

Chapter 7 Prices, resource allocation and concept of the margin

Answers to Knowledge checks

- 7.1** Under rational choice, consumers are assumed to maximise satisfaction, or utility. This idea was introduced in Chapter 1.
- 7.2** The additional benefit to the firm would be the revenue that it receives from selling an additional unit of its product — the **marginal revenue**.
- 7.3** The marginal utility curve would drop off very quickly indeed, as you would gain very little utility from a second haircut if you had just received one!
- 7.4** If consumer incomes increased the *MU* curve would shift to the right.
- 7.5** If there is a glut in the market, the supply curve has shifted to the right, so (*ceteris paribus*) the equilibrium price will fall.
- 7.6** The difficulty arises because the economy can only produce more agricultural goods if it sacrifices production of manufactured goods. This trade-off could only be resolved by knowing more about society's preferences.
- 7.7** The two key aspects of efficiency are *productive efficiency* (whether firms are producing on the *PPF*) and *allocative efficiency* (whether firms are producing an appropriate balance of goods to meet consumer preferences).

Answers to Exercises and Case studies

Exercise 7.1

- a** It is somewhat difficult for me to comment on this question, as I do not know you, nor do I know about the decisions that you take in your daily life. However, how about the following? Your alarm clock wakes you on one of those cold, dark winter mornings. If you don't get up you will have to rush your breakfast, or be late for college. You could decide by weighing up the benefits of taking a few moments extra in the warmth of your bed against the costs of a rushed breakfast or being late for college. In this case you would be balancing the marginal benefit of a few moments in bed against the marginal cost of missing breakfast or being late. Of course, you may not actually think of the decision in those exact terms, but it is one way of analysing that decision. Or you are having dinner at a restaurant. Extra chips or dessert?
- b/c** Again, I don't know how you take your decisions. Would you freely choose to do something if there is an alternative that you would enjoy more?

Exercise 7.2

- a** Point *B* is productively inefficient, as it lies inside the frontier. By employing resources more effectively, more of each product could be produced.
- b** Points *A* and *C* both represent points of productive efficiency, as both lie on the frontier.
- c** This is trickier: in order to identify a point of allocative efficiency we need information about consumer preferences. Either *A* or *C* could be such points, but we do not have enough information to be sure.
- d** Point *D* is outside the frontier, and therefore cannot be reached given existing resources. The only way to reach it would be to expand the productive capacity of the economy. This could occur if there was an improvement in technology, or an increase in the amount of labour, capital or other inputs available in the economy.

Case study 7.1

Jewellery

The first paragraph indicates that the market starts off in equilibrium, with the jewellery sellers just making enough profit to remain in business. This can be seen in Figure A7.1, where D_0 represents the original demand curve and S_0 is the supply curve.

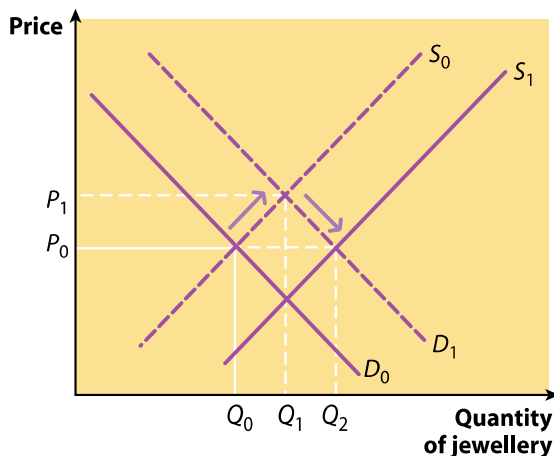


Figure A7.1 The market for jewellery

The equilibrium price is P_0 and the quantity traded is given by Q_0 . The publicity given to the jewellery results in a rightward shift of the demand curve to D_1 , and the equilibrium price rises to P_1 . The jewellery makers find that they are selling more jewellery — namely the amount Q_1 . There has been a movement along the supply curve. However, this situation does not last long, as new jewellery sellers join the market, shifting the supply curve to S_1 . The equilibrium price falls back to the original level P_0 , but with higher quantity traded of Q_2 . There has now been a movement along the demand curve, and the market has settled down again.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 d. Produce only if the marginal cost is lower than or equal to the marginal benefit
- 2 d. A person gains less marginal utility from each additional unit consumed
- 3 a. When measured in terms of money, demand and marginal utility are the same thing
- 4 b. A market is both allocatively and productively efficient
- 5 c. Price equals marginal cost

B Knowledge and understanding questions

- 6 The concept of the margin is based on the additional benefit gained from the production or consumption of one additional unit, for example the extra benefit gained from the consumption of one more chocolate bar.

An explanation of the concept of the margin AND an example	2 marks
An explanation of the concept of the margin OR an example	1 mark

- 7** Productive efficiency is attained when a firm operates at minimum cost, choosing an appropriate combination of inputs and producing the maximum output possible from those inputs.

A full explanation of productive efficiency	2 marks
A vague or partial explanation of productive efficiency	1 mark

C Stimulus response question

- 8 a** 20 utils – 17 utils = **3 utils (answer)**

Note: award 1 mark each for identification of the correct figures

- b** As customers get fuller they get less satisfaction from eating more food due to the law of diminishing marginal utility (1 mark). This eventually leads to a customer getting over-full and uncomfortable, reducing their total utility when the sixth plate of food is consumed (1 mark).

A full explanation	2 marks
A vague or partial explanation	1 mark

- c** Rationally customers should only eat five plates of food, which equals a cost to Sandy of £12.50 (1 mark). Therefore the rice of £13 will allow her to make more profit as long as her customers are rational in their consumption (1 mark).

A full explanation	2 marks
A vague or partial explanation	1 mark

- d** Factors may include:

- Costs of supplying food may increase
- Costs of running the restaurant may have increased (labour, capital items, etc.)
- Taxes may have increased for supplying food in a restaurant (business rates, VAT, etc.)

Two factors explained	4 marks
One factor explained AND one factor identified	3 marks
One factor explained OR two factors identified	2 marks
One factor identified	1 mark