

## Fundamentals of Economics

### Assignment No. 2

Q. No. 1: Briefly explain about the market failure, demand side failure and supply side failure.

Ans..

#### **Define Market Failure.**

Market failure is a situation in which the allocation of goods and services is not efficient.

State the two types of Market Failures and give an example of each one.

1. Demand-side market failures happen when demand curves do not reflect consumers' full willingness to pay for a good or service.
2. Supply-side market failures occur when supply curves do not reflect the full cost of producing a good or service.

Q. No. 2: Discuss briefly about the externalities and government intervention.

#### **EXTERNALITIES**

An externality is a cost or a benefit imposed upon someone by actions taken by others. The cost or benefit is generated externally to that somebody.

- An externally imposed benefit is a positive externality.
- An externally imposed cost is a negative externality.

#### **Examples of Negative Externalities**

- Air pollution.

- Water pollution.
- Loud parties next door.
- Traffic congestion.
- Second-hand cigarette smoke.
- Increased insurance premiums due to alcohol or tobacco consumption.

### **Examples of Positive Externalities**

- A well-maintained property next door that raises the market value of your property.
- A pleasant cologne or scent worn by the person seated next to you.
- Improved driving habits that reduce accident risks.
- A scientific advance.

## **GOVERNMENT INTERVENTION**

### **PROS**

- Provide public goods (e.g. law and order) not supplied in free market.
- Provide merit goods (education, health) underprovided in free market
- Reduce inequality and poverty through tax and benefit system.

Gov't regulations can protect environment, workers and consumers.

- Protect long-term interests of environment.
- Limit monopoly power.

### **CONS**

- Government failure - poor information, time lags
- Lack of incentives to be efficient in the public sector.
- Government influenced by powerful pressure groups.
- Disincentive effects of higher taxes.
- Disincentive effects of welfare programs.
- Government ownership may lead to less choices

Q. No. 3: Define economic cost. Discuss the accounting profit and economic profit with the help of formula.

Ans..

**Economic costs**

They are equal to opportunity costs of the resources used, whether those resources are owned by others or by the firm

**Accounting profit**

It is what remains after it has paid individuals and other firms for materials, capital, and labor they supplied

**An economist views economic profit (pure profit) as:**

TR less economic costs (including normal costs)

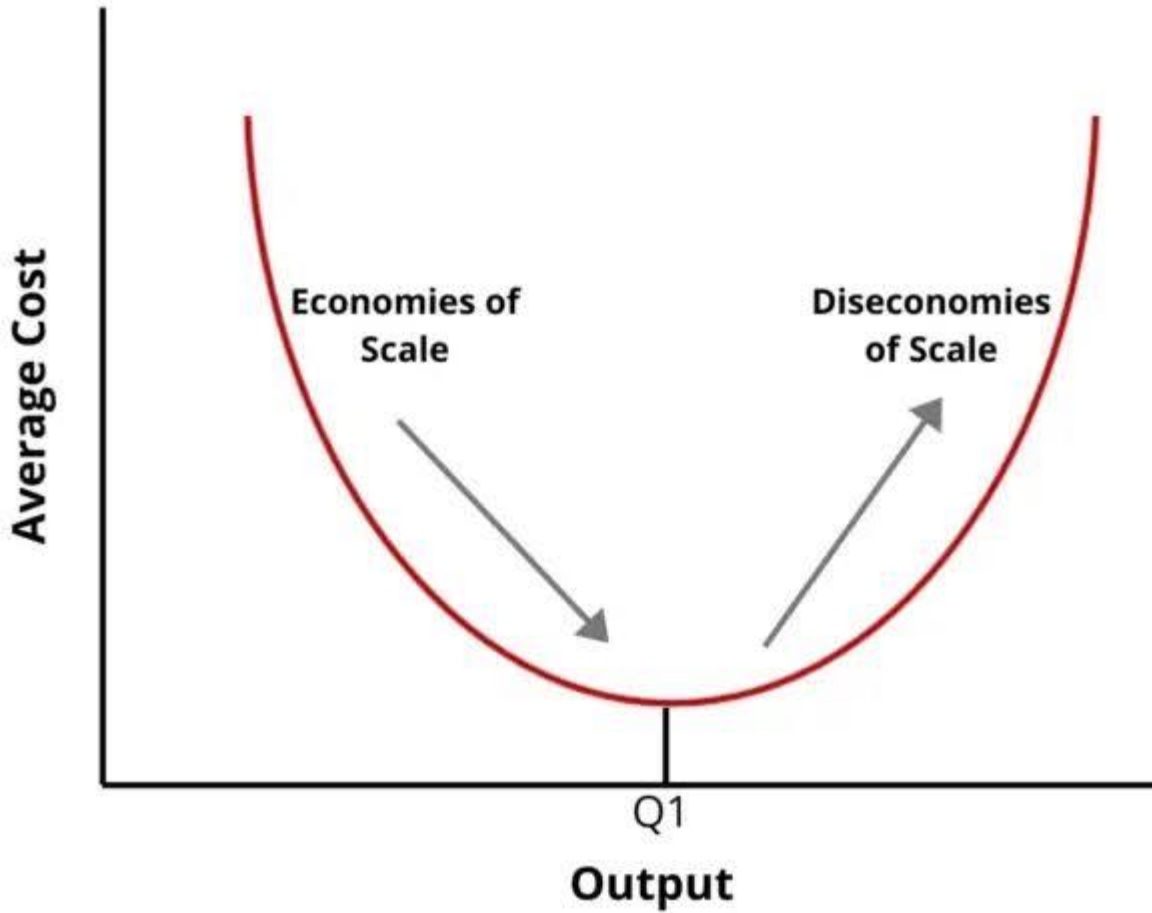
Q. No. 4: Briefly discuss about the economies and diseconomies of scale.

**Economies of scale**

Economies scale exist when long run average total cost decreases as output increases.

**Diseconomies of scale**

Diseconomies of scale occur when long run average total cost increases as output increases.



Constant scale constant returns to scale occur when costs do not change as output increases..

Q. No. 5: Discuss briefly the four market models.

## 8a – Four Market Models

PRODUCT MARKET MODELS				
CHARACTERISTIC	Pure Competition	Monopolistic Competition	Oligopoly	Monopoly
Number of firms	Very many	Many	Few	One
Type of product	Standardized (Homogenous)	Differentiated	Standardized or differentiated	Unique, no close substitutes
Control over price	None (price takers)	Some, depends on product differentiation	A lot with collusion, limited with mutual interdependence	A lot
Barriers to entry	Very easy, no barriers	Relatively easy	Significant barriers	Blocked
Nonprice competition	None	Very much	Very much with differentiated products	Would expect none, but some public relations advertising
Examples	Agriculture (like wheat, soybean, corn); stock market	Restaurants, hotels, pubs, retail trade (pharmacies, gas stations, grocery stores)	Steel, automobiles, farm implements, smart phones, video streaming, airlines, health insurance	Local public utilities (electricity, natural gas, water)

Q. No. 6: Define the long run in pure competition and also discuss the profit maximization in the long run.

Ans:

### **Summary of Long Run pure Competition**

1. In the long run, every competitive firm will earn normal profit, that is, zero profit

2. In the long run, every competitive firm will produce where price (P) is equal to marginal.

cost (MC),  $P = MC$ .

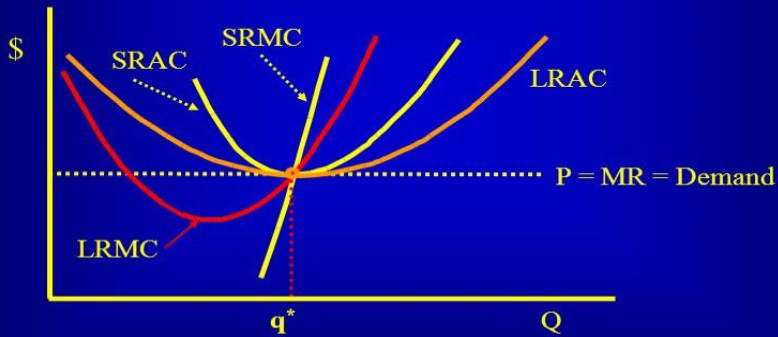
3. In the long run, every competitive firm will produce where price (P) is equal to the minimum of short run average cost (SRAC),

$P = SRAC$ . This implies zero economic profit.

4. In the long run, every competitive firm will produce where price (P) is equal to the minimum of long run average cost (LRAC = ATC),  $P = \text{minimum LRAC}$ . This implies that no identical firms will want to enter or exit.

5. Putting it all together:

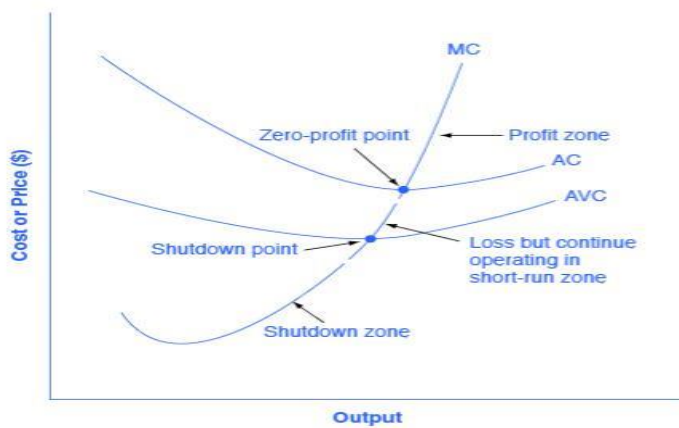
## Long Run Equilibrium



$$PMC = \min SRAC = \min LRAC$$

## PROFIT MAXIMIZATION IN LONG RUN.

The profit-maximizing choice for a perfectly competitive firm will occur where marginal revenue is equal to marginal cost—that is, where  $MR = MC$



Q. No. 7: Discuss the determinants of resource demand.

### **Determinants of Resource Demand**

#### Change in demand for the product

- Higher demand for lemonade would increase the demand for lemons

#### Change in efficiency

- The more efficient a resource is, the more valuable it is to a business (increase in MRP)

#### Change in the price of a substitute resource

- Firms demand more of the cheaper resource

#### Change in the price of a complementary resource

- If one resource gets cheaper, firms will demand more of the complementary resource as well

Q. No. 8: Discuss the role of our government getting the taxes and putting the expenditure for the sake of developing country economy.

To help fund public works and services—and to build and maintain the **infrastructure** used in a country—a government usually taxes its individual and corporate residents. The tax collected is used for the betterment of the **economy** and all who are living in it.

In the Pakistan and many other countries in the world, income taxes are applied to some form of money received by a taxpayer. The money could be income earned from salary, capital gains from investment appreciation, dividends or interest received as additional income, payments made for goods and services, and so on.

**With best wishes**