1.2 HOW MARKETS WORK

1.2.1 RATIONAL DECISION MAKING

Rational → economic agents can rank the order of different outcomes from an action in terms of their net benefit.

a) The underlying assumptions of rational economic decision making:

One of the key assumptions in economics is that economic agents make decisions in rational ways

- *Consumers aim to maximise utility*
  Utility is the benefit derived from consuming a good
  Due to resources being scarce, consumers have to make choices, so have to make comparisons between the utility gained from purchasing an extra unit of a product with its opportunity cost.
- *Firms aim to maximise profits*
  Firms aim to maximise their utility by selling products and services for the maximum amount of profit possible. This allows them to keep shareholders happy.

1.2.2 DEMAND

Demand is the amount that customers are willing and able to buy at any given price in a given period of time.

a) *The distinction between movements along a demand curve and shifts of a demand curve*

The demand curve shows the relationship between price and quantity demanded.
Movement along → change in price
Shift of curve → change in one of the factors of demand
If the curve shifts outwards, demand has increased at every price level

b) The factors that may cause a shift in the demand curve (the conditions of demand)

- Changes in real incomes
  -Demand for a normal good rise when income rises, and demand for inferior goods falls.
- Changes in tastes and fashions
  -If there is a new fashion trend demand for these products is likely to rise sharply
- Advertising and branding
  -Helps to influence consumer choice and likely to increase demand.
- Changes in the prices of complimentary goods and substitutes
  -Increased price of substitutes will increase the demand for your product
  -Increased price of complementary goods will decrease the demand of your product
- Changes in size and age distribution of the population
  -If population increases demand should increase as theirs more consumers

c) The concept of diminishing marginal utility and how this influences the shape of the demand curve

The law of diminishing marginal utility explains why the demand curve shows an inverse relationship between quantity and price.
-The value (utility) of consuming the final product bought falls as more units are consumed in a given period of time.
-Therefore, if more of a good is consumed, less satisfaction can be derived from the good, so consumers aren't willing to pay higher prices for these goods.

1.2.3 PRICE, INCOME AND CROSS ELASTICITIES OF DEMAND

a) Understanding of price, income and cross elasticities of demand

PED (price elasticity of demand) measures the responsiveness of quantity demanded to change in price

YED (Income elasticity of demand) measures the responsiveness of quantity demanded to a change in income.

XED (cross price elasticity of demand) measures the responsiveness of quantity demanded for one good to a change in the price of another good.

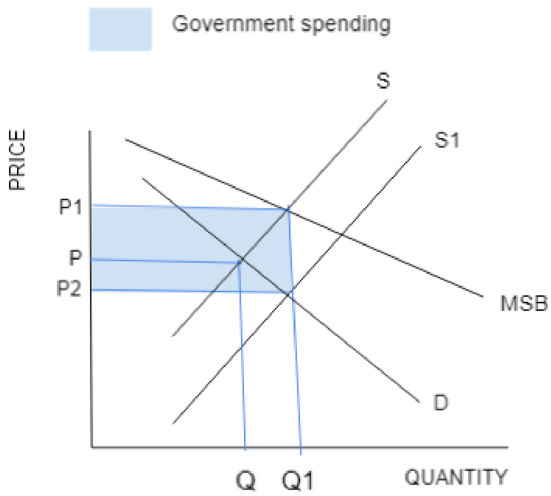
b) Use formulae to calculate price, income and cross elasticities of demand

PED = (% change in quantity demanded) / (% change in price)
YED = (% change in quantity demanded) / (% change in income)
XED = (% change in quantity demanded of good x) / (% change in price of good y)

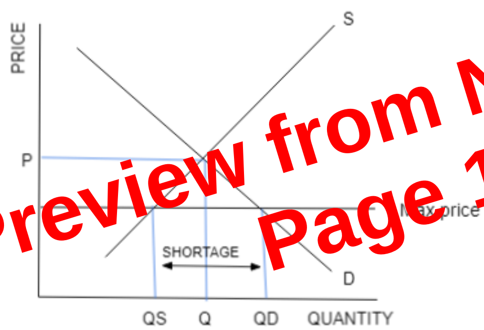
Advantages	Disadvantages
Allows market to return to social equilibrium position	Difficult to know what level to set the tax at in order to reach equilibrium
Government gain revenue from taxes	Could encourage creation of black markets to avoid taxes

- *Subsidies*
  Subsidies increase supply, reducing the price, which leads to more production and consumption. This is used for goods with positive externalities.

Advantages	Disadvantages
Allows market to return to social equilibrium position	Money government spends may have a high opportunity cost
Can help smaller businesses and encourage exports	May be inefficient



- *Maximum and Minimum prices*
  Imposing maximum prices can make them more affordable, it helps to encourage consumption of that good
  Minimum prices can be used to discourage consumption.



b) Other methods of government intervention

- *Trade pollution permits*
  These are used in order to tackle negative externalities. A desired level of pollution is decided upon by the government and a number of permits are released, which can be traded by firms, meaning firms that don't pollute as much can sell their permits for profits, so this acts as an incentive to improve.

Advantages	Disadvantages
Guarantees that pollution will fall	Expensive to monitor
Encourages more sustainable production	Raises costs for businesses

- *State provision of public goods*
  This is where the state provides a good or service with the use of tax revenue. The free rider problem prevents the private sector from providing these goods and services

Advantages	Disadvantages
Benefits of goods themselves	Expensive and has opportunity costs