***1 (a) Explain what is meant by an efficient market equilibrium. [12]***

***(b) Discuss how the market mechanism might fail in the allocation of resources. [13]***

(a) Economic efficiency refers to achievement of productive efficiency in production and allocative efficiency in allocation of economy's resources. To ensure best possible use of economy's resources, economic efficiency is important that helps to maximize citizens' living standards.

Productive efficiency refers to production of goods/services at the minimum possible cost. This makes producers maximize output for each unit of input. Without productive efficiency lower total output from economy's resources will result in comparatively lower materialistic well-being of citizens' living standards.

Allocative efficiency refers to resource allocation patterns that maximize consumers' utility from consumption of produced goods/services. Resource misallocation will be when inappropriate resources are allocated towards production of certain goods/services and therefore inappropriate quantities of these goods/services are produced. Over and under-production of demerit and merit goods is one reason for market failure that arises because of economies' allocative inefficiency.

When both components of this economic efficiency are present only then there is no market failure and best possible use of economy's resources is being made. (b) Market failure arises because of different reasons. Inappropriate quantities of merit and demerit goods being produced, no provision of public goods, over and under consumption of goods with negative and positive externalities are some examples of market failure. In each case governments being market facilitators should devise appropriate strategies to avoid such market failure arising because of productive and allocative inefficiency.

For instance market failure arising because of merit and demerit goods can be corrected using indirect taxes and subsidies respectively. Similarly provision of public goods has to be ensured by governments because it is not profitable for private producers to produce public goods. Moreover presence of monopolies can result in deadweight loss that is another reason for allocative inefficiency. Under-production of goods/services produced



in monopolistic markets is a cause of concern for governments and they might correct such issues through improved regulations compelling monopolists to produce more. Furthermore markets at times fail because of incomplete information. Adverse selection is particular type of market failure that arises because of lack of information. Correction of such market failures that arise because of limited information are often difficult to correct.

Market failure related to negative and positive externalities exist because of consumers' inappropriate demand levels for such goods. Since individuals do not consider external effects of their economic decision hence their demand for products will be solely based upon private costs and benefits. Since inappropriate quantities of goods with positive and negative externalities are produced therefore it makes a case for government intervention to correct such market failure.

***2 In 2007 the cost of a single ticket on London trains bought at the time of travel was £4. The same ticket bought in advance was £2.50 if used up to 19.00 hrs and £2 after 19.00 hrs. Children could travel free at any time, and those over 60 could travel free after 09.00 hrs.***

***(a) Explain what is meant by price discrimination and analyze what evidence there is of price discrimination in the above statement. [12]***

***(b) Discuss how the output and pricing policy adopted by a firm might differ depending on the market structure in which it operates. [13]***

(a) Price discrimination is defined as firm's strategy of charging different prices for same products/services to different customers. This is to maximize firm's revenue helping it to maximize its profits. Charging higher prices to consumers with higher consumer surplus and vice versa. Firms' prices charged to various customers or group of customers should be in line with consumers' willingness to pay. Customers who for any reasons are willing to pay higher prices should be charged higher prices to maximize firms' profits. Price discrimination is possible when firms can classify its customers in different groups and it is hard or not possible for customers belonging to different groups to shift between groups. If a cinema charges higher prices for weekend tickets than weekday tickets then it



can be said to be price discrimination. According the information provided in the question, the firm can said to be price discriminating. For off timings they charge lower prices and vice versa. Since lower demand for train services in off-timings significantly affect firm's revenue therefore it can be beneficial if firm charges lower fares to incentivize its customers. Moreover too much of demand in prime timings make firm to ration its services demand by charging higher prices because at lower price the firm might not be able to satisfy all potential demand. Similarly not charging children and elderly people might be a good idea to overall increase firm's services' demand. This might be to incentivize people to prefer train travel or this particular firm over other alternate means of transport. Price discrimination apart from helping firms to maximize their profits also helps them to achieve other objectives including achievement of break even in off timings. As stated earlier, low demand during off-timings can prevent firm to cover its fixed cost like cost incurred for operating at certain routes. Therefore lower prices will encourage people to travel during off-timings especially those who have more elastic demand for travel services and can afford to travel during off-timings.

(b) Market structure refers to characteristics that determine industries' level of competition. Certain economic variables including number of firms, entry and exit barriers, nature of products/services and extent of markets' international openness will all determine industries' market structure.

Depending upon level of competition, industries are classified in different market structures. Most competitive market structure is known as perfect competition in which innumerable buyers and sellers are found selling homogenous products, there are low or no barriers to entry or exit, there is complete information among all market participants and all firms of the industry earn normal profits in long run. Perfect competition firms are both productively and allocatively efficient in both long and short run.

On the other hand, monopolies lie on the other extreme of competition spectrum where in an industry only one seller is producing and there are high barriers to enter and exit in terms of high initial capital costs and high sunk costs. Monopolists are found earning abnormal profits in both short and long run. Lack of competition in monopolies often results in higher prices where price discrimination is common. Moreover monopolist



often produces less than allocatively efficient output levels unless intervened by governments.

Other two markets structures that lie between the extremes of perfect competition and monopoly are monopolistic competition and oligopoly. Monopolistic competition is a market structure where there is decent number of firms each one of them producing similar but differentiated products. Though the nature of products produced in such market structure is quite similar but firms attach high importance to branding to differentiate their products from that of their competitors. This is important to establish unique product image and to make its demand less price elastic which is expected to help firms earn higher profits during times of rising prices. Though monopolistic competitive firms are expected to earn abnormal profits in short run but they are often reduced to normal profits in long run due to low barriers to entry that makes new firms enter the industry. The output of such market structures is not allocatively efficient but it is still higher than monopolistic industries output.

Oligopoly is a market structure where there are comparatively few firms. Products might be homogenous to some extent but higher entry barriers help firms to earn abnormal profits in short and long run.

***3 For some years governments of developed countries have been promoting Fair Trade, which means paying a fair price for primary products bought from African developing countries. Now the governments in developed countries, anxious to conserve resources, are complaining that the transport of products around the world increases pollution and should be limited. They support instead the purchase of goods produced at home. These are often more expensive***

***to produce.***

***African farmers may be left with products that their local people do not eat. (a) Discuss whether the old and the new approaches to trade of the developed countries would help achieve the conservation of resources. [13]***



(a) Though conservation of scare resources has become extremely important to limit rapid depletion of global resources that are posing threat to future generations' high living standards; however it should not only limit growth and development of few developing economies and instead all countries should play their role to ensure achievement of sustainable global growth. Free trade is fully supported by economic theory because it is expected to support higher national income of participating economies due to higher world output levels. Countries specializing in production of products for which they possess comparative advantage are expected to achieve higher growth rates by making more efficient use of their scare resources and not wasting precious resources on production of resources they have higher production costs than their competitors.

Self-sufficiency as opposed to specialization and trade is inefficient use of resources and is expected to result in lower global output. If lower cost of production exceeds transport costs between various economies then international trade is expected to be beneficial. Reducing international trade based upon the idea that increased transportation will result in higher pollution levels will be unjust to countries that have spent time and energies specializing in certain products and rely on other countries for import of other products. In this case African economies are expected to experience substantial fall in their exports for products that they export and are not consumed locally. Similarly investment in primary sector industries by developed economies will be economically inefficient. Their high production costs might exceed cost of production of developing economies for such products by much more than external costs imposed through pollution. Therefore just like economies' internal legislation that tries restricting pollution levels by internalizing externalities; appropriate international legislation can prove beneficial in controlling such market failure. But definitely restricting international trade based upon higher transportation costs cannot be justified in any way. Hence in presence of effective legislation international stakeholders can expect to achieve their desired objective of slower environmental degradation and resources conservation without adversely affecting economies' growth and development.



***4 (a) A firm undertakes a major investment. Analyze why in a closed economy without a government the increase in national income from this investment might be higher than in an open mixed economy. [12]***

(a) Multiplier effect is a Keynesian concept that explains how changes in economies' national income will be more than proportionate to changes in their investment levels. This concept is shown graphically where rightward shifts in economies' aggregate demand levels increase their national income more than proportionately. Though Keynesian Cross, the graph that demonstrates the concept of multiplier effect, takes certain set of assumptions and therefore multiplier effect might not exist in real world but based upon concept's theoretical understanding Keynesian explained that value of multiplier effect for any economy will be 1/sum of different marginal propensities of withdrawal.

According to Keynesian theory of multiplier effect lower the economy's withdrawals higher will be the increase in its national income following any increase in injection like investment. Since unlike closed economies for which savings is the only possible withdrawal, for open economies imports are also potential withdrawals. Presence of government in economies makes taxes another potential withdrawal. As the above mentioned formula depicts, lower the withdrawals from economies' circular flow of income/money higher will be their multiplier effect. Therefore absence of government would mean that there is no potential withdrawal from the economy in terms of taxation and therefore higher will be the multiplier effect.

***5 Economic analysis adequately explains how a rational consumer determines a pattern of consumption from a given income in a perfect market with no advertising. It does not explain the more common case of what happens if income changes or if there is advertising. The theory is, therefore, of little merit.***

***Do you agree with these assertions? [25]***



(a) Consumers' utility maximization model explains how consumers should ideally allocate their expenditure among various products to achieve highest possible level of utility. Budget lines and indifference curves collectively determine consumers' utility maximization consumption patterns. Budget lines are graphs depicting consumers' consumption possibilities. Indifference curves on the other hand are graphs representing consumers' different utility levels. Any indifference that lies up and to the right of another indifference curve represents higher utility levels than the other indifference curve and vice versa.

The point where budget lines are tangent to indifference curve is known as equilibrium point. Changes in consumers' income cause budget lines to undergo parallel shift inwards or outwards. Higher income levels allow consumers increased consumption possibilities and therefore this is represented through parallel outward shift in consumers' budget lines and vice versa. On the other hand increased products' advertisement is expected to increase consumers' marginal utility from consuming certain quantities of certain goods and this might also increase products' prices because of consumers' greater willingness to pay higher prices for certain quantities of certain products.

Outwards shifts in budget lines will allow consumers to consumer more and therefore they will be able to consume more of both goods. Most probably, given both products are normal goods, greater quantities of both products will be consumed. On the other hand if prices are rising because of reduced price elasticity of advertised goods then due to lower or no increase in consumers' real income the budget line either shift slightly outwards or not at all. The shape of indifference curve will shape to represent more utility extracted from the advertised good. Therefore for given price of the advertised good consumers will be willing to buy larger quantities of more advertised good.

Therefore depending upon actual changes taking place in consumers' indifference curves and budget lines will determine the actual amounts of goods consumed by the consumer. However utility being qualitative variable is hard to objectively record for different consumers therefore for given changes in advertisement the change in equilibrium will be unique for every consumer.



***6 In March 2009, the government of France agreed to pay 250 million Euros to the car manufacturer Renault, which employed 63 000 workers, on condition that it would not reduce the number of French jobs or factories. General Motors, a US car manufacturer which employed 600 000 workers, said that it needed $2 million in government aid to avoid bankruptcy.***

***(a) Describe the characteristics and likely pricing policy of the market structure in which a car manufacturer is likely to operate. [12]***
***(b) Discuss whether economic theory supports the idea that governments should encourage all large organizations. [13]***

(a) Market structures are set of characteristics that determine industry's level of competition. Most competitive market structures are known as perfect competition. On the other end of the spectrum lies monopolies which are least competitive market structures. Apart from these two extreme market structures there are two more namely monopolistic competition and oligopoly.

Auto manufacturing is expected to have either monopolistically competitive or oligopolistic markets. Number of firms is expected to be more than monopoly but definitely less than perfect competition. Similarly barriers to entry and exit are expected to exist but there are not to be as high as those present in monopolistic markets. Moreover products are often differentiated and branding is major strategy for businesses to establish their unique selling points. Auto manufacturing businesses are expected to spend substantial amounts of their revenue on branding to create unique product image.

Moreover presence of market segments because of specific consumers' needs and preferences make auto industries monopolistically competitive. For the sake of more efficient use of firms' resources they should ideally specialize in production of certain types of products within an industry to maximize their profits. Hence different car manufacturing firms are seen specializing in certain car variants and any one manufacturer is hardly observed producing all types of car variants. Depending upon



state of technology and type of factor of production available to a firm it decides upon its product range.

Moreover firms are expected to earn supernormal profits in short-run which fades away in long-run because of entry of new firms that share in among existing firms' supernormal profits. Therefore prices are likely to be higher in such markets in short run but they will fall to much lower levels in long run when due to increased competition from new firms existing firms will feel pressure to reduce their prices.

(b) Where large firms are expected to be extremely beneficial for host economies, smaller firms also have unique benefits for countries that often large firms are not able to provide. Apart from generation of substantial employment opportunities and significant contribution to economic activity (GDP) large firms are also major contributor to economy's national taxation. Moreover larger firms being more economically efficient because of economies of scale can produce more price competitive products which helps them boost economy's exports. Smaller firms are not expected to earn this foreign currency for the country.

However provision of personalized goods and especially services is only possible through presence of smaller firms that can better utilize their expertise to provide unique products demanded by their customers. Furthermore successful smaller firms have decent chances to expand in future to become large firms in future. Entrepreneurship is better exercised through operations of smaller firms.

***7 (a) Analyze whether an increase in the wage rate always leads to an increase in the number of hours worked by an individual. [10]***

***(b) A government stated that pay increases in the coming year should be kept to a minimum. Discuss whether the main determinants of wage rates are factors such as trade unions and the government rather than market forces. [15]***

(a) Individual supply curve captures relationship between wage rates and number of hours worked. This is generally an upward sloping curve that shows positive relationship between wage rate and individual's willing to work (in terms of hours worked). Higher wage rates increase individuals' opportunity cost of being out of work and therefore



greater substitution of leisure with work will take place at higher wage rates. This is known as substitution effect for which individuals' supply curve is upwards sloping. However for certain people beyond a certain wage rate their supply curve might bend backwards. This is known as income effect which is expected to have negative effect on individuals' labor supply for they will want to work for lesser hours at higher wage rates. Therefore in case income effect is present then it is quite plausible to assume that individuals' supply curve will be backward bending beyond a certain wage rate. Though each time wage rates increase people will experience increased opportunity cost of leisure but some people might be more concerned about their total earnings and hence they might prefer to work lesser hours if they can achieve that income target with lesser working hours.

However unlike individual supply curve that can be backward bending market labor supply or economy's aggregate labor supply is never expected to be backward bending. This is because though some people might prefer to substitute work for leisure for higher wage rates but there will always be more people joining economy's labor force at higher wage rates. This can be thought of people who previously were not part of country's labor force because they did not consider the wage rate to be decent compensation of their efforts. Hence at higher wage rates there is expected to be greater increase in economy's total labor hours by new people joining the labor force than reduction in labor hours experienced from some people working lesser hours. Therefore industry and aggregate labor supply of countries unlike individual supply curves are also assumed to be straight upward sloping curve showing direct relationship of wage rates and labor hours at all wage rate levels.

(b) Market forces of demand and supply of labor are sole determinants of wage rates in free markets. This is because government intervention and pressure groups including labor unions are not expected to exist in free markets. Therefore in absence of external forces demand and supply of labor alone determine market equilibrium resulting in determination of equilibrium wage and equilibrium labor quantity employed.

However in real world since government intervention is frequently witnessed therefore market forces are rarely observed to be sole determinants of labor market equilibrium. At times governments set minimum wage for people they consider to be earning less than



what is required to ensure their decent living standard. This is often seen in developing economies where abundant labor supply and limited economic opportunities force citizens to work for very low wage rates. This is because of this problem that makes government set minimum wages through which they expect to improve less-skilled working class living standards. Such market intervention however might not prove to be beneficial for this result in higher unemployment. This happens because of labor surplus at minimum wages that makes firm employ lower quantities of labor than what was previously employed. This new market equilibrium where lesser people are employed at higher wages than before is not necessarily a better outcome and we cannot objectively advocate for improved well-being of citizens. Therefore proponents of free market knowing that government intervention can result in deadweight loss propose for minimal government intervention in product and input markets. Similarly trade unions also try achieving higher than equilibrium wages for their members. Such pressure groups intervention also have similar effect on economies' labor markets where trade unions pressure to maintain higher wages adversely affect their members' job security and generation of employment opportunities is slower than otherwise.

Hence overall since government and trade union is not always expected to improve employees' well-being therefore it will be better if labor market equilibrium is solely determined by market forces of demand and supply.

***8 Economic theory emphasizes the idea of an equilibrium position. Discuss whether the idea of an equilibrium is a useful and practical way of explaining the behavior of a consumer. [25]***

(a) Consumer equilibrium is economic model that explains consumers' utility maximization behavior. This can be graphically and mathematically demonstrated to explain consumers' income allocation pattern across varying products to maximize their utility for their given income levels.

Budget lines are graphs that depict consumers' consumption possibilities for given income levels. Graph axes record quantities of different goods/services. Indifference curves are graphs representing consumers' consumption preferences for the two



goods/services quantities of which are recorded on axes. Indifference curves lying to the right represent higher utility levels. This is because more consumption is assumed to be preferred over lower consumption levels. There indifference curves that lie right of other indifference curves represent higher consumption levels and therefore are assumed to be preferred over all others that lie left of them.

Graphically consumer equilibrium exists where consumer's budget line is tangent to one of its indifference curve on indifference map. The point of tangency is where gradient of both curves is equal. This is where marginal rate of substitution (name given to gradient of indifference curves) and $P_x / P_y$ are equal.

By rearranging the formula it equals $MU_x / P_x = MU_y / P_y$. This theoretically means that to maximize total utility consumer should spend upon goods/services for which their marginal utility is highest. Meaning if consumer derives greater utility from spending each dollar on good A than good B then he should first consume good A and later when marginal utility derived from each unit of A will fall then consumer will become indifferent between consumption of good A and good B.

Consumer spending pattern will not change until any factor important in determining this equilibrium does not change. Change in income levels, changes in consumer's preferences and/or changes in prices of goods will cause equilibrium to change. Higher income levels will allow consumer to consume larger quantities of the two goods and vice versa. Higher prices will reduce consumer's consumption and vice versa. And change in consumer's preferences will make him/her consume more of good for which his utility has now increased and vice versa.

***9 (a) Explain the causes of unemployment. [12]***

(a) Keynesian explained concept of cyclical unemployment that arises because of economies' low economic activity. Classical economists, on the other hand, provide more microeconomic explanations for economies unemployment levels including Frictional and Structural unemployment. Frictional unemployment includes people who are casually, seasonally or voluntarily unemployed. As the names suggest, seasonal



unemployment refers to people who are seasonally unemployed because of seasonal demand for industries' products. Tourism industry might be expected to generate seasonal employment in Pakistan. Moreover people who are between switching jobs are known as casually or voluntarily unemployed. Structural unemployment is defined as people becoming unemployed because of being part of shrinking industries. Structural changes are referred to varying significance of economies' industries based upon their contribution to countries' GDP. Expanding industries generate greater employment opportunities that should at least offset reduced employment opportunities from economies' shrinking industries or else there will be overall reduction in countries' employment opportunities that will result in higher unemployment levels.

Classical defined natural rate of unemployment as sum of economies' frictional and structural unemployment. According to Classical economists use of effective supply side policies are only appropriate strategies to reduce countries' natural unemployment levels beyond their natural rate of unemployment. Classical refute Keynesian view that use of expansionary fiscal and monetary policies can reduce such unemployment levels.

Cyclical unemployment being result of lower economic activity levels can be effectively treated through use of expansionary fiscal and monetary policies.

***10 'Developing countries have a low standard of living, yet many have much wealth in natural resources which multi-national companies would like to exploit.'***

***Discuss which is the better way of increasing the standard of living: to allow multi-national companies to exploit all the natural resources, or for the government to increase expenditure on education and health. [25]***

(a) Unlike economic growth that is easier to calculate and define, development is multi dimensional concept that is affected by innumerable economic and non-economic variables. Higher economic activity levels are defined as economic growth that is evident through the GDP figures. However since economists have previously realized that growth and development might be related but are different concepts; therefore some specific



development indicators have been developed and are commonly referred to evaluate economies' level of development.

Since growth being indicator of economies' materialistic well-being is necessary element of economies' higher development levels. Therefore any initiative that is expected to increase economic activity levels should be considered desirable by policymakers. This also includes increased foreign direct investment from multinationals. Higher employment levels will generate higher national income which is expected to improve citizens' consumption possibilities. In this case, multinationals increased investment in economies' mineral extraction industries will be beneficial for host economies in terms of higher national income but development might not be a natural consequence of such FDI (foreign direct investment).

Greater revenue collection from foreign firms operating in mineral extraction firms can be used to finance host economies' improved educational and health care services. This is important to ensure improved human capital that in return is expected to enhance countries' potential growth rates. Therefore unless host economies are not making best possible use of higher national incomes arising from increased foreign investment there are poor chances for them to rapidly develop.

Hence ideally governments apart from being supervisor of foreign firms' economic activity should also ensure best possible use of higher revenue and income to fuel even higher future economic growth.

***11 In 2007 the UK Competition Commission indicated that failure in the market mechanism would result in both winners and losers.***

***(a) Explain why producers are usually the winners and consumers are usually the losers when the market fails. [12]***

***(b) Discuss what the government might do when there are losers because the market mechanism has failed. [13]***

Qasim 15

(a) Market failure is said to exist when economies are unable to achieve economic efficiency. Absence of productive and/or allocative efficiency refers to market failure for it prevents economies to maximize their citizens' living standards.

Depending upon specific types of market failure winners and losers will be determined. Presence of monopolies, inappropriate quantities of merit and demerit goods being produced, no provision of public goods, over and under consumption of goods with negative and positive externalities and limited information are some common causes of market failure.

Since it is not profitable for private sector to produce public goods, therefore absence of public goods in free markets results in lower consumers' well-being. In this case, consumers are loser but producers are also not expected to gain in any way. Over production of goods with negative externalities benefits producers or consumers depending upon which market participant is involved in generating these negative externalities. Negative production externalities mean that producers are not compensating individuals whose well-being is adversely affected. Similarly negative consumption externalities like related to private cars consumption mean that consumers are exempt from bearing the burden of their external costs. Hence in absence of government intervention producers will gain from being involved in products having negative production externalities and consumers are expected to benefit from consuming goods with negative externalities.

Presence of monopolies means that producers will gain from being sole producers of certain goods etc. Such imperfect market structures adversely affect consumers' well being from limited competition. Higher prices and limited choice are some natural consequences of such imperfect markets.

Moreover depending upon which market participant has more information will determine winners in cases of market failure where limited information is present. Therefore depending upon nature of market failure and government strategies to correct such market inefficiencies will determine winners and losers. But producers might not always be the winners.

(b) Presence of market failure justifies government intervention. Depending upon specific nature of market failure will determine governments' most effective intervention tools.



For instance to correct misallocation of resources related to production of merit and demerit goods governments can use indirect taxes and subsidies. Moreover through improved regulation and greater supervision of monopolist firms governments can ensure higher consumer welfare.

Similarly economies experiencing excessive unequal income/wealth distribution require appropriate government intervention through alteration of tax and state benefit schemes.

***12 International conferences have been held to discuss the effects of global warming and to persuade governments to agree to improve efficiency in the use of resources by limiting the amount of harmful gases produced by their country.***

***Explain what is meant by an efficient use of resources and discuss whether efficiency can only be achieved if governments are involved. [25]***

(a) Economic efficiency refers to best possible use of economy's resources. Productive and allocative efficiency are two components of economic efficiency and without any of two a country will not be able to maximize its citizens' living standards for available state of their resources.

Productive efficiency is maximizing output for each unit of input. This can be thought of as productivity. Higher the output for each unit higher will be economy's output. Allocative efficiency on the other hand refers to ideal allocation of economy's resources to maximize citizens' utility. Right quantities should be produced for economy to have allocative efficiency. Therefore countries are more likely to achieve allocative efficiency when prices are allowed to undertake allocative mechanism. However in cases of market failure there will be need for government intervention to ensure efficient allocation of economy's resources.

Over and under production of demerit and merit goods respectively is example of market failure. Similarly absence of public goods, presence of monopolies, lack of information etc are different examples of market failure.



Government being facilitator of private sector in an economy is expected to play the role of watchdog/supervisor for private sector.

Just like markets fail governments can also fail due to lack of information, corruption, nepotism and many other problems. When this will happen then instead of improving market failure situation the government might even worsen it. This will result in generation of deadweight loss which means that loss of certain people will be greater than benefit received by others which technically refers to net loss of welfare.

Therefore even though governments often use specialized tools to deal with different market failures but they might not always be successful in achieving their economic objectives of attaining higher economic efficiency.

For instance for monopolies governments might use maximum prices and production quotas requirements to minimize their allocative inefficiency but such strategies might not be effective due to corrupt law enforcement agencies etc. Therefore given such case the government intervention is not expected to improve market inefficiency.

Moreover through indirect taxes and subsidies governments can deal with demerit and merit goods respectively but such intervention results in deadweight loss. In case of subsidies combined increase in consumer and producer surplus will be lower compared to government expenditure resulting in deadweight loss. Similarly government revenue collected through indirect taxation is lower compared to loss of consumer and producer surplus.

Since it is hard to objectively say anything government involvement in market operations should not always be preferred or discouraged.

Hence depending upon specific circumstances and economic objectives government should decide upon its extent of intervention and intervention tools.

***13 With a perfect market and a given income, economic analysis explains how a rational consumer decides the quantities of which products to demand. It cannot, though, explain what happens when incomes change or when businesses in imperfect markets manipulate prices. Discuss whether you agree with this opinion about the economic analysis of consumer behavior. [25]***

Qasim 18

(a) Consumer utility maximization model explains consumers' expenditure allocation behavior. Budget lines and indifference curves collectively determine consumers' consumption patterns. Budget lines are graphical depiction of consumers' consumption possibilities. Indifference curves are graphical depiction of consumers' preferences.

The equilibrium point is where consumers' indifference curves interact with their budget lines. Changes in budget lines and /or indifference curves will cause alterations in consumers' consumption patterns.

Increase in consumers' incomes cause a rightward shift in their budget lines depicting improved consumption possibilities for given prices of the recorded products. Changes in prices will cause budget lines to pivot inwards from axis for which price is increasing and vice versa.

On the other hand, changes in consumers' preferences will cause changes in their indifference curves. In equilibrium consumer are choosing combination of products for which their marginal utility for each dollar spent on a certain goods/service is equal to marginal utility for each dollar spent on any other good. This mathematical equation can be generalized for infinite number of goods/services.

Increase in income will make consumers consume more of both goods given their preferences are constant. Therefore higher incomes will result in higher utility making consumers better-off. Similarly changes in prices by affecting consumers' real income will impact their consumption. Increase in prices will result in lower marginal utility for dollar spent on any goods and vice versa. Therefore lower real incomes will adversely affect consumers' consumption possibilities which will make them consume lower quantities of any particular good. Lower consumption will result in lower utility making consumers relatively worse off.

Consumers' consumption behavior is based upon the principle of maximizing their total utility. This can only be achieved if consumers are spending on goods/services that yield highest possible satisfaction (marginal utility) for each dollar spent on any particular good. Therefore consumer utility maximization model intuitively explains consumers' consumption patterns.

Qasim 19

***14 (a) How does economic analysis explain the level of wage rates in a perfectly competitive labor market? [12]***

***(b) Here are two press statements.***

***'A government announced that it would limit the top level of pay for senior executives in private industries by imposing a maximum wage.'***

***'The trade union for transport workers decided to call a strike unless its members were awarded a higher rate of pay.'***

***Discuss how the economic analysis of wage determination would be changed by the announcement of the government and the decision of the trade union. [13]***

(a) Market forces of demand and supply are sole determinants of wages in free markets. Just like product markets in labor markets the equilibrium is determined through interaction of demand and supply.

Higher the wage rate lower quantity of labor will be demanded and vice versa. Labor demand in based upon marginal revenue product that is product of marginal product and product prices. Employees' marginal revenue product is maximum wage that employers are willing to compensate to their employees. Any wage less than employee's marginal revenue product will be economically beneficial for employer but any wage higher than marginal revenue product means that employer is compensating employees more than what they have contributed towards firm's revenue. To avoid loss, profit maximization firms cannot afford to compensate their factors of production more than what they have contributed towards business revenue. Therefore firms' demand for labor is labor's marginal revenue product curve. Any factor that causes labor demand to increase causes labor demand to shift rightwards and vice versa.

Labor supply is total number of labor hours or total number of people willing to work at varying wage rates. Labor supply is upward sloping graph with regards to wage rates. Factors expected to positively affect labor supply including increased working age population will cause labor supply curve to shift rightwards and vice versa.



Point where economy's labor demand intersects with labor supply is known as equilibrium point that determines wage rate and level of employment.

(b) Labor market analysis can be broken down in two levels namely microeconomic and macroeconomic. When economists are interested in analyzing labor market of any specific industry/occupation/industry then that is microeconomic analysis because for that only occupation's labor demand and labor supply is considered. On the other hand aggregate labor demand and labor supply is relevant in analyzing macroeconomic equilibrium of labor market.

Wage differential among occupations is based upon their specific demand and supply curves. Apart from demand and supply levels that affect labor wage rates elasticity of labor supply and labor demand are also significant factors in explaining wage differential. Higher labor demand for given level of labor supply results in higher equilibrium wages and vice versa. Similarly higher labor supply for given level of labor demand means lower wages and vice versa.

More elastic labor supply given increase in labor demand will result in smaller increase in wage rate than for less elastic labor supply.

For analysis purposes economists break up factor input earnings in two groups namely transfer earnings and economic rent. Transfer earnings of any employee are minimum compensation that is needed to retain him in current profession which is obviously equal to their opportunity cost (next best alternative forgone). Any earning above transfer earnings is known as economic rent.

Occupations that have less elastic labor supply because of long years of formal education and training required have higher economic rent for given level of demand and vice versa. For instance people with unique skills like actors, singers, sports players have exceptionally low wage elasticity of supply and therefore have high economic rent. On the other hand occupations for which no or little formal education and training is required like cashier has low economic rent and therefore large proportion of such people only consist of transfer earnings.

Government wants to limit economic rent for senior corporate executives whereas trade unions want to increase transfer earnings of low income individuals. To some extent based upon standards of social justice both the external groups' claims are justified.



Imposition of maximum wages for executives is expected to create shortage in the labor market where imposition of minimum wages through trade unions' pressure is expected to create surplus in labor market for less skilled employees.

***15 (a) Explain why manufacturers differentiate their products and describe the characteristics of two market structures where product differentiation occurs. [12]***

(a) Product differentiation is the idea of creating unique selling points in a brand to have it differentiated from competitor products. Firms' ability to charge higher prices is based upon their products' uniqueness which can be created through increased branding. Product differentiation refers to firms' strategies to successfully create unique product image which helps them charge higher prices to their consumers.

Monopolistic competitive industries and oligopolistic markets are two market structures where product differentiation is frequently observed. In monopolistic markets due to limited competition there are lower incentives for product differentiation. Similarly in perfect competition product differentiation is difficult because of highly similar/homogenous products.

Moreover product differentiation is generally observed in markets where producers have incentives to charge higher prices and to price discriminate through development of different product variants. Since monopolistic competition and oligopoly market structures are where competitor products are considered close substitutes by consumers therefore it requires producers to differentiate their products to maximize their revenue.

Creation of unique brand personality helps producers make their products' demand less elastic. This lack of price sensitivity helps producers charge higher prices without their products' demand being adversely affected.

***16 In 2013, a new aircraft, the Boeing 787 Dreamliner, was assembled in the United States (US).***



***United Airlines, an American private company, ordered 50 of these aircraft, each costing over US$200 million.***

***(a) Imagine that the US was a closed economy with no government intervention. Analyze why the increase in national income from this investment in new aircraft might be different than if it were an open, mixed economy. [12]***

(a) Circular flow of income is graphical depiction of money/income flow in an economy. Firms, households are the only two sectors in case of purely free market without government intervention and without international trade assuming economy does not engage in international trade. This diagram is different for mixed economies where government intervention is present and further for open economy that engages in international trade.

The basic model of circular flow of income shows how first factors of production move from households to firms and firms produce goods and services that are demanded by households. Later households are compensated for provision of factors of production that is spent as expenditure on goods and services. This process continues and national income is continuously generated in different economies. However there are more injections and withdrawals for economies in which government and international trade are present. Government spending is injection that increases money circulating in an economy. On the other hand taxation is leakage for it withdraws money flowing in a country. Similarly exports inject more money in an economy and imports are considered withdrawal from an economy.

Lower the withdrawals from an economy larger will be economy's multiplier effect for given level of injections. Multiplier effect is a Keynesian concept that states that increase in national income for certain level of injections results in more than proportionate increase. This basically means that if investment levels have risen by Rs 10 million then national income will increase by more than Rs 10 million. The formula used to calculate multiplier coefficient is 1 / withdrawals.

As stated earlier, withdrawals are different for different type of economies. For closed and free market economies withdrawals just consist of savings undertaken by its citizens.



Therefore multiplier coefficient of such economies will be calculated as 1 / mps; where mps is marginal propensity to save. Higher the proportion of additional incomes saved lower will be economy's multiplier effect and vice versa.

For closed economies where government intervention is present the multiplier formula of 1 / mps + mrt; where mrt is marginal rate of taxation. Higher government taxation for additional income generated lower will be economy's multiplier effect.

Lastly for economies with both government and international trade the multiplier effect is calculated as 1 / mps + mrt + mpm; where mpm is marginal propensity to import. Lower the proportion of additional income spent on imports higher will be economy's national income following a change in its injection.

Since there is only one possible withdrawal for closed economies without any government intervention therefore the multiplier effect for one dollar increase in injection is expected to be highest.

***17 In 2012, a table for Gross Domestic Product (GDP) per head showed that only three of the world's ten richest countries had populations above 7 million. These were the United States: 315 million; the United Arab Emirates: 8.2 million; and Switzerland: 8 million.***

***(a) Explain how GDP is calculated and show how GDP at market prices is different from net national income at factor cost (basic prices). [12]***

***(b) Classifications often distinguish between developed (rich) and developing (poor) countries. Consider in what sense a developing country is said to be 'poor' and discuss whether the best way to become developed (rich) would be to reduce the size of its population. [13]***

(a) GDP which stands for Gross Domestic Product is a statistic for economies' national income. GDP is market value of all goods/services produced in an economy during certain time period. Percentage change in countries' GDP is used to gauge their growth rates. Higher the increase in GDP, greater will be increase in their national income. Achieving high growth rates is economies one of the macroeconomic objectives that are closely linked to their objective of becoming more developed.



Gross domestic product is not the only national income statistic; Net domestic product (NDP), gross national income (GNI) and net national income (NNI) are three more quantitative measures used to estimate economies' materialistic well-being. Unlike gross calculations of national income that do not account for fixed assets' depreciation and therefore includes gross investment in national income calculations; net measures account for depreciation and only includes net investment in national income statistics. For instance if out of Rs 20 million investment that took place in Pakistan during certain year if Rs 5 million was to replace worn-out capital goods then unlike gross measures that will include total 20 million investment net measures will only include 15 million as economy's investment for that period. Hence gross domestic and gross national income statistics are measures of increase in national income regardless of whether that has increased economy's production potential but net domestic and net national income statistics only account for national income that has resulted in economy's enhanced production potential.

On the other hand where domestic measures are account of how much national income has been generated by people living in an economy; national measures including gross national product and net national product only account for income earned by economies' nationals regardless of their residence. Meaning if any Pakistani is earning anything abroad that will be part of Pakistan's national income statistics but not accounted for in country's domestic statistics.

Furthermore all production can either be valued at market prices (including profits) or at cost prices (cost of factors of production). Unlike market prices estimates that include producers' profits and therefore are affected by changes in economies' profit levels; cost prices statistics do not include profits and therefore might be better estimate of true change in economy's output levels. For instance even if production has not changed but producers have increased their profit level then market prices statistics will increase but cost prices estimates will show no change correctly representing the reality that output levels have not increased. However since profits are also income for investors/producers therefore they should be included in economy's national income statistics.

Hence depending upon economists' specific research needs the selection of national income statistic is determined. However for usual national income comparison among



economies it will be appropriate to compare their performance on same statistics for long time periods.

(b) Though development and growth are interrelated but different concepts. Unlike growth that does not account for non-materialistic aspects of countries, development is holistic measure of changes in citizens' living standards or quality of life. Higher income general result in higher development but that is not always true and there will be reasons why economies' growth might not be translating into improved/higher development. Higher income levels being necessary for development require countries to specifically focus on higher growth rates but that should not prevent policymakers to not explicitly focus on aspects that are necessary for economies' higher development. For instance increased production of military goods will increase countries national income but such contributions to national income do not provide goods/services that citizens really require to experience improved living standards. Inadequate educational/health care services, poor infrastructure, political instability, lack of political freedom all adversely affect citizens' living standards and these variables are not explicitly accounted for in economies' national income statistics. Therefore over time economists have developed specialized statistics to estimate countries' level of development. Human Development Index a development indicator was established back in 1990 by Indian and Pakistani economists to gauge economies development by gauging their performance on education, health care and national income dimensions. Similarly Human Poverty Index was developed in 1972 and since then it has been used as development indicator that evaluates economies' performance on health care and education but using more proxies than HDI.

Countries relative performance and improvement in these development statistics over times is indicator of improvement in their development levels.

As mentioned earlier, economies' growth or increase in national income often do not directly translate into improved development levels. Therefore countries should explicitly target sectors which are necessary for improving their citizens' living standards. Hence provision of better educational and health care services, improved infrastructure is extremely important.



***18 (a) Discuss whether demand schedules and budget line diagrams are similar in the way they represent the effect of***

***(i) a rise in the price of a good***

***(ii) a rise in a consumer's income. [12]***

***(b) Analyze what is meant by the equi-marginal principle of consumer demand and whether it can be linked to the derivation of a market demand curve. [13]***

(a) Demand schedule is tabular representation of demand curve. The demand schedule show the quantities of certain product demanded for varying prices levels. This demand schedule is used to make demand curve.

Budget line is graph that shows any consumer's consumption possibilities for given income levels for certain prices of two products. These budget lines along with indifference curves show consumers' optimal expenditure allocation.

Rise in product's price cause budget line to pivot inwards from the axis on which the quantities of that product are recorded. On the other hand demand schedule shows inverse relationship of quantities demanded and products' prices. If prices for both products increase then budget line will shift inwards from both axes.

Rise in consumers' income will cause budget line to shift outwards. This will be a parallel outward shift in budget line and vice versa. On the other hand demand schedule will show higher quantities of each product being demanded for each price level due to their improved purchasing power.

(b) Equi-marginal principle is quantitative generalization of consumers' utility maximization behavior through which consumers try maximizing their marginal utility from each dollar spent on any good. Therefore in equilibrium consumers will receive equal amount of marginal utility for each dollar spent on any two products.

Equi-marginal principal can be theoretically explained through the use of budget lines and indifference curves. The gradient of indifference curves is known as marginal rate of substitution that is equal to marginal utility received from consumption of good recorded in x-axis divided by marginal utility received from consumption of good recorded on vertical axis. Where highest indifference curve is tangent to consumers' given budget line that is the equilibrium point which represents consumers' highest possible level of utility.



Since gradient of the two lines will be equal to each other at the point of tangency therefore if we equalize budget line gradient with gradient of indifference curve that mathematical equation will represent consumers' utility maximization behavior. Demand curve is graphical representation of certain product's quantities demanded at varying price levels. Higher prices result in lower quantity of any goods being demanded and vice versa. According to equi-marginal principle higher prices for given level of marginal utility result in reduced quantities being demanded for certain products. This is also graphically represented on consumers' demand curve. Higher prices make them demand lower quantities and vice versa. Therefore the fact that demand curve can be derived using equi-marginal principle.

***19 (a) Discuss whether it is always advantageous for a firm to grow in size. [12]***

(a) Firms grow through business expansion when they are able to produce larger quantities of final goods and /or providing larger quantities of services. Increased demand for business products is necessary requirement for business to grow. Mere ability to produce larger quantities when not matched by increased product demand is not very beneficial since businesses' markets are not expanding and therefore they technically can't sell additional output produced.

There are different possible strategies for businesses to grow/expand. Internal growth refers to business expansion that is financed through reinvestment of undistributed profits. External growth is when businesses merge / take-over other firms/businesses. Though businesses often have varying economic objectives and they might not always want to grow or maximize profits but often businesses have higher growth rates as their primary objectives.

Increased production and sale of firm's products help them benefit from economies of scale. Lower average cost of production will help businesses earn higher profits. Businesses are expected to benefit from bulk-buying, marketing, financial and other types of economies of scale. Lower per unit cost of raw material due to bulk buying, lower per



unit marketing, availability of loans on cheaper rates etc will all help businesses to produce cheaper products.

Increased market share from growth will helps firms to charge higher prices due to their improved bargaining power. Given price inelastic demand for firms' products due to their higher market share will help them increase their overall revenue.

Higher profits are often linked with businesses' higher growth rates which help them better satisfy their shareholders' expectations. Improved return to business shareholders will encourage them to undertake more investment in future which will improve the flow of finance to growing businesses.

***20 (a) An increase in investment will raise national income but an increase in the desire by consumers to save will reduce national income.***

***Explain why this is the case. [12]***

***(b) To increase national income, interest rates should be lowered; indeed lowering interest rates is the only policy available to increase national income.***

***Discuss whether you support this opinion. [13]***

(a) Aggregate demand and aggregate supply collectively determine economies' national income levels. For given level of aggregate supply higher aggregate demand for economies will result in higher national income levels. Aggregate demand for economies is made up of consumption, investment, government spending and net exports. Hence higher investment will result in higher aggregate demand levels which will result in higher national income levels and vice versa.

On the other hand, lower consumption due to increased savings result in lower consumption which results in lower aggregate demand levels.

Keynesian Multiplier Effect explains how a given change in economy's injections will result in changes in economies' national income levels. Multiplier effect is larger given there are lesser withdrawals from an economy. 1 divided by economy's all possible withdrawals is used to calculate countries' multiplier effects.



Saving being one of the possible withdrawals from an economy should be low to ensure their higher multiplier effects. Lesser the savings and therefore higher the consumption will result in higher national income levels.

That is why economist believe in the idea of higher consumption and lower savings. This ideology is compatible with Keynesian ideology that advocates for higher aggregate demand levels to help achieve higher national income and higher employment levels. However high consumption can result in lower investment and therefore might adversely affect their long term potential. Therefore economies need to maintain a certain balance between their optimal consumption and investment levels.

(b) Interest rates are significant determinants of economies' consumption and investment levels. Higher interest rates reduce investment because of lower profits arising from higher cost of production and vice versa. On the other hand lower interest rates will encourage higher consumption because of reduced cost of borrowing.

However interest rates are not the only variable that affects economies' investment and consumption levels. Political situation, relative inflation rates, domestic demand levels etc are significant variables in determining economies' investment levels. Therefore even during times of low interest rates changes in other variables might not be favorable hence investment levels might remain low. Similarly aggregate consumption levels are affected by variables like future expectations, general price level, and purchasing power based upon consumers' income levels etc. Therefore even if changes in interest rates are favorable but if other variables move unfavorably then there is a decent chance that economy's consumption levels fall.

***21 (a) As an economy develops, the relative importance of different sectors of production changes.***

***Explain, with examples, why the pattern of employment might change as an economy develops. [12]***

(a) All economies undergo some structural changes at all times. This refers to changes in relative importance of different sectors/industries with regards to their contributions towards economy's total output (GDP). Industries experiencing expansion in terms of



higher revenue and profits require higher employment of various factors of production including labor. This means that there will be increased labor demand in booming industries for various type of labor including skilled and un-skilled workforce. On the other hand, industries experiencing lower demand for their services/products will cut upon their labor force for reduction in costs is necessary in times of lower revenue to ensure decent profits.

These structural changes that result in changes demand for labor by various industries make individuals part of labor force to react to changes in incentives. Higher demand for labor by certain sectors / firms will encourage / motivate individuals to educate/train themselves in disciplines that are experiencing relative expansion and vice versa. For instance with recent technological advancements in IT has encouraged greater individuals/students to study IT related courses. Similarly there is increased demand for professional courses that are expected to train potential candidates for such sectors.

Moreover people working in sun-set industries face increased threat of becoming redundant because of lower demand for firms' products. Therefore they will feel the need to retrain themselves to help them adjust in expanding industries.

***22 (a) Explain, using a budget line diagram, whether***

***(i) the substitution effect of a price change and***

***(ii) the income effect***

***would be similar for a normal good and an inferior good. [12]***

(a) Budget line is graphical depiction of consumer's consumption possibilities. This downward sloping line shows quantities of two products that a consumer can purchase for given level of income. Budget line can shift in and outwards following decrease and increase in consumer's income respectively. Similarly budget line can pivot in and outward from the axis for which the price for the recorded good has increased and decreased respectively.

Changes in consumer's consumption patterns following a change in products' prices is broken down in substitution and income effect. Substitution effect is change in



consumer's consumption patterns due to change in relative prices and real income levels are kept constant. On the other hand, income effect is recorded by keeping relative prices constant as before but recording change in consumer's real income on their consumption patterns.

Substitution effect is same for all types of goods whether normal or inferior. Normal good is any product that has direct relationship between consumer's income and quantities consumed. Inferior good on the opposite has inverse relationship between income and quantities of good consumed. For normal and inferior goods when their prices decrease larger quantities of the both type of products is expected to be consumed by consumers and vice versa.

Income effect on the opposite is positive for normal but negative for inferior goods. As stated earlier, normal goods have positive relationship between income and quantities consumed therefore when consumers experience increase in their real income the quantities of normal good consumed increases and vice versa. But since consumers have better options when their income levels are rising therefore any increase in real income will make them consume lesser of inferior goods. On the opposite, when consumers' real income is falling their consumption of inferior goods is expected to increase because of lesser options of cheaper products available.

***23 (a) Distinguish between perfect competition and monopolistic competition. [12] (b) Discuss***

***whether oligopoly is likely to be the most realistic market structure in a mixed economy. [13]***

(a) Perfect competition and monopolistic competition are two different market structures. Market structures are characteristics of markets that determine their level of competition. Any market's level of competition is based upon various characteristics including number of firms operating, barriers to entry and exit, nature of products produced, extent of market segmentation and firms' spending on marketing etc.

Perfect competition is market structure that is difficult to find in real world but it serves as good benchmark to evaluate level of competition for other types of market structures.



Perfect competition is defined as market where are large number of buyers and sellers and no one seller can significantly influence price levels. This is because each producer is producing a very small proportion of total market output and therefore price elasticity of demand is high. Any attempt to raise price will make consumers to shift to competitors' products that are homogenous and are generally the same quality.

Barriers to entry and exit are either not present in perfect competition or are very low. This helps new firms establish in the industry to share among existing firms' supernormal profits. Moreover nature of products produced by different firms is similar and due to production of homogenous products producers cannot price discriminate by establishing unique selling points and therefore firms are said to be price takers. Lastly there is no element of market segmentation to satisfy unique needs of different market segments.

As opposed to perfect competition, monopolistic competition is market structure that is mixture of perfect competition and monopoly. Monopolistic competition is market structure where there are not too much firms but more than monopoly and oligopoly but definitely less than perfect competition. This can be partially explained by the fact that such market structures have relatively high barriers to entry and exit. This makes it difficult for new firms to penetrate in such markets. Market segmentation is common characteristic of such markets where firms try satisfying unique needs of different consumer groups. This gives firms ability to price discriminate to capture consumer surplus. Though products of different firms is not exactly same in monopolistic competition but still products of different firms is quite similar and therefore it is important for firms to differentiate their products through more marketing and advertisement. Therefore unlike perfect competition firms that experience perfectly elastic demand curves, demand curves of monopolistically competitive firms is downward sloping.

However long run equilibrium is expected to be similar for both types of market structures. This is because of lower entry barriers new firms are expected to enter the industry and will reduce existing firms' supernormal profits and therefore firms in both types of market structures are expected to earn normal profits in long run.

(b) Oligopoly is defined as market structure where there are more firms than monopoly and duopoly but lesser firms than monopolistic competition and perfect competition. The



barriers to entry and exit are high. Entry barriers include high initial investment cost; high sunk cost is potential exit barrier. Use of illicit competition practices by existing firms can also deter new entrants. This is because collusion is frequently observed in such markets where comparatively smaller number of firms expects to benefit by collectively setting their prices and output levels.

Such market structures are generally seen in auto, telecommunication, mineral extraction and refining industries. All these industries require high initial investment in terms of expensive capital goods needed to operate in the industry. The nature of products is generally homogenous with relatively similar products produced by different firms. Limited number of firms and relatively similar products create substantial incentives for firms to collude among themselves.

Though collusion is illegal and is an illicit competition practice but it is hard to be identified by regulatory bodies if collusion is done through price leadership. Industry's dominant firm prices changes are followed by other players and generally there is increase in prices over time. Without collusion competitors will be reluctant to increase prices following their rivals' higher prices due to lack of trust. On the opposite, price reductions are followed because then firms fear losing their market share to their competitors. These price wars can significantly reduce firms' revenue and profits and therefore it is in their interests to engage in collusion practices.

Collusion allows existing firms to act as one producer which helps them maintain their abnormal profits even in long run unlike perfect competition and monopolistic competition.

Market structures are function of market circumstances and government intervention and they are rarely affected by type of economic system in place. In mixed economies some industries like agriculture might be perfect competition whereas some others as explained might be oligopoly and similarly natural monopolies might be present in some other. In Pakistan, Pakistan Railway is natural monopoly whereas petrol stations, telecommunication and auto industries are more of oligopolistic market structures.

Hence it can be concluded that economic system might be significant determinant of type and extent of government intervention in markets but it hardly directly influences market



conditions and therefore is not important factor explaining economies' market structures for different markets.

***24 In 2010 the directors of a major UK chocolate firm, worth over £10 billion, recommended that its shareholders accept a takeover offer from a large US food firm. The firm would not then be controlled in the UK. It was feared that some production in the UK would cease.***

***(a) Analyze what economic theory suggests might be the outcome of such a takeover for the enlarged firm and its workers. [12]***

***(b) Discuss the possible macroeconomic outcomes for a domestic economy of such a takeover by a foreign firm. [13]***

(a) Take-over is when one firm purchases another business to expand its scale of operations. Unlike merger where two firms mutually agree to work together to benefit from synergies, take-overs are complete purchase of one firm by another. This is often done through purchase of majority shares of any firm on stock exchange. Such external growth strategy might be beneficial for firm taking over the other firm but it is definitely not seen very positively by the employees and customers of firm that is being taken over. Employees' motivation of the firm being taken over might be low due to uncertainty about their job security. Redundancies are expected to occur due to duplication of resources that is quite inevitable consequence of any take-over. Similarly customers might now be less loyal towards the firm that has been taken-over. Shareholders are also expected to react negatively for they are not sure about their future expected returns and might want to liquidate their shares.

However given these problems do not exist or acquiring firm's management devise appropriate strategies to tackle such problems then new larger firm is expected to receive substantial economic benefits in terms of increased market share, higher revenue and profits and enhanced products' competitiveness in terms of lower cost of production.

Lower average cost of production due to increased scale of operations will positively affect larger business's products' competitiveness and will make them capture larger



chunk of domestic and international markets. However, too much expansion and lower employees' motivation might adversely affect firm's average total cost. Moreover higher revenue can help firm undertake more research and development to constantly improve their products and production processes. This will help larger firm create its unique competitive points making it more economically stable due to improved ability to satisfy shareholders' return expectations.

(b) A take-over of domestic firm by a foreign firm is not expected to have positive effects on the local economy. Foreign management of local firm would mean greater money outflow which is expected to adversely affect economy's balance of payments' situation. Persistent deficits due to greater money outflow in terms of higher profits being remitted back to host economies will put downward pressure on economy's exchange rates. This constant depreciation of economy's exchange rate is expected to cause cost-push inflation due to lower purchasing power of local currency in terms of foreign currency. This exchange rate depreciation can prove to be severe burden on economy's foreign currency reserves. Moreover weaker exchange rates and depleted foreign currency reserves mean that repayment of international debt will be burdensome.

Moreover such takeover of domestic firm by foreign firm will generate domestic employment opportunities if the new firm continue operating in local economy and commit to some new investments. However some of the business operations might be outsourced to the firm's home country resulting in lower economic activity contribution of the firm taken over towards the local economy GDP.

Moreover after takeover firm's senior management might be replaced with foreign nationals that prevent locals to benefit from lucrative employment opportunities and to improve their professional skill set.

Furthermore unlike domestic investment that is comparatively more stable than foreign investment is expected to generate more long term economic benefits for the economy. But if for certain industry local resources mainly labor force and enterprise lack necessary skill set that is needed to ensure industry's progress then such takeover might prove beneficial. Better human resource and capital goods might significantly improve industry's functioning.



***25 Population is increasing more rapidly in developing countries that can least afford it if they wish to encourage economic growth.***

***(a) What are the main characteristics of a developing country? [12]***

***(b) If a developing country wishes to become developed, the main aim of its government should be to control the growth of its population. Discuss this opinion. [13]***

(a) Developing economies are generally the ones with low income per capita. Illiteracy, poor health care, high crime rates and pollution levels are some other characteristics of developing economies. Low income levels result in limited consumption possibilities for economy's citizens. This prevents individuals to afford decent living standards. Poor sanitation and waste disposal techniques present serious health issues for citizens of developing economies. Poor health care and inadequate health care services result in serious health related issues and therefore result in low well-being for citizens of developing economies.

Moreover poor infrastructure limits citizens' mobility across different areas of the country that is expected to cause employment differential across different regions. Low economic activity result in limited employment opportunities and therefore cause high unemployment. Deteriorating terms of trade due to excessive reliance on primary products for export earnings and substantial balance of payments deficits are some other characteristics that are common among developing economies.

High repayments of international debt leave lower proportion of government revenue to be spent on developmental projects. Moreover worsening terms of trade often result in serious balance of payment deficits. Furthermore weak institutional framework often results in tax evasion and causes problems related to budget deficits. Poor health care, educational and infrastructure facilities at rural areas result in massive rural urban migration. This migration puts severe pressure on urban areas' resources and meeting residents' housing and food needs become very difficult. This result in excessive demand pulls inflation adversely affecting citizens' purchasing power.

(b) Economists believe in idea of optimum population growth that refers to the idea of maximizing output per head. Economies' optimal population level is that maximizes their



output per head for given level of other factors of production including capital, land and enterprise.

Any population below optimal level would mean lower output per head because of increasing returns to human resource that economies are experiencing and any population level higher than optimal level would mean than due to decreasing returns to scale output per head would be lower.

Therefore according to this concept policymakers should be mindful of this idea and should try achieving this optimal population level. However since growth of other factors of production can cause optimal population level to increase therefore economies that are experiencing constant growth of their other factors of production can afford to have rising population level.

Increased investment in capital good, increased investment in human capital, and improved quality of land all are expected to positively affect economy's production potential and therefore can ensure higher growth rates even during times of rising population levels. Hence depending upon specific economic circumstances economy's optimal population level will be determined and therefore every time population control might not be necessary to ensure achievement of economy's macroeconomic objectives.

However for developing economies where basic necessities for life are not in adequate supplies to satisfy the needs of growing population such countries are generally considered to be better off with lower population levels. Therefore low income economies that don't have decent supplies of education and health care services might need to explicitly target to control rapidly rinsing population levels. China recently used one child policy to control its population and to boost their GDP per capita levels.

Hence, in short, depending upon economy's economic circumstances optimal level of population will be determined.

***26 Discuss whether the higher wage rates paid in some occupations occur solely because some trade unions have a stronger bargaining power than others. [25]***



(a) Wages in free markets or perfectly competitive labor markets are determined through interaction of market forces of demand and supply. Increased labor demand for given level of supply will cause wages to increase and vice versa. On the opposite, increased labor supply will cause wages to fall and vice versa.

Wages are not always the product of market forces of supply and demand and there might be government and/or pressure groups involvement to affect the market outcome. Government, at times, set minimum wages to ensure comparatively higher earnings for lowest earners of the economy. This however causes labor supply to exceed labor demand and therefore results in unemployment. This might cause previously employed individuals to work on lower wages if they are unable to find jobs due to rising unemployment in the country and therefore imposition of minimum prices might result in creation of informal market where people are not paid government determined minimum wage.

Trade unions being employees' rights protection organizations work for attainment of improved working conditions and labor compensation. Closed shops that are the strongest form of trade unions are when all firm employees are expected to be part of certain trade union. This causes labor supply to become inelastic and therefore helps trade unions to negotiate higher salaries for their members. Trade unions' negotiations are generally to ensure fair wage rise that should compensate members according to their productivity and economy's inflation rates.

***27 It is important that an economy makes the most efficient use of its resources. This can only be done if firms are allowed to increase in size. Government regulation of firms should, therefore, be minimized.***

***Discuss whether you agree with this statement. [25]***

(a) Increased firm size if often beneficial in helping firms achieves their most economic objectives but not all objectives might not be achieved due to firms' larger scale of operations. However since economies of scale and increased market share, revenue and profits are often linked to larger business size therefore businesses will want to expand.



At times government regulation might limit businesses' growth. This is because regulatory bodies and governments are threatened by larger firms that are suspected to adversely affect consumers' well-being in terms of higher prices and lower consumer surplus.

However since markets frequently fail due to different reasons therefore it is important for governments to intervene to correct different market failures. No provision of public goods, presence of positive and negative externalities, over and under production of demerit and merit goods, existence of monopolies and information asymmetry are all different cases of market failure. Allocative and Productive inefficiency prevents economies to achieve economic efficiency and therefore make case for market failure. At times government intervention through various economic instruments to improve situations of market failure are beneficial but not always. This is when government itself fails resulting in generation of deadweight loss that is net loss of economic well-being. When such situation arises then obviously government intervention has not proven to be economically beneficially and government should not have intervened in the first place. However a lot of cases of market failure can be corrected through use of appropriate economic instruments including taxes, subsidies, etc. Similarly in absence of government intervention to regulate operations monopolies operations are expected to adversely affect consumers' well-being.

Similarly injection of more competition in different market structures through incentives for potential investors to help government to improve use of economy's resources. Greater competition will incentivize existing and new firms to operate at lowest possible average total cost curve to ensure cheapest possible production because that is often most important determinant of demand for firms' products. Moreover greater total output from different industries will make them improve their allocative efficiency.

However use of taxation and subsidies to correct market failure result in generation of deadweight loss that is net loss of economic well-being. In case of taxes government revenue generation is less than loss of consumers' and producers' surplus. This means that government gain is less than loss of consumers' and producers' well-being. Therefore overall society has become worse off. Similarly in the case of subsidies government expenditure is greater than combine gain in consumer and producer surplus.



Therefore use of both indirect taxation and subsidies adversely affect economies' state of economic welfare.

Since success of government intervention is dependent upon use of economic instruments and market circumstances therefore we can't objectively advocate for increased or reduced/no government intervention. Therefore policymakers should devise their intervention strategies considering particular market circumstances to ensure achievement of more desirable market outcome.

***28 (a) Explain how the quantity of labor employed and the wage rate are determined by a firm in a perfectly competitive labor market. [12]***

***(b) Discuss why wage rates might be different in practice from those in a perfectly competitive labor market. [13]***

(a) Market forces of labor demand and supply determine labor market equilibrium in free and competitive markets. Labor demand is function of firms' output and products' prices. Marginal revenue product of labor is product of good prices and employee's marginal product that is physical quantities of the good made by any employee. Labor demand for firms is marginal revenue product curve. At higher wage rates lesser quantities of labor are demanded and vice versa. Moreover since labor demand is marginal revenue product the downward sloping nature of labor demand can be explained by the fact of diminishing marginal product for labor. Earlier units of labor contribute more towards firm's output than their later counterparts. This is because of diminishing returns to labor input. Hence for initial units of labor firm is willing to compensate their employees with better compensation and vice versa. Labor supply on the other hand is upward sloping graph that shows larger quantity of labor supplied at higher wage rates and vice versa.

Where labor demand and labor supply interact that represents market equilibrium and determines wage rate and equilibrium quantity of labor employed.

(b) Perfectly competitive labor market is one where labor is homogenous and it is not possible to differentiate between different candidates applying for certain type of job. Moreover there are many people willing to work and many firms willing to hire these individuals. Imperfect labor market on the other hand is where there is one employer



known as monopsony market. Being sole employer, monopsony exploits labor by employing labor according to his profit maximization level where marginal revenue is equal to marginal cost of labor but each employee is compensated at average cost of labor.

Unlike perfect labor market assumption of labor being homogenous, labor is often classified and evaluated on different dimensions for the sake of their wage determination. Nuclear energy houses will mainly demand nuclear scientists and so on. Moreover financial institutions are generally looking for people who have undertaken their formal education in finance etc. Therefore since labor is not homogenous therefore it makes case for individual wage determination. All people will not be suitable for all available jobs and therefore labor markets can hardly be expected to be perfectly competitive. Moreover since all employees cannot be expected to be equally productive therefore wage differential across employees involved in similar activities might be economically justified.

However there are certain types of occupations where labor is comparatively very homogenous and moreover generic nature of job makes huge pool of people suitable for such job vacancies. For instance blue collar workers are expected to have less wage differential as compared to people with very specific skills/professional experience etc.

***29 Governments often suggest that there has been an improvement in the standard of living in their economy and support their statement by referring to a range of economic indicators. One of the indicators they use is GDP.***

***Discuss whether GDP is a reliable indicator of changes in the standard of living in an economy. [25]***

(a) Living standards refers to economy's quality of life. Improved living standards refer to idea that quality of life is improving and vice versa. Living standards are function of materialistic and non-materialistic well-being. Materialistic well-being refers to citizens' purchasing power. Higher average income levels will allow consumers to afford more goods/services which allow for enhanced consumption possibilities. Therefore high and



sustainable economic growth will allow for improved materialistic well-being. Hence policymakers are concerned about economies' economic growth and are constantly looking for strategies through which they can help countries enhance their growth rates. Therefore GDP being national income statistic can be to some extent used as proxy for economy's living standards. However since GDP does not account for non-materialistic well-being aspects like crime rates, pollution levels, voluntary work etc therefore sole reliance on GDP as living standard indicator will not be a good idea. Moreover, at times, GDP also does not provide holistic perspective of economy's materialistic well-being. Presence of non-marketable goods, voluntary work and depletion of resources are not taken into account in national income statistics. These issues prevent national income statistics to be reliable indicator of even materialistic well-being.

Therefore net economic welfare that adjusts national income statistics to account for economic good like voluntary work, non-marketable goods and informal sector and economic bad like pollution, depletion of resources and high crime rates is much better indicator of citizens' materialistic well-being. Similarly human development index and human poverty index can be good indicator of non-materialistic well-being through evaluating economies on education and health care dimensions.

Therefore sole reliance on national income statistics to gauge countries' development or living standards should be avoided and they should be used jointly with other developmental indicators to better estimate citizens' living standards.

Hence selection of developmental indicators should be based upon economists' specific research questions.

***30 Discuss, with reference to liquidity preference theory, whether interest rates are the main determinant of consumers' demand for money. [13]***

(a) Keynesian liquidity preference theory is an economic model that explains interest rate determination in an economy. According to this model money demand and money supply collectively determine interest rate that will prevail in any economy. Money supply



according to this model is fixed as it is determined by monetary authorities. Hence through this reasoning Keynesian economist argue that money supply will be perfectly inelastic to changes in interest rates. Money demand on the other hand is explained through transaction, precautionary and speculative motive. Since people want to make necessary transaction and therefore they want to carry certain amount of cash. Similarly often people hold more cash than they need for making necessary transactions and this motive of holding cash is known as speculative motive. Finally speculative motive is defined as reason for holding money when interest rates are low and therefore citizens prefer to hold cash instead of saving in financial institutions. Unlike transaction and precautionary motive that are regardless of interest rates; speculative motive is expected to be inversely related with economy's interest rates. Therefore during times of higher interest rates people on average are expected to hold lesser cash and vice versa.

Hence overall money demand is expected to be downward sloping line with regards to economy’s interest rates. Where money demand intersects with money supply that is where economy’s interest rates are.

***31 (a) A newspaper reported that ‘unemployment had risen for the third consecutive month.’ What might be the cause of a rise in unemployment? [12]***

***(b) Discuss whether achieving a fall in the level of unemployment should be the main macroeconomic aim of a government. [13]***

(a) Level of unemployment refers to number of people in an economy who are unable to find paid employment. This is different from rate of unemployment that refers to percentage of total labor force that is unable to find employment. There can be very different reasons for people being unemployed.

Keynesian and Classical economists have studied economies’ unemployment patterns from different perspectives and therefore have identified different factors for economies’ unemployment levels. Keynesian theory advocate for use of expansionary fiscal and



monetary policies to reduce high unemployment rates. On the other hand Classical economists have studied unemployment from microeconomics perspective and have identified frictional and structural unemployment as reasons behind countries’ unemployment.

Frictional unemployment refers to people who are casually, seasonally and at times voluntarily unemployed. Casual unemployment refers to unemployed individuals who are out of work between different employment periods like actors, farmers and people engaged with industries that experience seasonal demand. Structural unemployment refers to people who are experiencing reduced or no demand for their skills. Such unemployment is often due to technological advancements that not only generally reduce the demand for labor but it also makes certain individuals’ skill set obsolete. Such people require retraining to be readjusted in countries' labor markets. Therefore reliance on appropriate supply side policies is the most effective way of tackling such unemployment. Moreover due to economies' structural changes some industries will be booming and others will be experiencing reduced demand which means that people associated with shrinking or sunset industries experience serious unemployment problems.

Keynesian, on the opposite, provided macroeconomic justification for countries' unemployment levels. Their understanding of cyclical unemployment refers to high unemployment due to lower aggregate demand levels. Aggregate demand along with aggregate supply determines countries' national income levels. Therefore for given aggregate supply levels if economies' aggregate demand levels are low then they are expected to experience high unemployment levels. Hence to tackle such unemployment Keynesian suggests for reliance on demand management policies including monetary and fiscal policy.

(b) Yes policymakers should strive to achieve low unemployment levels. To achieve full production potential countries require best possible use of their all available factors of production including capital, labor, land and enterprise. Therefore to achieve productive efficiency it is utmost important for economies to achieve high employment levels.



Moreover high unemployment levels are frequently seem to be correlated with social problems including crime rates and high stress levels resulting in other serious problems. Therefore it is important for economies to achieve high employment levels. Furthermore people experiencing unemployment due to their skills becoming obsolete should be provided adequate financial and technical assistance from governments to ensure their smooth readjustment in labor force. Absence of appropriate supply side polices to readjust structurally unemployed individuals mean that such people remain unemployed for infinite time periods resulting in unnecessary depletion of economy's labor force.

However governments might be unable to ensure satisfactory employment of its entire labor force at all times. This is because some people are often voluntarily unemployed who do not want to work at prevailing wage rates. This might be because of their understanding that they are not fairly compensated for their services. Therefore these people might be unemployed even when economy's labor force is in equilibrium.

But maintaining low unemployment levels is not the only macroeconomic objective that countries should be concerned about. Achieving high and sustainable growth rates, maintain low inflation rates, balance of payments equilibrium and avoiding exchange rates fluctuations are often concerned to be countries' main macroeconomic objectives. Without higher national income levels countries cannot expect to provide improved living standards to their citizens. This means that increased economic activity should be countries' priority. Moreover low inflation rates are important to ensure healthier economy by encouraging higher investment levels. Similarly decent performance with regards to international trade is also important to ensure better utilization of economy's resources.

Hence though maintaining low unemployment levels is countries one of the top macroeconomic priorities but it is definitely not the only objective. Depending upon specific countries' specific economic circumstances they decide to prioritize upon varying and at times conflicting objectives to ensure improved quality of life for their citizens.

***32 The use of cars causes market failure. To achieve an efficient use of resources it would be better if governments intervened to affect both the production and the use of cars.***



***Explain the meaning of the terms 'market failure' and 'the efficient use of resources' and analyze whether economic theory can be used to support this argument. [25]***

Market failure refers to situation when economies fail to achieve efficiency with regards to production and/or allocation of their resources. This is because absence of economic efficiency results in lower living standards hence constraints countries' development. Government intervention is justified in cases of market failure when resource misallocation or inefficient production can be expected to adversely affect countries' living standards. Depending upon the nature of market failure governments decide upon their intervention instrument. At times governments need to provide goods/services that are not provided by private sector since it is not profitable for them to do so. In other cases other types of policy instruments are used including subsidies and taxes. For instance in cases of over-consumption of demerit goods and negative externalities indirect taxes are considered appropriate.

Any production process that causes external cost in terms of increased pollution should be subject to government legislation. Except for firms operating in perfect competition no other industry is productively and allocatively efficient.

Therefore depending upon the nature of market failure government should decide upon their appropriate intervention technique. In case of production externalities government should consider imposition of indirect taxation. This will make car manufacturers to pay for the external pollution cost being imposed upon individuals not involved in this economic transaction.

Moreover in case of allocative ineffiency government can try making the industry more competitive through incentivizing establishment of new firms. The more competitive the industry becomes lower will be its allocative inefficiency. Similarly increase in car producers will put greater pressure on all firms to become more cost effective. This will be to ensure their higher revenue and profits. Moreover since consumption of cars also result in pollution and therefore imposes external costs therefore ideally use of cars should also be subject to indirect taxation. This can be done by either imposing taxes on cars or on fuel. Since fuel usage is better measure of external cost imposed through



pollution therefore ideally governments should impose appropriate amounts of indirect taxes for users of private transport so that externality can be internalized.

***33 (a) Discuss whether it is always advantageous for a firm to grow in size. [12] (b) Explain the economic theory of profit maximization for a firm and consider whether firms are likely to follow this theory in fixing their price and output. [13]***

(a) Expansion of firms is important for that is the route through which they achieve their many important economic objectives. Higher market share, higher profits and increased returns to shareholders all become possible through firms' expansion. This is why firms especially the small ones are always looking for avenues to increase their size.

Moreover firms can achieve economies of scale by increasing their scale of production. This makes them more cost competitive with regards to their domestic and international competitors and therefore helps them to achieve higher profits.

Increased market share reduces products' price elasticity of demand and that in turn helps them charge higher prices. This makes other competitors' products less attractive and this in turn provides firms with increased market power making it easier for them to convert consumer surplus into producer surplus.

However there might be some economic benefits for firms to stay small. Provision of personalized services is one of them. This is when small firms are more capable to meet unique needs of their different customers/market segments. Since smaller firms are generally better able to capture smaller market segments therefore firms operating in such markets might never want to expand beyond a certain level where they fear to lose this unique competitive advantage.

Moreover some smaller firms are being outsourced some work from larger firms and therefore increase in firm's size is expected to adversely affect their business. Furthermore fear of experiencing diseconomies of scale might restraint firms to grow beyond a certain level. Too large of firm size is expected to make them become less cost competitive because of rising average total cost. Coordination problems resulting in



slower decision making process and lower labor motivation are major reasons behind firms experiencing diseconomies of scale.

Therefore though generally increase in firm size is desirable for firms but this is not always the case. Therefore depending upon firms' economic priorities and their market conditions they will choose between different objectives.

(b) Firms often try maximizing their profits to ensure best possible return to their shareholders. Firms are able to maximize their profits by producing an output where their marginal revenue is equal to their marginal cost. Any unit produced beyond this quantity will mean that marginal cost is greater than marginal revenue and it will therefore reduce firm's total profits.

The price that corresponds to firms' profit maximization quantity is known as profit maximization price. This is the price at which firm should sell its each unit. Firms in all types of market structures aim at achieving profit maximization. Perfect competition firms make normal profit in long run. This is because of too intense competition that erodes firms' short run abnormal profits. On the other hand monopolies and oligopolies are expected to make abnormal profit in both short and long run. Monopolistic competition firms also make supernormal profit but only in the short run. In long run due to lower barriers to entry new firms enter and higher supply reduce prices which eliminate existing firms' abnormal profits.

Hence depending upon market circumstances firms' profit levels will be determined. Higher profits levels are not always beneficial and therefore firms at times might try achieving some alternate objectives. Higher market share, improved brand image, lower average total cost, survival and revenue maximization are some alternate economic objectives.

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***34 Explain the difference between structural, cyclical and seasonal unemployment and discuss whether a general rise in income in a country would have the same effect on each of these types of unemployment. [13]***

(a) Structural unemployment refers to people getting unemployed because of structural changes in an economy. All economies are constantly undergoing structural changes in terms of changes in industries' significance in terms of their contribution towards country's GDP. Booming industries that start contributing greater output to economy's GDP generate more employment opportunities for country's labor force. On the opposite, sunset industries experience fall in labor demand because of their reduced output levels. These structural changes can be explained through various economic, political and social factors including international demand for industry's products, changes in domestic demand levels, discovery of raw materials/factor endowments needed to manufacture certain products. Technological changes are also expected to bring structural changes in an economy that will increase demand for certain labor that possess technological skills and reduced demand for labor that do not have technological skills and therefore are substituted by capital goods.

Cyclical unemployment as explained by Keynesian economists is caused due to low economic activity. Lower economic activity levels due to high interest rates are expected to adversely affect local consumption and investment levels. Or pessimistic future expectations of consumers might negatively affect their current consumption, investment etc. Therefore during booming periods such unemployment is low and vice versa. Expansionary monetary and fiscal policies are expected to be effective tools for managing such unemployment problems.

Lastly frictional unemployment is Classical concept that refers to people who are voluntarily or casually unemployed. Voluntary unemployment refers to people who have job offers but they do not want to work at prevailing wage rates because they do not consider current wage rates as decent compensation of their efforts. Casual unemployment refers to seasonal unemployment. People who are out of work during usual periods of employment are known as seasonally or casually unemployed. This is



when demand for products is seasonal and therefore labor demand that is derived demand is also seasonal.

Increase in national income is only expected to reduce cyclical unemployment but not casual, seasonal or structureal.

***35 'Wage determination in the factor market is just like price determination in the product market. It is entirely dependent on the forces of supply and demand.'***
***Do you agree with this statement? [25]***

(a) Wage determination in free markets is function of labor demand and supply just like prices of goods/services are determined through demand and supply for goods. Higher the demand for given supply, higher will be goods' prices and vice versa. Higher the supply of given goods, lower will be their price and vice versa.

Similarly if for certain occupation demand for labor is higher compared to its supply then wage level will be high and vice versa. Often demand and supply of different occupations explains wage differential across different occupations/professions. However, at times, trade unions and government intervention might also be relevant in explaining wage differential across professions.

Price discrimination might be explained through the concept that market is divided into different groups and therefore different demand/supply of different market segments allows firms to price discriminate. However this might also be explained through the fact that producer is providing unique services to its customers and knowing their willingness to pay can charge them differently. Therefore if this is true than firms are not charging based upon market demand and supply condition but are charging consumers based upon their individual demand curves to convert maximum possible consumer surplus into producer surplus.

Therefore market forces might not always fully explain varying price and wage levels. Similarly for the labor market it is quite possible that individuals are able to separately negotiate their wages. Therefore depending upon individuals' unique academic and professional qualification an employer might be willing to compensate more or less to



one employee as compared to another employee even if they are involved in similar tasks.

***36 'Lack of consumer spending causes recessions. Recessions do not improve a country's standard of living. It is always better, therefore, to encourage consumer spending for this improves a country's standard of living.'***

***(a) What is a recession and is it always caused by a lack of consumer spending? [12]***

***(b) Discuss what policies a government may use to try and end a recession. [13]***

(a) Recession is defined as periods of low economic activity. Recessions are result of low aggregate demand levels that result in low economic activity and therefore low national income. Aggregate demand of an economy comprises of consumption, investment, government spending and net exports. Lower aggregate spending due to lower consumption, investment, government spending or net exports will result in recessions reducing national income.

Though lower consumption being one component of aggregate spending will result in lower aggregate demand but other components are also important. Therefore policymakers should not only worry about consumption and should try enhancing consumption by reducing marginal propensity to save but they should also ensure higher investment, government spending and net exports.

Higher consumption can be encouraged by reducing average marginal propensity to save. But lower marginal propensity to save will adversely affect economy's aggregate investment levels. Hence higher consumption might be coming at lower investment levels. Moreover if government does not heavily tax its citizens then long term government spending cannot be increased. Hence higher government spending is expected to adversely affect consumption due to lower average disposal income levels.

However net exports might be increased through effective supply-side policies. This can be done through subsidized research and development to positively affect product or process innovation. Moreover increased investment in human capital will result in higher human productivity which is expected to enhance products' competitiveness. Moreover



reduced imports through use of protectionist policies are also expected to enhance net exports.

Hence just ensuring higher consumption levels might not be sufficient to avoid recessions and therefore policymakers should try maintaining decent levels of all aggregate demand components.

(b) Expansionary monetary and fiscal policies are expected to be effective in eliminating economies' recessions. Lower interest rates are known as expansionary monetary policy. Reduced borrowing costs encourage consumers to consume and invest more. Reduced borrowing costs due to lower interest rates are expected to boost firm's future profits that rely on loans for expansion of their operations. Similarly lower borrowing costs are less of burden on consumers' future income if they want to increase their current consumption through increased borrowing.

Similarly expansionary fiscal policy is when government direct taxation is low and government spending is high. Lower direct taxation will positively affect consumption whereas government spending directly influence aggregate demand levels to boost local economic activity.

Moreover use of appropriate supply-side policies are expected to enhance economies' products' competitiveness and therefore will help them maintain high net exports levels. Higher exports and lower imports will increase countries' national income levels. Countries having competitive products are less likely to face recessions because low domestic economic activity is expected to be compensated through higher export revenue. Therefore government spending should be directed at appropriate supply-side policies.

Reduced marginal propensity to save by income and wealth redistribution schemes might be an effective tool of increasing national consumption levels. This is because rich people often have lower marginal propensity to consume as compared to their less wealthy counterparts. Similarly lower marginal propensity to import and marginal rate of taxation are also expected to increase countries' multiplier effect. This means that each dollar increase in injections will result in higher overall increase in national income.



***37 'There is no point in calculating figures for GNP. They are never an accurate estimate of welfare, and people are more concerned about crime, pollution and health than GNP.' Do you agree with this argument? [25]***

(a) Gross national product is measure of economies' nationals' income. This is calculated by estimating aggregate income of country's nationals. Unlike gross domestic product that accounts for income of people residing in an economy; gross national income estimates income of country's nationals (which is regardless of their place of residence).

These two are not the only national income statistics and therefore few more. However all national income statistics are measuring increase in citizens' income levels which is definitely not a holistic measure of their level of development. Crime, pollution and other social bad that adversely affect living standards are not explicitly accounted for in any national income statistics.

Economists therefore have developed certain development indicators that explicitly account for other non-material dimensions of living standards that are expected to impact citizens' quality of life. Human Development Index and Human poverty index and Net Economic Welfare are some of these.

Unlike national income statistics that only record changes in countries' average income levels, these development indicators provide more holistic estimate of countries' extent of development. Unlike HDI and HPI that only use countries' performance on educational and health care services as proxy for their development, net economic welfare using national income as the starting point adjust for economic and non-economic variables that are expected to affect citizens' living standards. For instance pollution, high crime rates and lack of political stability will be deducted from economies' national income statistic and anything that is expected to positively affect countries' living standards including voluntary work and non-marketable goods like free childcare services are added to national income statistic for them to depict more realistic picture of economies' quality of life.

Therefore since people are rightly concerned about these issues hence they should be adjusted in quantitative national income measures to provide holistic picture of countries' level of development.



***38 (a) Explain what distinguishes a developing country from a developed country. [12] (b) When a country achieves 'developed' status does this mean that it has solved all its economic problems? [13]***

(a) Countries having higher national income are classified as developed and others with incomes below certain thresholds are defined as developing. This World Bank classification of countries provides general idea about citizens' living standards residing in these economies.

Though national income alone is not an accurate and holistic measure of economies level of development but since higher incomes mean improved consumption possibilities therefore this basic classification is often useful in comprehending countries' development trajectories. Economists have over times established specialized development indicators that explicitly account for different economic and non-economic variables that are expected to affect citizens' quality of life. Human Development Index and Human Poverty Index being proxy of countries' educational and health care services provide comparatively better estimate of their development levels. Therefore economists these days use these development indicators along with countries' national income statistics to better gauge their level of development.

Higher national incomes do not always translate into improved living standards. If higher growth rates are coming at the expense of future generations' living standards then obviously sole reliance on national income statistics will portray misleading picture of economies' level of development. Similarly if increase in national income is coming from increased government expenditure on military goods then that also does not mean better quality of life. How well an economy is doing with regards to individuals' personal and professional development opportunities is true measure of their development. This multidimensional nature of development has been substantially highlighted in Amrita Sen's contribution to economics literature.

Therefore national income statistics alone should not be used to gauge economies' level of development. Use of development indicators and other proxies to capture countries'



performance on important non-materialistic dimensions is also important to better gauge countries' extent of development.

(b) Development being a qualitative and multidimensional variable is hard to estimate and is relative measure of countries' living standards. Unlike growth that is quantitative variable and is therefore objectively analyzed; development is compared across economies to better analyze differences in their living standards. There is no maximum extent of development that any economy can attain and therefore no matter how much developed an economy has become there will always be margin for improvement. Meaning if an economy at this point in time is most developed then it does not mean that it cannot attain higher development levels. Any improvement in citizens' living standards that are not adversely affecting any individual or group of individuals will mean overall higher development.

Though development is economies' ultimate goal but attainment of certain development does not mean that countries have overcome their all economic problems/issues. To ensure sustainable growth economies need to be constantly in search of ways to maximize their output for available stock of goods. Moreover economies should also ideally try enhancing their potential growth through improvement in their factors of production. Increased investment in research and development is needed to improve stock of capital goods. Furthermore any investment in economy's human capital might not be enough to sustain its very long term growth which means that countries will constantly need to devise appropriate strategies to enhance their labor force productivity. Similarly maintenance of favorable position on exchange rates and balance of payments is important to ensure achievement of growth objectives.

Since economies, regardless of their development, have to constantly take care of innumerable issues therefore it will be wrong to claim that developed economies are no more facing any economic problems. Ageing population resulting in reduced work force, outbreak of new diseases adversely affecting labor productivity and innumerable issues such as these are require attention for policy makers to ensure achievement of countries' macroeconomic objectives.