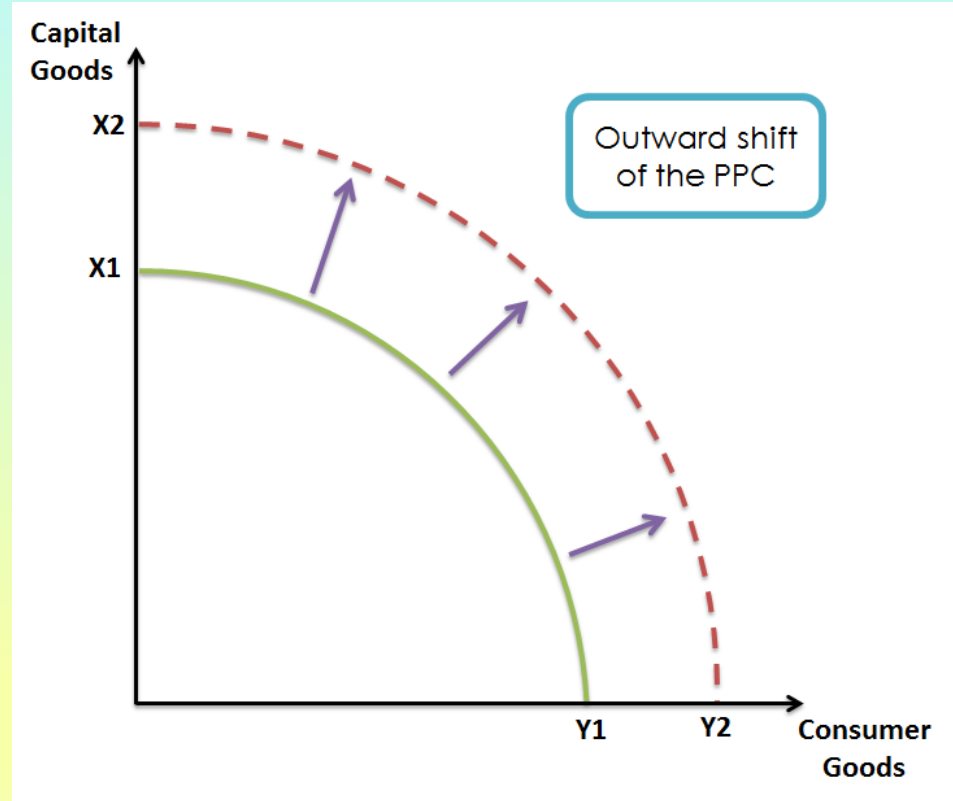
Downwards sloping because there is an opportunity cost at any point due to scarcity.

Bowed outwards, represents:

- Increasing opportunity costs.
- As more of one good is produced, resources that would have been more suitable for another good starts getting used up.

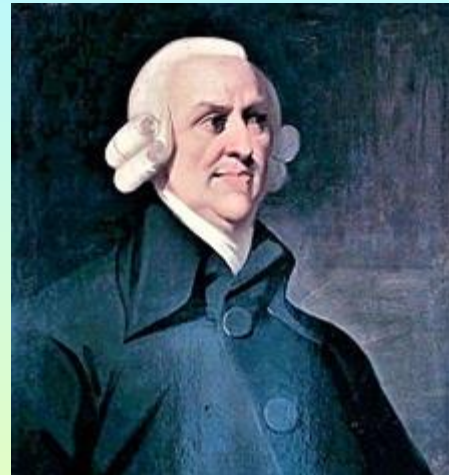
Curve - not all factors of production are suitable for production of all goods.

Straight line - constant opportunity cost.



Free Market Economy

- Resources are automatically allocated by market forces
 - ☞ **The Invisible Hand** → the interaction of demand & supply and the price mechanism.
 - All economics decisions are taken by households and firms.
 - Assumption:** they act in their own self-interest.
- ✓ 'Consumer sovereignty' - resources are allocated according to the wishes of consumers.
 - ✓ No expensive central planning.
 - ✓ Efficiency and hard work encouraged due to incentives.
 - ✓ Competition - low prices, best possible quality, promotes innovation.
 - X Lack of equality - e.g. in the distribution of wealth.
 - X Firms can act undesirably to maximise profits.
 - X Monopolies arise - higher price, lower choice.



YED - Income Elasticity of Demand

The responsiveness of quantity demanded of a good to a change in income.

Interpreting values of YED:

$$\text{Income Elasticity of Demand (YED)} = \frac{\% \Delta \text{ in } Q_d}{\% \Delta \text{ in } Y}$$

- +ve = **Inferior good**
 - ↳ any good where if our income rises, we reduce our spending on it.
- -ve = **normal good**
 - ↳ 1) **Luxury good** (YED > 1) - demand increases by a greater proportion than the increase in income.
 - ↳ 2) **Necessary good** (YED between 0-1) - demand increases by a smaller proportion than the increase in income.

The Price Mechanism

- Prices do not necessarily reflect the usefulness of a good but rather the scarcity of a good.
- **3 Main Functions of Prices in an Economy:**
 1. **Rationing Function** - when demand is greater than supply, then prices are bid up to discourage demand and conserve resources.
 2. **Signalling Function** - help to determine where and how resources should be allocated. Sends a message to producers that demand is probably high and that they should increase production or new producers enter the market. Tells consumers that they should leave the market.
 3. **Incentive Function** - prices help to change the behaviour of consumers and producers. E.g. govt. taxes on cigarettes; firms are incentivised by higher prices to expand production to maximise profits.

Govt. Intervention in Markets

To correct market failure caused by externalities and missing markets.

Main ways of intervention:

1. Taxation
2. Subsidy
3. State provision
4. Advertising/Information campaigns

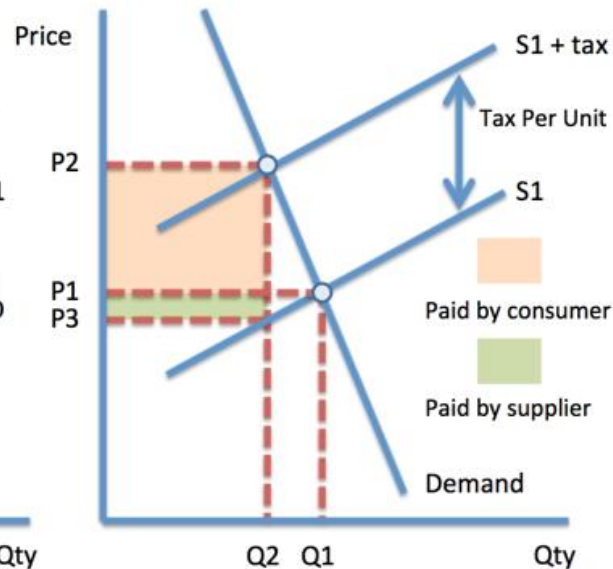
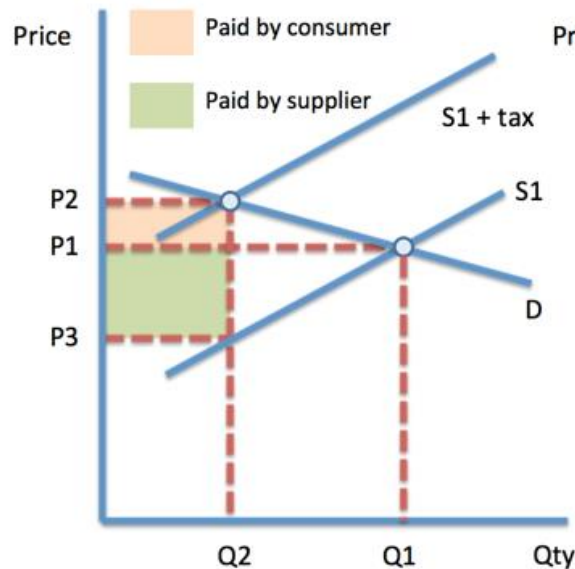
Public choice theory - Free market economists believe that the price mechanism allocates resources efficiently and any govt. intervention to correct market failure would lead to a further misallocation of resources.

Public Interest Theory - Keynesians support govt. intervention at the market (micro) level to correct market failure and at the macro level to promote maintaining the macroeconomic objectives.

Indirect Taxes with Different Coefficient of PED

If the co-efficient of price elasticity of demand >1 , then most of the burden of an indirect tax will be absorbed by the supplier

If the co-efficient of price elasticity of demand <1 , most of an indirect tax can be passed on to the final consumer



State Provision

- The government directly provide goods with external benefits.
- This eliminates the free-rider problem
- Consumers have common standards.
- Increases access to services.

EVALUATION:

1. Expensive - opportunity cost; increased taxes or borrowing to finance.
2. Difficult to manage + inefficient.
3. Difficult to maintain consistent standards - requires further regulation.

Ad + Info. Campaigns

- Aim to increase consumption of merit goods and decrease consumption of demerit goods.

EVALUATION:

1. Expensive/opportunity cost.
2. People become immune from negative advertising - they ignore the messages that campaigns seek to spread. Need to think of more innovative ways.