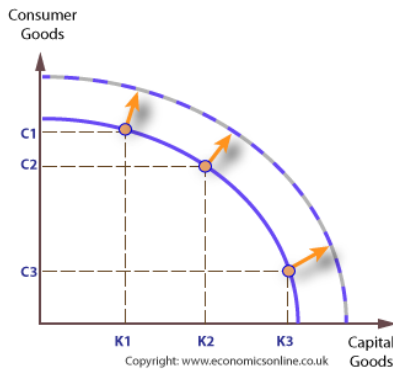


Choice between consumer and capital goods:



-For developing and command economy.

Calculate the opportunity cost for Colin and for Debbie when producing 1 bracelet?

What can you tell about the opportunity cost? What would the PPC look like.

Colin:

<u>Pots:</u>	<u>Bracelets:</u>
0	12
3	9
6	6
9	3
12	0

Debbie:

<u>Pots:</u>	<u>Bracelets:</u>
0	36
3	30
6	24
12	12
18	0

-For Colin the opportunity cost of producing one bracelet is always 1 pot. This means the opportunity cost is constant so the PPC is linear.

-For Debbie the opportunity cost of producing one bracelet is always 0.5 pots. This also has a constant opportunity cost.

Trade-off: the calculation involved in deciding on whether to give up one good for another.

Economic Systems and the Role of the Market

Economic system: the way in which production is organised in a country or group of countries.

The 3 questions faced by economies:

1. What? – what goods and services are to be produced.
2. How? – how these goods and services are produced.
3. For whom? – who should receive these goods and services.

3 main types of economic system:

1. Market economy:

Market economy: an economic system whereby resources are allocated through the free market mechanism.

-Resources are allocated by the forces of **demand** and **supply** through **price mechanism** (by the people).

Demand: the quantity of a product that consumers are able and willing to purchase at various prices over a period of time.

Supply: the quantity of a product that producers are willing and able to provide at different market prices over a period of time.

Price system: a method of allocating resources by the free movement of prices.

-The government has little or no direct involvement in this process.

-Households and firms interact as buyers and sellers.

Normal goods: goods for which an increase in income leads to an increase in demand; goods with a positive income elasticity of demand.

-If it is an **inferior good**, demand decreases with an increase in income.

Inferior goods: goods for which an increase in income leads to a fall in demand; goods with a negative income elasticity of demand.

2. The prices of other products:

-If the price of a **substitute** goes down people may switch to that product and demand for its substitute goes down, for example tea and coffee.

Substitute: a competing good.

-If the price of a **complement** goes down then, they more people will demand that product, and in change the demand for the complement were also go up, for example cars and petrol.

Complements: goods for which there is joint demand.

3. Tastes and fashion:

-If something is fashionable or trendy people will pay more for a certain quantity.

-This causes the demand curve to shift to the right.

-Tastes are to do with personal preferences.

-Various forms of advertising can have a very substantial influence on tastes and fashion.

4. Population:

-Larger population means more demand, so the demand curve shifts to the right.

A change in demand due to a change in non-price factors:

-When there is a **change in demand**, it results in a shift of the demand curve. This means that a different amount of goods is demanded at the same price.

Change in demand: this is where a change in a non-price factor leads to an increase or decrease in demand for a product.

-Two results:

- An increase in demand, where the demand curve shifts to the right. This means that more of the product is demanded at the same price.
- A decrease in demand, where the demand curve shifts to the left. This means that less of the product is demanded at the same price.

-Summary of effects of a change in non-price factors on the demand curve:

Change in demand due to	Effect on the demand curve
An increase in consumer income A rise in the price of substitutes A fall in the price of complements A positive change in tastes and fashion	A shift to the RIGHT
An decrease in consumer income A fall in the price of substitutes A rise in the price of complements A negative change in tastes and fashion	A shift to the LEFT

Graph:

-The **equilibrium price** is where the amount consumers wish to buy and the amount producers wish to put up for sale are equal (both parties are satisfied as demand is being met and there are no unsold products).

Equilibrium price: the price where demand and supply are equal.

-2 cases where there can be **disequilibrium**:

Disequilibrium: any position in the market where demand and supply are not equal.

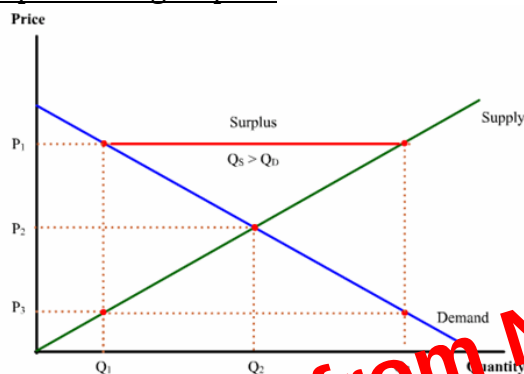
- The price set by producers is too high. Not all the products are sold, as the consumers demand less (**surplus**). Supplier is forced to lower the price to clear the surplus supply. So when supply is greater than demand, price will fall.

Surplus: an excess of supply over demand.

- The price set by the producers is too low. More products could be sold, because consumers demand is higher (**shortage**). The producer then increases the price in order to maximise profits and provide more products to the market. So when demand is greater than supply, price will rise.

Shortage: an excess of demand over supply.

Graph showing surplus:

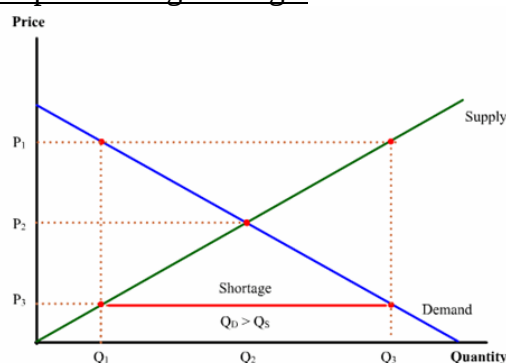


-At P2, Q2 everything that is produced is sold (equilibrium).

-When price is raised from P2 to P1, there is a surplus of goods supplied (not at equilibrium) of Q3-Q1.

-This causes pressure for the prices to be lowered to return to equilibrium.

Graph showing shortage:



-At P2, Q2 everything that is produced is sold.

-When price is lowered from P2 to P3, there is a shortage of goods supplied (not at equilibrium) of Q3-Q1.

-This causes pressure for the prices to be raised or production capacity to be expanded shifting the supply curve to the right, to return to equilibrium.

Clearing price: same as equilibrium price.

-The harder it is to get factors of production, the harder supplying is, making it more inelastic and vice versa.

-The risk for firms is that market conditions may change before any increased production can reach the market.

a) Labour:

-Usually the most available factor of production.

-Provided there is spare capacity workers can be used to produce more output, often in a relatively short period of time.

b) Capital:

-If more machinery has to be purchased, the elasticity of supply will be inelastic.

3) Time period:

-A firm will be more inelastic at the beginning than after a longer period of time.

Business relevance of elasticity estimates:

Ways of collection information for elasticity:

-Sample surveys of consumers (e.g. PED and YED).

-Past records from within a company (e.g. PES).

-Competitor analysis (e.g. XED).

Disadvantages of data collection methods:

-They are estimates, so they may or may not be true.

-Difficult to get data for a full range of price changes (much easier to obtain data for price changes that are close to each other).

-Over time, there could be other factors that affect the demand and supply of a product (the elasticity can change over time).

Use of PED:

-Used as an essential input into the pricing strategy of firms, enabling them to maximise sales revenue.

-When demand is inelastic, an increase in price will lead to an increase in total revenue. So the company should increase the price to maximise sales revenue.

-When demand is elastic, an increase in price will lead to a decrease in total revenue. So the company should decrease the price to maximise sales revenue.

Use of YED:

-In most economies, real disposable incomes tend to rise over time.

-So firms who produce goods and services with a high positive income elasticity of demand can expect to do well in the future.

-Estimates of income elasticity of demand, can provide a basis for forecasting future market demand.

-Deciding whether they are inferior or normal goods helps the company predict whether demand will increase or decrease with an increase in income.

Use of XED:

-Particularly important if companies are operating in markets that are very competitive.

-Where there are close substitutes (high positive XED), then firms are likely to cut down their prices in order to steal market share from their rivals.

-Increasing the price, in such markets, is a dangerous strategy (unless a rival producer follows with a similar price rise, market share can be quickly lost and is invariably difficult to regain without resorting to heavy price reductions).

- When given to the consumer it can encourage them to benefit more from consuming something like education, which can be beneficial to the private user.
- Lower price (potentially higher standard of living).
- Firms can spend more money on advertisement and therefore correct information failure.

Disadvantages:

-Can be controversial:

- A key consideration in the decision-making process is whether there is an external benefit (is it a merit good).
- Opportunity cost to the expenditure on the provision of merit goods.
- Subsidies come from tax, which in turn reduce consumption of an economy.
- Can encourage inefficiency:
 - Firms rely on subsidies, rather than improve efficiency.
- Difficult to measure the level of externality.
- A provision of subsidy does not mean the producer will lower the price.

Depends on:

- What is the subsidy used for?
- How does it get enforced?
- Elasticity:
 - If it is inelastic a decrease in the price will not cause a large increase in the quantity demanded.

Regulations, standards and legal controls

- Purpose is to over-ride the workings of the market mechanism.

Examples:

a) Environmental:

- Legislation relating to the emission of pollutants into the atmosphere.

b) Transport:

- Legislation governing the compulsory use of seat belts and vehicle speed limits.

c) Professional:

- Regulations relating the qualifications of doctors.

d) Use of demerit goods:

- Restrictions on the sale of tobacco products and alcohol.

Disadvantages:

a) How do you decide the level of pollution where you can fine a company?

- Limits too high:

- Not achieving the aim of sustainable growth.

- Limits too low:

- Increase in cost of production.
- Domestic firm's ability to compete internationally and domestically.

b) How do you divide the amount to fine?

- Too high?

- Decrease in firm's ability to compete i.e. fines lead to an increase in cost of production.

- Too low?