

## **Micro Economic Essays**

These are some suggested micro economic essays. The essays are from different exam boards. In practise they ask similar questions so they will be helpful whatever your exam board.

There are different ways to answer questions. But, all these answers contain enough material to get the top grade.

Whenever the question requires evaluation, the essay contains the necessary critical distance. On the last page, there are some general tips for evaluation.

**Note:** These essays are for revision purposes giving suggestions for how to answer questions. Don't try to pass them off as your own work.

For more micro economic help. See also the Economics Revision Guide available at [www.economicshelp.org/](http://www.economicshelp.org/)

# Micro Economic Essays

## Market Structure

1. Discuss how firms within an oligopolistic market compete.
2. Discuss whether monopoly is always an undesirable form of market structure.
3. Explain how interdependence and uncertainty affect the behaviour of firms in Oligopolistic markets
4. Evaluate the view that only producers, and not consumers, benefit when oligopolistic firms collude to try to reduce the uncertainty they experience.
5. Explain why contestable markets generally function more efficiently than non-contestable markets.
6. Explain various barriers to entry to a market and how these barriers might affect market structure.
7. In the past, utility industries such as the postal service, electricity and gas, have been heavily protected by entry barriers. Evaluate the possible effects on efficiency and resource allocation of removing these barriers.
8. Explain the meaning of price discrimination and the conditions necessary for price discrimination.
9. Evaluate the view that, because price discrimination enables firms to make more profit, firms, but not consumers, benefit from price discrimination.
10. Evaluate different ways in which governments could make markets more competitive.
11. Discuss the extent to which new technology, such as the internet, has increased or decreased the competitiveness of markets.

## Government Intervention

1. Discuss the impact of deregulation on the local bus industry in Great Britain.
2. Evaluate the view that the government should give financial assistance to firms producing cars in the UK to increase their competitiveness.
3. Evaluate the view that government intervention can correct all the market failures caused by the effects of economic activity on the environment.
4. In some European countries, price controls are imposed upon pharmaceutical companies. Discuss the case for government intervention to control market prices.
5. Discuss whether the government should ever consider nationalising privatised industries?

## Labour Markets

1. Footballers receive high pay, while those in disagreeable occupations, such as road sweepers, are among the most lowly paid. How does economic theory explain such differences in pay?
2. Assess the case for and against the government intervening to raise the disposable income of workers on low pay.
3. Do you agree that if a trade union persuades employers to increase wages in a labour market, employment must inevitably fall in that labour market? Justify your answer?
4. Assess three labour market policies which might be used to increase the level of employment amongst incapacity claimants and lone parents on benefits.

5. Discuss the impact of net migration on UK labour markets
6. Discuss the relative merits of welfare benefits and taxes for reducing relative poverty in the UK.

### Market Failure / Transport

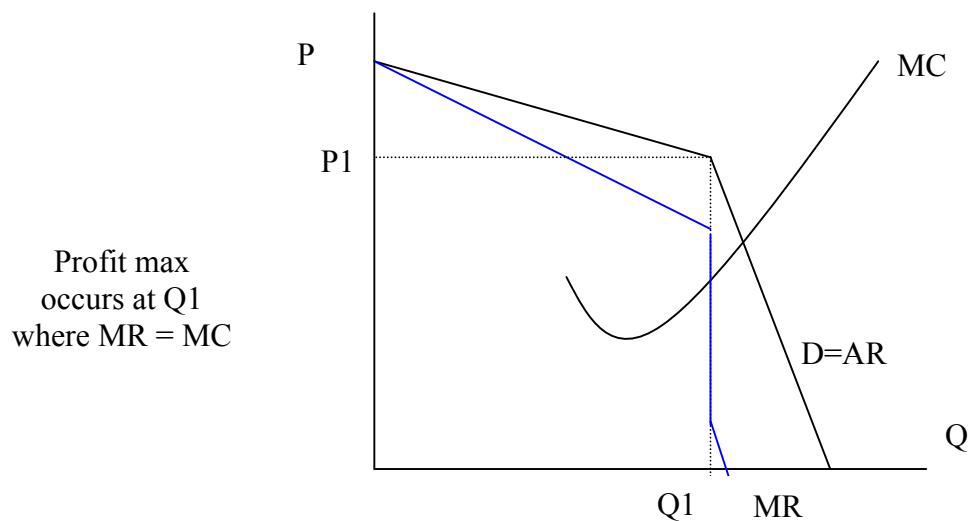
1. Discuss whether Cost-benefit analysis is a practical way to decide whether projects, such as new roads, should go ahead.
2. Discuss the case for a toll on motorway travel.
3. Discuss whether giving increased subsidies to firms providing bus services would correct the market failure arising from urban road congestion.

### 1. Discuss how firms within an oligopolistic market compete.

An oligopolistic market is a market structure dominated by a few firms. One definition of an oligopoly, is a market where the five firms biggest firms have 50% or more of the market share. There are different ways firms in an oligopoly may compete.

Firstly, the kinked demand curve model suggests that prices will be stable because firms have little or no incentive to change prices. If a firm increased price, they would be uncompetitive and lose market share; therefore demand is price elastic for a price increase. If they cut prices, other firms follow suit and there is a price war; therefore, if they cut prices, demand will be price inelastic and they will have less revenue. Therefore, the best solution is to keep prices stable.

### The Kinked Demand curve



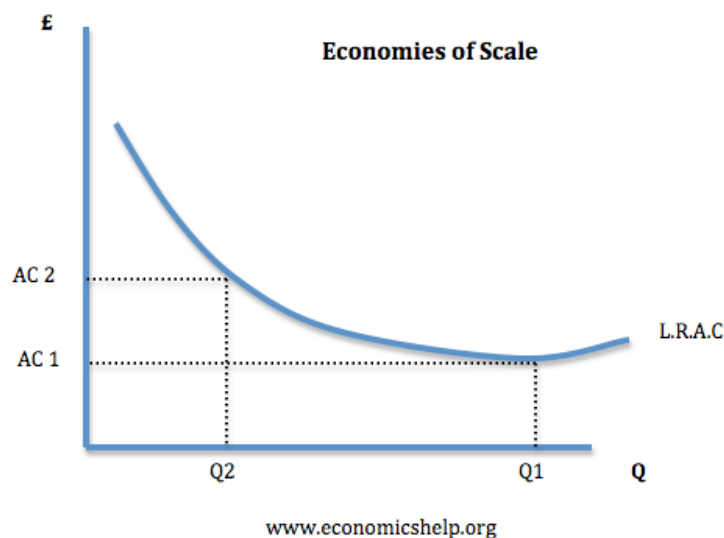
Because there is no incentive to change price, firms compete through non-price competition such as advertising, branding, after sales service and offering a better product. In other words firms try to sell goods through measures other than price.

Non-price competition is particularly important for markets where branding is important such as soft drinks, clothes and mobile phones. Firms will try hard to differentiate their products through extra features, good reputation and effective advertising campaigns.

However, the kinked demand curve has limitations. It doesn't explain how prices were arrived at in the first place. In the real world, it doesn't explain why prices in oligopoly do change. It is only one theoretical model to explain some behaviour under certain conditions.

Also, if firms seek to maximise market share rather than profit maximisation then they may compete by cutting prices. Although, this makes them less profit, some firms may see increasing market share as the most important long-term objective. If demand is price inelastic, cutting prices will lead to lower revenue, however a firm may feel it is worth it. This is because cutting prices leads to increased market share, and it may enable a reduction in competition in the long term. Also with higher output they may be able to benefit from economies of scale and get rid of surplus stock. However, price wars are often selective (e.g. supermarkets cutting certain products) or short term. Also, shareholders often prefer profits and dividends to growth maximisations

If there are a small number of firms, and there are barriers to entry in the industry, then firms in oligopoly may be able to collude. This is when they formally or tacitly agree to restrict supply, keep to quotas and therefore maintain higher prices which maximise profits. Collusion is actually illegal, but if there are barriers to entry then it may be possible for firms to tacitly collude and avoid detection. Collusion will be more likely if there is a dominant firm in the market who can influence market by setting output and prices.



If there are large economies of scale in the industry, the oligopoly is more likely to be highly concentrated with less competitive pressures.

The outcome of an oligopoly depends on several factors. If the oligopoly has very high barriers to entry, such as, economies of scale and strong brand loyalty, then it will be much easier for firms in oligopoly to act a like a monopolist and set higher

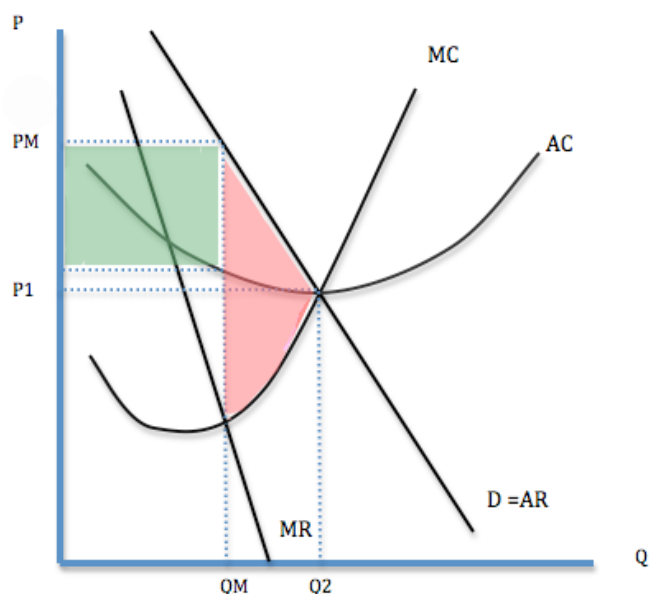
prices. For example, the market for cola is highly concentrated; a large share of the market is held by two firms (Pepsi and Coca-Cola), and because of strong brand loyalty there is little price competition in this oligopolist market structure.

However, in other oligopolies, such as clothing, there are lower barriers to entry and more competition. If an oligopoly is contestable, (no barriers to entry), then the oligopoly may be very competitive and the outcome similar to competitive markets.

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## 2. Discuss whether monopoly is always an undesirable form of market structure.

A pure monopoly is when there is only one firm in the industry. However, a firm with a high market share (greater than 25%) is said to have monopoly power. A monopoly is seen as undesirable for several reasons.



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A monopolist maximises profit where  $MR = MC$ . Therefore it sets a price (PM) higher than in a competitive market (P1), leading to a fall in consumer surplus. Selling at the price of Pm, means that the firm is allocatively inefficient because at Qm, price is greater than marginal cost. Secondly, this monopoly diagram is productively inefficient because it is not the lowest point on the average cost curve. (Note if the market was competitive the firm would produce at P1, where  $D=AC+MC$ ; this is normal profit and allocatively efficient)

A monopoly may also have fewer incentives to cut costs because of a lack of competitors. Therefore, it will be x inefficient. This means the cost curves of a monopoly will be higher than they would if there was more competitive pressure. Similarly a monopoly may lack the incentives to develop new products and offer a

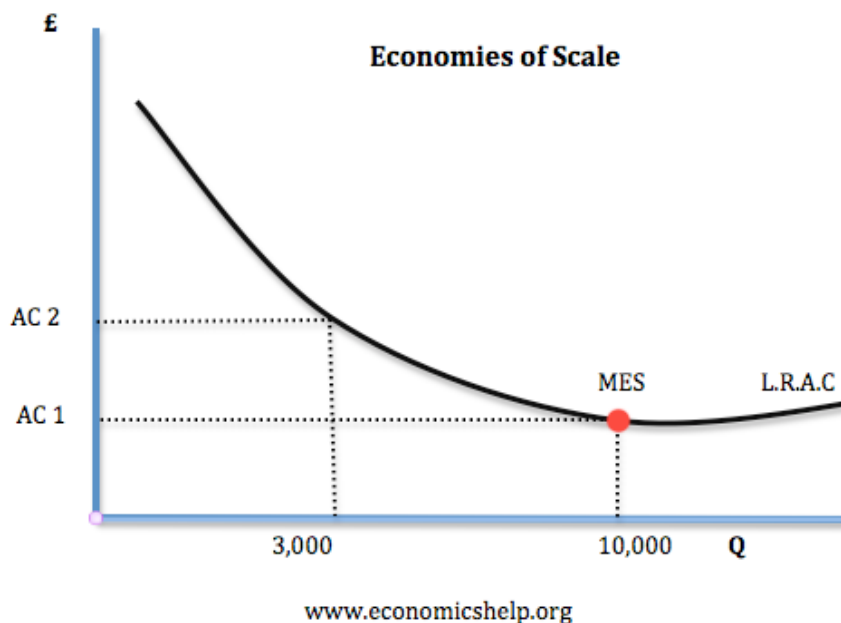
good quality service. e.g. the standard of food in a service station arguably drops due to lack of competition.

Some monopolies may become too big and therefore suffer from diseconomies of scale because in a big firm it is harder to co-ordinate and motivate workers.

Monopolies may also be able to use their market power to pay lower prices to suppliers. For example, a big supermarket like Tesco may be able to squeeze the profit margins of farmers who supply them. Tesco's can use their monopoly buying power to reduce incomes of farmers because farmers don't have any alternatives to selling to supermarkets.

Lastly, monopolies make supernormal profit and this can be said to be an inequitable and unfair distribution of resources in society.

However, monopolies are not always against the public interest. If an industry has high fixed costs, then the economies of scale may mean the most efficient number of firms in an industry is one.



If industry demand was 10,000, then the most efficient number of firms would be one. If there were more firms, then the average costs would be higher. However, this kind of natural monopoly is only relevant to certain industries like tap water and national networks of electricity and gas distribution. In many industries, economies of scale are not that large. Even in the car industry, which has high fixed costs and scope for specialisation, there is still enough room for several firms.

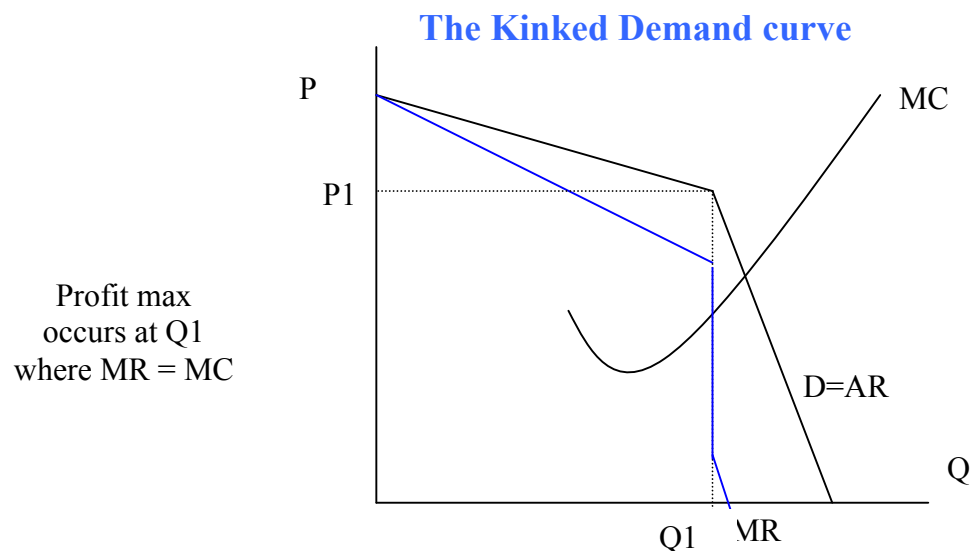
In some cases, monopoly can use their supernormal profit to invest in research and development. For example, a drugs company may rely on a patent to make supernormal profit which justifies the high cost of research and development.

However, for many industries like supermarkets, it would be difficult to justify a monopoly as supermarkets have limited need for research and development. Thirdly, it is often assumed monopolies face less competitive pressure and so are likely to be x-inefficient. However, this is not always the case. A firm may gain monopoly power because it is efficient and dynamic; for example, Google, has monopoly power, but people wouldn't consider it to be inefficient. The desirability of monopoly depends on the market and industry. As a general rule, competitive markets have several advantages over monopolies. However, in certain cases, monopoly may be justified, especially if these industries have very high fixed costs and there is a need of profit for research and development. In other cases, the government may need to allow the monopoly, but regulate the firm to prevent price increases (e.g. in case of privatised firms like water and electricity)

### 3. Explain how interdependence and uncertainty affect the behaviour of firms in Oligopolistic markets.

Firms in oligopolistic markets can behave in numerous different ways. The kinked demand curve model suggests interdependence is very important.

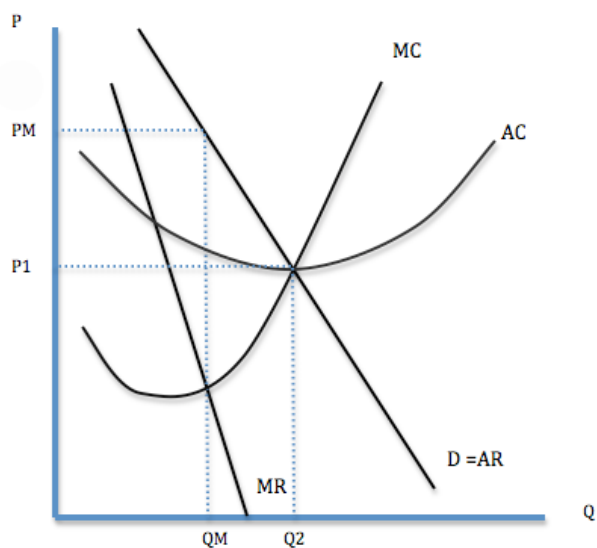
The model suggests that firms don't have an incentive to increase prices because if they increased price, others wouldn't follow suit and therefore they would be more expensive and lose market share.



The kinked demand curve also suggests that there is little incentive for firms to cut prices because if they did, other firms would probably retaliate and cut prices as well (other firms wouldn't want to lose market share). Therefore, for a price cut, demand is inelastic. Therefore, the kinked demand curve model suggests because of the interdependence of firms, prices will remain stable and firms will compete on non-price competition. However, the kinked demand curve model makes a lot of assumptions which may not stand up in the real world. A firm cannot assume that others will respond to a price cut by also cutting prices. There is a great uncertainty; perhaps the firm wants to avoid a price war. Therefore, a firm may cut prices hoping

that others won't follow suit. This will happen if the firm is pursuing profit maximisation.

Another model for oligopoly is collusion. In collusion firms seek to restrict output and increase price; this maximises profits for the industry.



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However, there is always the temptation for firms to exceed their quota and break the collusive agreements. If the collusive agreements are tacit, then there is no certainty that firms will stick to the agreement. Also, a firm may want to break the collusive agreement itself. They may think that other firms won't retaliate so they can get away with it. It is this uncertainty which encourages firms to try and break the collusive agreement.

Because of uncertainty about whether a price war may break out, firms may try to enter into collusive agreements. These could be informal agreements such as following the dominant firm and increasing prices at same rate. These collusive agreement and collusive practises are very desirable to insulate against uncertain prospects of a price war and consequent fall in profits.

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#### **4. Evaluate the view that only producers and not consumers, benefit when oligopolistic firms collude to try to reduce the uncertainty they experience.**

When oligopolistic firms collude, they are effectively acting like a monopolist. They are looking at the profit maximising price and output for the whole industry and setting output quotas accordingly. This will lead to higher prices and higher profits for firms. Because firms benefit from supernormal profits they can spend more on research and development. However, it could be argued that consumers may benefit from this investment. For example, in industries like automobile production and drug research, expensive investment is required to develop new engines and new drugs.



Collusion is necessary to generate sufficient profits to finance investment. Although it means higher prices, consumers benefit in the long run because they get better quality products.

However, there is no guarantee that firms will use profits for research and development into better products. They may simply give it to shareholders in the form of higher dividends. Alternatively, they may use the supernormal profits to fund predatory pricing in another market. This would be very bad for consumers.

Under collusion, consumers face higher prices and a decline in consumer surplus, but they don't benefit from any extra economies of scale. In monopoly, supernormal profit margins are justified because it is argued the monopoly is able to benefit from economies of scale which lead to lower average costs and therefore lower prices for consumers. However, in collusion, the consumer doesn't benefit from economies of scale, but just faces higher prices.

However, you could argue that collusion is essential to enable firms to survive. For example, there may be a bus industry which is struggling to survive. Without collusion one or two firms would go out of business. This would be bad for consumers because there would be less choice and less competition. Collusion may be necessary to keep the service going. Although prices may rise, this may be better in the long term because the service survives. However, there may be better ways to keep a bus industry in business. If necessary, the government could subsidise the industry. Collusion is not the best way to keep unprofitable firms in business.

The merits of collusion depend on the industry in question. If the industry is already profitable, then collusion is unlikely to give any benefit to the consumer. The benefit will be the producers who gain more profit. However, in some industries collusion may give benefits to the consumer in the form of more funds for investment and better products or just enough profit to keep the firms in business.

## **5. Explain why contestable markets generally function more efficiently than non-contestable markets.**

A contestable market is a market which has no barriers to entry or exit. This implies that sunk costs (costs which cannot be recovered on leaving) are zero or very low. This freedom of entry means that there is always the potential for new firms to enter. This threat of competition helps to keep prices low. If firms set prices too high, the supernormal profit would encourage new firms to enter. The low prices help to increase allocative efficiency because prices will be close to marginal cost.

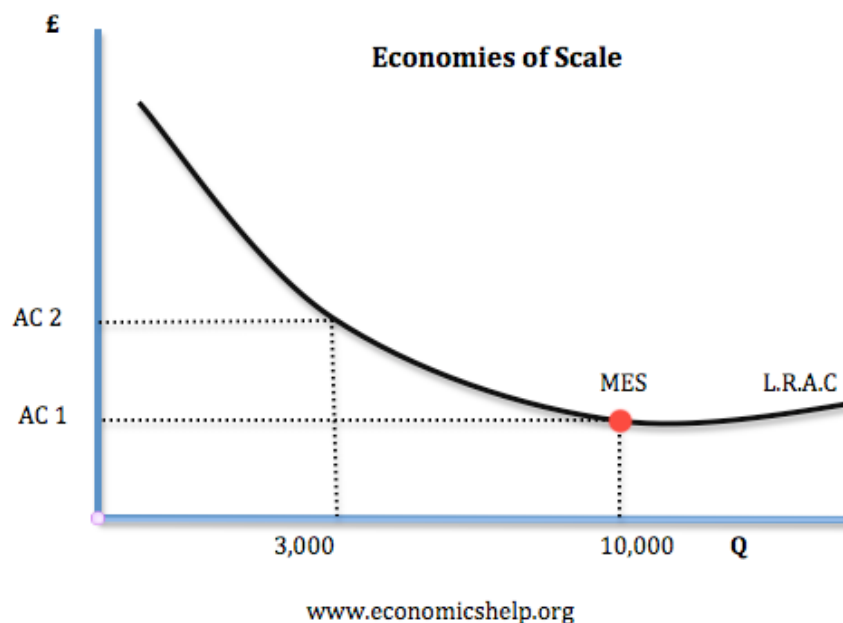
A contestable market may also be more X efficient. The threat of competition means firms have more incentives to cut costs and remain efficient. Otherwise they will become unprofitable. For example, in a monopoly firms may have low incentives to be efficient and therefore, have no incentives to cut costs – leading to X inefficiency. A monopoly also tends to be productively inefficient, because it restricts output and keeps prices high, leading output which has high average costs. However, in a contestable market this will not happen.

You could also argue that contestable markets enable some economies of scale (there doesn't have to be 1,000s of firms like in perfect competition). This can mean contestable markets have greater efficiencies of scale.

## 6. Explain various barriers to entry to a market and how these barriers might affect market structure.

A barrier to entry is a feature which makes it difficult or impossible for a new firm to enter the market.

A common barrier to entry is the existence of economies of scale. If an industry has high fixed costs, then new firms will face higher average costs than the incumbent firm. If a firm enters the market and sells  $Q_1$  then it cannot compete with firms who are already publishing at the MES with an average cost of  $AC_1$ . Economies of scale can occur for various reasons such as technical, specialisation, managerial. They are common in industries which require large investment such as car production, airplane production.



Brand loyalty is another common type of barrier to entry. If incumbent firms have a strong brand loyalty, it makes it difficult for new firms to enter. They would need to spend a large amount of money on advertising. Advertising is a sunk cost – they cannot get it back, if they have to leave the market. Therefore, it becomes a barrier to entry. Examples include soft drinks like Pepsi and coca cola.

Sometimes barriers to entry can occur for geographical reasons. For example, only a few countries are able to produce diamonds.

Being the first firm in the industry often leads to barriers to entry. For example, Microsoft was the first firm to dominate office software. This made it difficult for new firms to enter because everyone wanted compatibility with Microsoft. Google,

was not the first search engine, but, now the internet is developed it would be hard for anyone to knock it off top spot because Google has built up a critical mass of support and is included in many packages automatically.

Finally, barriers to entry might occur because it is difficult to get access to supplies. e.g. a new airline might not be able to get landing slots at Heathrow airport.

**7. In the past, utility industries such as the postal service, electricity and gas, have been heavily protected by entry barriers. Evaluate the possible effects on efficiency and resource allocation of removing these barriers.**

Removing the barriers may encourage new firms to enter the market. If new firms enter the market it will become more competitive. A more competitive market will help to reduce prices as new firms try to gain market share. This should enable greater allocative efficiency. If a firm has a monopoly power, they are able to set prices higher than marginal cost. More competition will lower prices closer to marginal cost (although in these industries, marginal cost is often very low and fixed costs very high; therefore, perfect allocative efficiency is unlikely)

Another benefit of competition is that firms may have greater incentives to offer a better service to customers. Firms will not just compete on price, but also non-price competition. For example, electric firms may offer special deals to insulate the house or create more energy efficiency. This greater competition will reduce x inefficiency in the industry. It is also possible that the threat of entry may encourage more innovation; helping to improve dynamic efficiency.

However, there are potential drawbacks of deregulation. Firstly, many of these industries are natural monopolies. For example, the distribution of gas is a natural monopoly because of the high fixed costs. Therefore, there is a danger of creating a private monopoly, which charges higher prices. These private monopolies will need regulating. However, the regulators can make sure new firms have access to the network, therefore, even in an industry which was thought to be a natural monopoly can have competition, at least, in the retail sector.

If new firms enter the market, competition may reduce the profitability of the industry. This may leave insufficient funds to finance investment in improving the network. Also, firms have a temptation to offer short-term price cuts rather than invest in the long-term future of the infrastructure. The customer may benefit in the short term, but lose out in the long term.

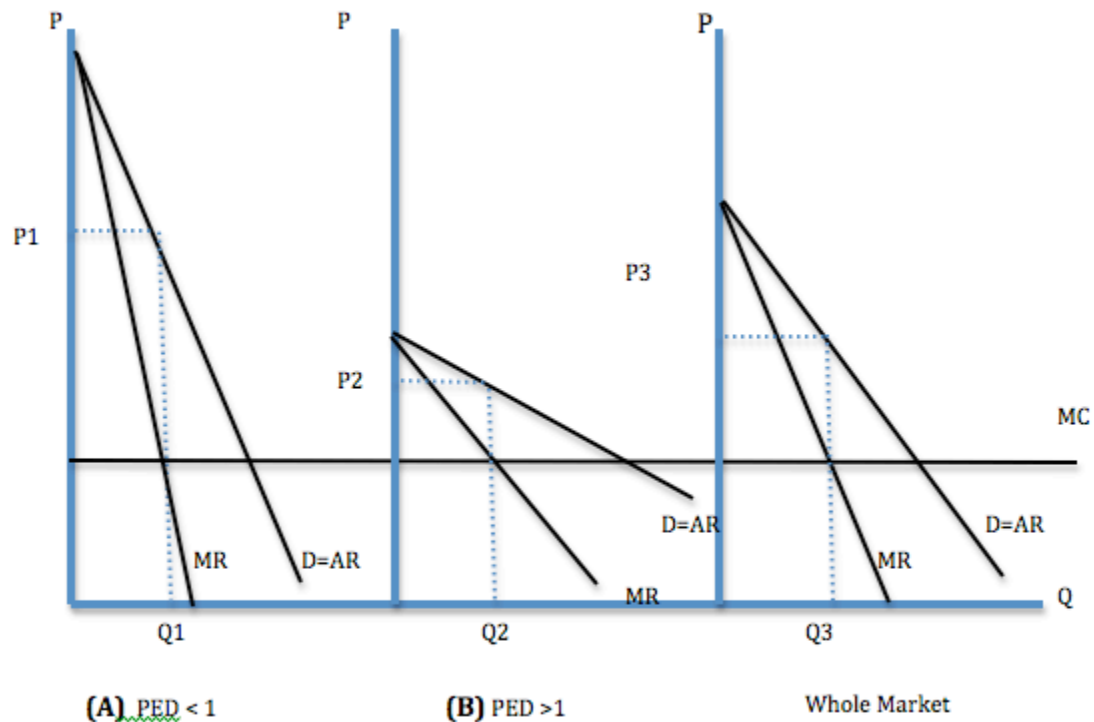
However, you could argue, that firms exaggerate how much money they need for investment; the majority of profits goes to shareholders rather than gets invested.

Firms may use resources to try and create barriers to entry or resources to keep existing customers; arguably this is an inefficient waste of resources.

**8. Explain the meaning of price discrimination and the conditions necessary for price discrimination.**

Price discrimination involves selling the same good to different groups of customers for different prices. Third degree price discrimination involves selling to different groups. For example, OAPs may get cheaper train tickets than adults. Second-degree price discrimination involves charging different prices depending on the quantity bought. For example, the first 100 units of gas and electricity may be more expensive than subsequent units. First-degree price discrimination involves charging the maximum price that customers are willing to pay; it involves reducing all consumer surplus. It is rarely practical except in a Dutch auction.

The first condition necessary for price discrimination is that consumers must have different elasticities of demand. For example, people travelling at peak time to get to work have a more inelastic demand and (like market segment A) so can be charged a higher price.



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Group B, which could be students, have a more elastic demand. Therefore, a lower price is charged.

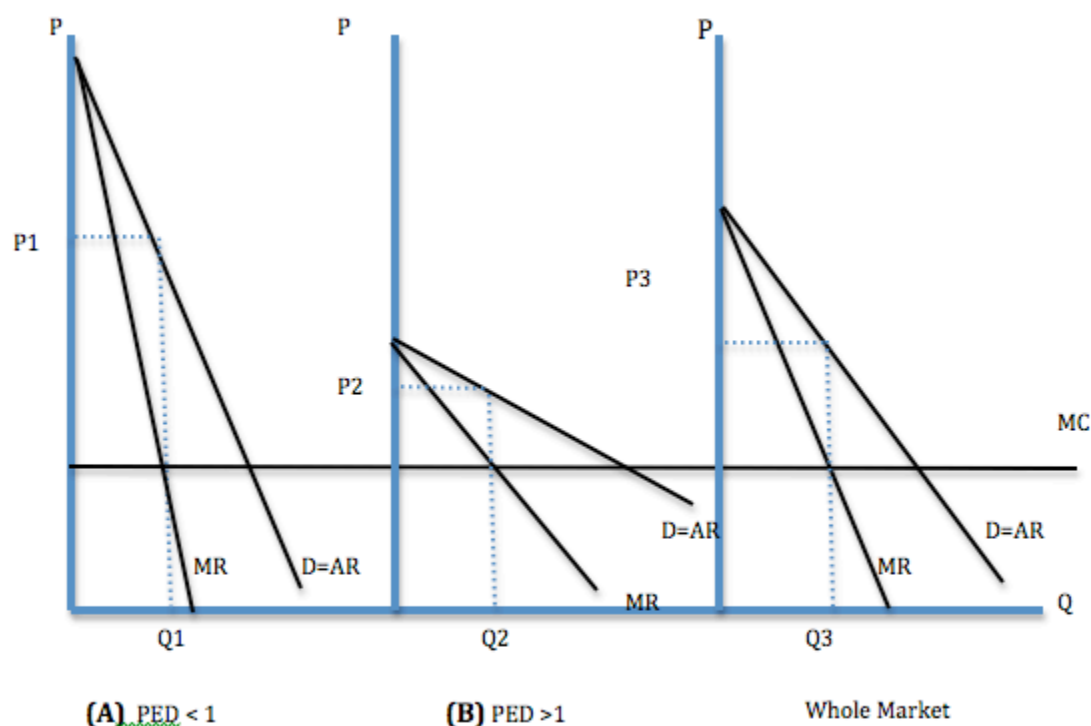
Secondly, it must be impossible to resell the good between the different markets. For example, it mustn't be possible for an adult to use a child's ticket to travel on the train.

The firm must be a price maker. Price discrimination is not possible in perfect competition. Also the costs of implementing price discrimination must be less than the benefits.

**9. Evaluate the view that, because price discrimination enables firms to make more profit, firms, but not consumers, benefit from price discrimination.**

Price discrimination enables firms to increase the profitability of the industry. Firms can set a profit maximising price for different groups of consumers and therefore increase total profits.

Therefore, some consumers will pay higher prices. For example, customers with inelastic demand – buying peak tickets will have a reduction in consumer surplus as firms increase their prices. Therefore some customers will lose out and pay a price higher than marginal cost (allocative inefficiency)



However, some customers will benefit from price discrimination. The higher prices paid by inelastic customers can subsidise lower prices for other groups of consumers. For example, the high prices paid by customers travelling at peak time can help subsidise lower prices for old aged pensioners. Often people with inelastic demand (adults, people travelling peak time) have greater ability to pay than people with elastic demand (e.g. students, old people) Therefore, you could argue that price discrimination enables a fairer distribution of resources in society. However, it is not always possible to use price discrimination on the grounds of income. For example,

an unemployed adult would have to pay full fare on the train. Pensioners who get cheap tickets could be quite well off.

It could be argued that it is unfair firms make profit at the expense of consumers. However, profit can be beneficial for consumers. Firstly, firms may use profit to fund research and development. This enables dynamic efficiency and enables consumers to benefit from better quality products and services in the long term. This is important for some industries like pharmaceutical drugs and airplanes where a lot of investment is needed. However, it is debatable how much firms like supermarkets and cinemas would spend on research and development.

Another potential benefit of profit is that it might enable a firm to stay in business, who otherwise would go out of business. For example, without price discrimination a train firm may not be able to survive. There might be no one individual price greater than average cost. However, through price discrimination, it can cover its losses and stay in business. In this case price discrimination is definitely beneficial for consumers. It is better to have higher prices than to have no service at all.

Price discrimination also enables firms to spread demand more evenly over a season. It gives a reward to consumers who can travel out of season / off peak. This reduces overcrowding at peak times.

## **10. Evaluate different ways in which governments could make markets more competitive.**

To make a market more competitive requires a reduction in barriers to entry and encouraging new firms to enter the market.

The first policy would be deregulation. This involves removing legal barriers to entry. For example, there used to be a legal monopoly for the delivery of letters. Removing this legal barrier enables new firms to enter the market providing choice and competition. However, there are problems. Firstly, these industries like mail delivery are often natural monopolies. This means the most efficient number of firms is one. For example, there are very high fixed costs in delivering tap water to every home in the UK. Therefore, deregulation of tap water would not encourage a new firm to enter because a new firm would never be able to compete and set up a network of pipes. The government could remove legal patents, for example drug patents. This would make the market for drugs more competitive. However, if the government abolished patents, it would discourage drug companies from investing in new medicines and alternatives. This would increase competition, but could leave the consumer worse off.

The government could make sure the Office of Fair Trading investigates any potential anti-competitive practises. For example, if firms engage in predatory pricing or vertical price fixing agreements they will prevent new competitors from entering. If the government increased the penalties for predatory pricing (selling below cost), then new firms would have more confidence to enter. However, the OFT already have the

potential to investigate, so it is doubtful whether increasing potential fines will make much more difference. Also, practices of vertical price fixing can be difficult to spot.

If markets are dominated by monopolies; the government could consider breaking up the monopoly into smaller firms. For example, the US government considered breaking up Microsoft because it had too much market power. This could be an effective way to increase competition, however there are some problems. Firstly, the government may disrupt the smooth working of the firm. The new smaller firms may not be able to benefit from economies of scale. Also, there is the potential for the new firms to collude, because they share a common starting point.

The last policy could be government subsidies for new firms to enter. For example, the government could subsidise firms to enter the gas industry and sell it. However, government subsidies require higher taxes and the government may have poor information about the best type of firms to subsidise.

### **11. Discuss the extent to which new technology, such as the internet, has increased or decreased the competitiveness of markets.**

The internet has become an important tool for business. It has changed the way people shop and buy, having implications for the competitiveness of markets. A competitive market implies several firms, with relative ease of entry, low prices and low profits. An uncompetitive market would be characterised by a few firms and higher prices.

The internet has made it easier to find information about prices and costs. This has helped increased the competitiveness of markets. Consumers have easy access to relative prices; this existence of perfect information is a characteristic of perfect competition. Therefore many retail markets like selling books and DVDs are more competitive than before the internet. However, other markets are less influenced by the internet. For example, restaurants and clothing are market segments rely on traditional sales, rather than over the web.

For many firms, the internet has helped reduced start up costs. This is because, with an internet presence, costs are much lower than buying a physical building. Thus for internet start ups, sunk costs (costs which can't be recovered) are much lower. However, it is only a few businesses that can rely on just an internet presence; there is still the need for factories and shops for the majority of businesses like manufacturing cars.

In some businesses, the internet has created barriers to entry; for example, firms who dominate Google search rankings have a powerful barrier to entry. A new firm may find it difficult to enter because it is hard to get the good rankings which send a lot of customers. Google itself has generated strong brand loyalty, and a dominant market position, which is difficult for anyone to overcome. However, pay per click advertising is a way to get business from search results and it has lower overheads than traditional advertising.

Improved technology such as the internet and better international travel means that markets are increasingly global in nature. This means firms increasingly face competition from abroad. For electronics and cars, markets are very global, increasing their competitiveness. However, globalisation does not always increase competition. The growth of strong multinationals has in a way helped push out smaller independent retailers with a corresponding decline in diversity and competition.

Another issue is that in some markets, the internet has changed people's patterns considerably. For example, many young people don't buy music, but download for free on internet sharing sites. This has changed the market much more than an increase in competition. However, it has meant the decline of several record shops and music publishing companies, leading to a higher market concentration in this area.

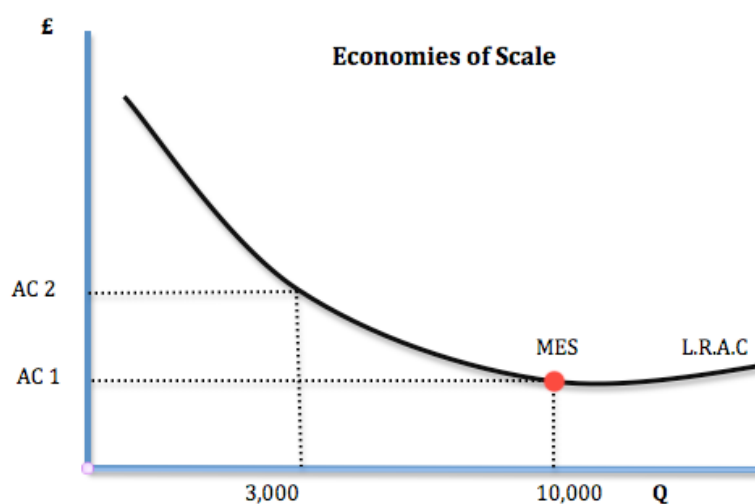
## Section - Government Intervention

### 1. Discuss the impact of deregulation on the local bus industry in Great Britain

Deregulation involves opening up a monopoly to competition. Often deregulation involves privatisation as well. For example, the bus industry in the UK, used to be run by a state monopoly (local council). However, after deregulation, new private firms can enter.

The first impact of deregulation is the increase in number of firms and hence greater competition. As more firms enter the market, there is more price competition and therefore, price of bus tickets could go down.

However, it is argued that prices haven't fallen, but increased. This is because, firstly, the bus industry has large economies of scale. It is not practical to have several bus companies competing; the most efficient number of firms is 1 or perhaps 2.



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In the above diagram, the minimum efficient scale is 10,000 bus journeys a week. If the total demand was 10,000 then the most efficient number of firms would be one. If



there were two or three firms then the average costs will be higher than if there was a natural monopoly.

Also, with only one or two companies, there is not sufficient competition to reduce prices significantly. It is easy for two companies to collude, even tacitly. Also, before deregulation, bus companies were owned by local councils and low fares were often subsidised. However, the private companies want to maximise profits and often they find demand is inelastic so prices have risen.

It is argued that more competition and the entry of private firms have created greater incentives for bus companies to offer better services. For example, since deregulation, there are more electronic bus stops, which give information on arrival times. This may be due to deregulation or just because better technology has made it more feasible.

The problem with deregulating the bus industry is that it is simply difficult to have effective competition. Some would even argue the bus industry is a natural monopoly. It is argued two bus companies can be inefficient because they duplicate routes and cause congestion. However, others point to some gains from competition such as better quality buses and efforts to attract customers.

## **2. Evaluate the view that the government should give financial assistance to firms producing cars in the UK to increase their competitiveness.**

Government assistance could be justified on the grounds of market failure. For example, there could be market failure with UK firms under providing education and training schemes to their workers. When the workers are qualified, they may leave giving the firm no benefits but all the cost, therefore, because of the positive externalities involved, firms have little incentive to train and educate workers. Governments could overcome this by paying for training schemes to increase labour productivity. The improved labour productivity will help the UK remain competitive and give long term economic benefits. The problem of this scheme is that it will cost money and there is no guarantee that it will be successful. For example, the government subsidies may be spent on training that does little to increase labour productivity; e.g. workers may be unwilling to learn or the firm may use the government subsidy to increase its profits rather than promote useful training schemes.

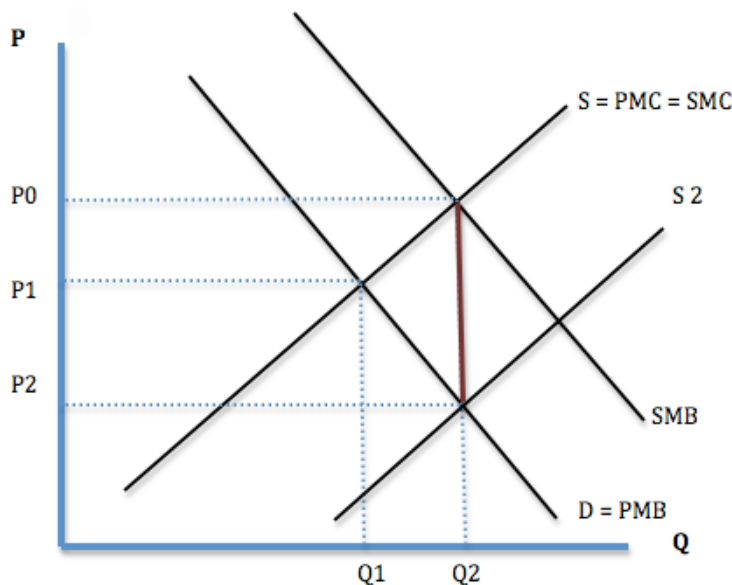
Government assistance may encourage firms to be inefficient because they come to rely on government help. In the 1970s, the UK government gave a lot of financial assistance to British Leyland because it was losing money. However, the money did little to transform the company. If a company is losing money, it is probably due to bad management or producing the wrong kind of products. In this case it is unhelpful for the government to give assistance in the hope they become more competitive. In this case, the government assistance is encouraging inefficient firms to stay in business. It will be expensive for the taxpayer and have no real benefit.

Governments often have poor information about the dynamics of industry. For example, the government may not know the best firms to subsidise or how to

subsidise them. When it comes to increasing competitiveness it should be firms who have the best idea. If the banks are not willing to lend money to firms, it is probably because they don't have a good business plan; therefore, the government would be advised to avoid it as well.

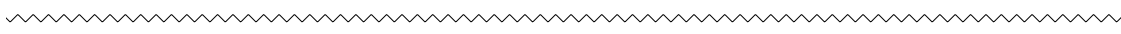
However, government assistance could be justified if the problem was a lack of suitable finance. For example, in a credit crunch firms may be unable to gain sufficient finance for investment, even though this investment would be good. Therefore, government assistance could be justified. Here the lack of business finance is an example of market failure.

Generally, cars have no positive externalities, they contribute to global carbon emissions, so governments might want to subsidise more environmentally friendly firms. However, the government might want to subsidise investment into low emission cars, which run on hybrid fuels. In a free market, there may be insufficient investment in this kind of technology because firms ignore the positive externalities of the low emission engines; therefore, this justifies government intervention.



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Governments could justify subsidising 'green technology' in cars, if they have sufficient positive externalities. This diagram shows how a government subsidy can increase output from Q1 to Q2, which is socially efficient.

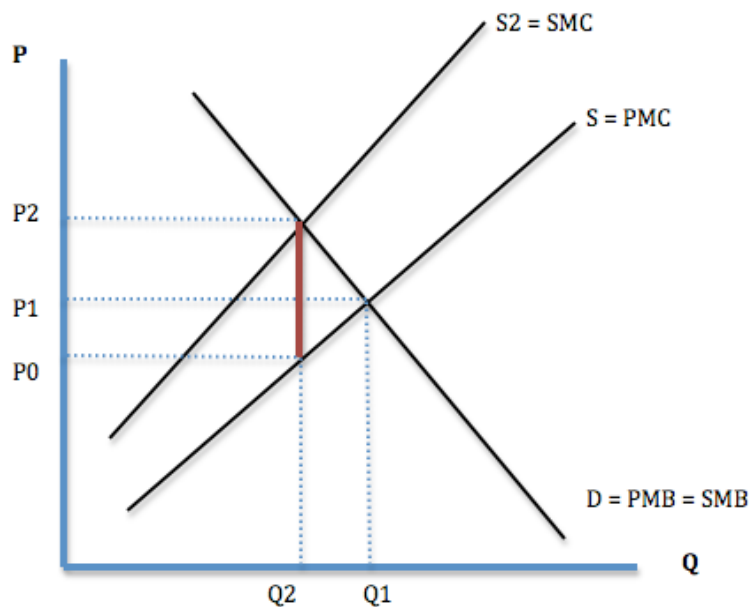


### 3. Evaluate the view that government intervention can correct all the market failures caused by the effects of economic activity on the environment.

Economic activity creates many negative externalities, which include damage to the environment. To some extent government intervention can overcome market failure and provide a more socially efficient level of economic activity.

Economic activity may cause pollution. This damage to the environment is a negative externality and is ignored by the free market. Therefore, there is overconsumption of driving cars. In a free market equilibrium, at  $Q_1$ , the marginal social cost is greater than the marginal social benefit.

The diagram below shows that the free market equilibrium is  $Q_1$ . However, at  $Q_1$   $SMC$  is greater than  $SMB$  therefore there is overconsumption. However, the government can place a tax on the good, to make people pay the true social marginal cost. This shifts supply to  $S_2 = S_1 + \text{Tax}$  and reduces demand to  $Q_2$ . This is socially efficient because the  $SMC = SMB$  at this output. Therefore, in theory the government have overcome the market failure.



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However, in practise, it is more difficult to achieve social efficiency. A tax on production may be ineffective in reducing demand if demand is very inelastic. There is scope for tax evasion e.g. a tax on disposal of toxic waste may lead to 'fly tipping' – illegal dumping which damages the environment.

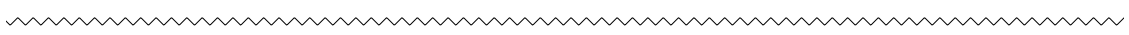
It is also difficult to measure the true external cost of economic activity. For example, the cost of global warming may be much higher for future generations; therefore,

efforts to reduce demand now, may be insufficient. Also, some costs of growth may be unpredictable. e.g. the Chernobyl disaster was not predicted and after the event, government intervention is too late.

Also some economic activity is too damaging to just place a tax on the good. In this case it may be more efficient to have regulations, for example, saying that nuclear power shouldn't be used at all.

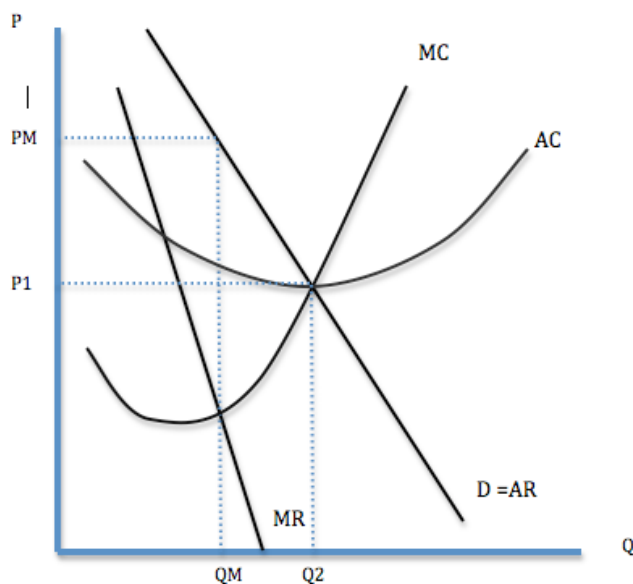
Another issue regarding the environment is that it requires global cooperation. For example, the UK government may seek to limit carbon emissions. One policy may be a system of pollution permits. Here the government regulator gives firms the right to pollute a certain amount. If firms wish to exceed their pollution quotes, they have to buy more permits; this creates an incentive to reduce pollution and introduce new technology.

In theory, pollution permits can provide a market-based system to reduce pollution levels. However, it may be difficult to implement; e.g. difficult to measure pollution levels. However, a more pressing difficulty is that carbon emissions are very much a global issue. If the biggest polluters, such as, China and the US keep increasing their carbon emissions, it makes the UK governments efforts' relatively futile.



**4. In some European countries, price controls are imposed upon pharmaceutical companies. Discuss the case for government intervention to control market prices.**

The first argument for government price controls is the idea of monopoly power. If firms have monopoly power in a market, they are in a position to increase prices. As the diagram below shows, this monopoly power enables firms to set prices ( $P_m$ ) above marginal cost, which is allocatively inefficient ( $P > MC$ ).



In an ideal world, the government would be able to increase competition. But, in some markets, competition is not practical. In the case of Pharmaceutical companies they may get a pure monopoly because of their patent. In the example, of tap water, very high fixed costs mean competition is not practical. Therefore, monopoly power is inevitable and price controls are the only realistic way to prevent abuse of monopoly power and prevent allocative inefficiency.

There are also issues of equity. In the case of drugs, it could be argued they should not be too expensive otherwise people cannot afford them. It is also the same with gas and water supplies. As an essential public service, it is important that they remain in reach of all income groups. Also, some goods like medicinal drugs may be paid for by the government. Capping prices on medicinal drugs will help to limit the government's health care budget and therefore lead to lower taxes.

However, there are arguments against price controls. If governments limit price, firms may not make sufficient profit to encourage more research and development. To develop new drugs is quite risky with no guarantee of success; therefore, it is essential to give firms sufficient incentive to develop them. Lower prices and lower profits could decrease dynamic efficiency. Also allocative efficiency may be an inappropriate measure given that the marginal cost of producing a drug is very low, but fixed costs are very high.

There is also an element of potential government failure. For example, the government may not have sufficient information about the state of the industry to make an appropriate decision on price. Government could set prices which are too low and cause firms to leave the market.

## **5. Discuss whether the government should ever consider nationalising privatised industries?**

Nationalised firms are owned and run by the government. Privatisation is the process of selling the firms to the private sector; this means the firm will be run like a normal public limited company, rather than by the government.

Several industries like rail, electricity, gas and telecoms were privatised in the 1980s and 1990s. There are several strong arguments for suggesting privatised firms are more efficient than nationalised industries.

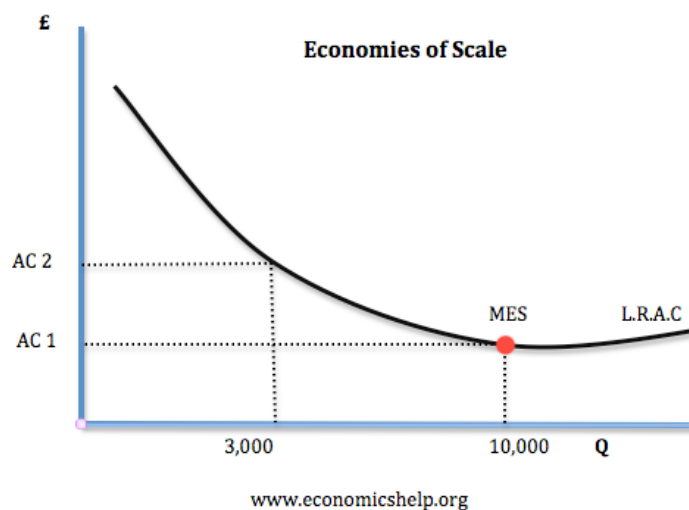
Firstly, it is argued that a private firm has a strong profit incentive to cut costs. A nationalised firm is not subject to the pressure of private shareholders, therefore it is more likely to be x-inefficient and productive inefficient. If the government nationalised privatised firms like BT and British Gas, it may result in greater inefficiency and therefore higher prices.

However, private firms may make mistakes because shareholders encourage short termism and risk taking. In the case of the banking industry, risks were taken to make more profit, but the government had to step in to bailout the banks when they made losses. Governments can, in theory, take a longer-term view and avoid short-termism.

However, governments may also be subject to political pressure, which encourages them to sacrifice long-term investment for short-term gain.

Some industries like the banking have a great importance to the wider economy. If banks went under, it might cause loss of confidence in bank deposits; this could cause a mass withdrawal of money, leading to a fall in financial confidence. In this case, the government may have no option but to nationalise private firms. Here the motive is preventing a collapse in bank confidence. This argument is mainly relevant to the banking sector. If a car firm collapsed there would be less reason to intervene, apart from to protect job losses, which is an expensive way to prevent unemployment.

One problem of privatised industries is that they were often in industries considered to be natural monopolies. For example, tap water and distribution of gas and electricity is essentially a natural monopoly.



A natural monopoly, where industry demand is close to the minimum efficient scale (10,000 in above diagram) and therefore most efficient number of firms is one.

Therefore, some privatised firms are a private monopoly and could exploit consumers through higher prices. This might be a reason to nationalise the firm. However, another option is regulation. Regulators can regulate price increases so we get the benefits of privatisation without the drawbacks of monopoly power. However, in practise, regulators may struggle to get right balance between protecting consumer and interests of firms. Regulators could suffer from regulatory capture and so they are too kind to the firm.

Other industries, like rail could justify greater government intervention because they have many positive externalities, which mean the good is under-consumed in a free market. For example, rail travel helps reduce traffic congestion and pollution. Under privatisation, rail maybe under-consumed with too little investment. There is a stronger case for renationalising rail because a government can make allowances for the external benefits in offering public transport. However, an easier option maybe for the government to subsidise the private firm. The subsidy should, in theory, help to overcome the under-consumption in a free market and prevent the need to renationalise.

Generally, privatised firms have better incentives to be efficient and respond to changing market signals. If the privatised firm is in a competitive market, for example, BT, there is no benefit to renationalising the firm because competitive pressures keep prices down.

However, in an industry like rail, there may be a greater justification of re-nationalisation. In this industry, competition is not realistic so the government have created a private monopoly. Also, the external benefits to railways means that the government may need to have closer direction and subsidy to overcome market failure.

Also the experience of the banks shows that sometimes, the government needs to nationalise firms for wider economic interest.

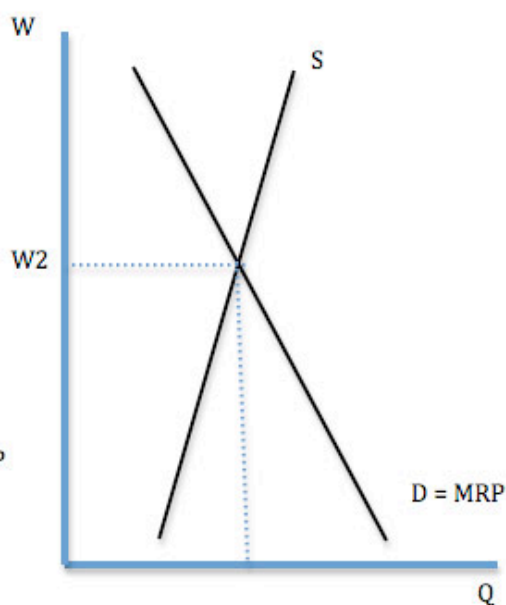
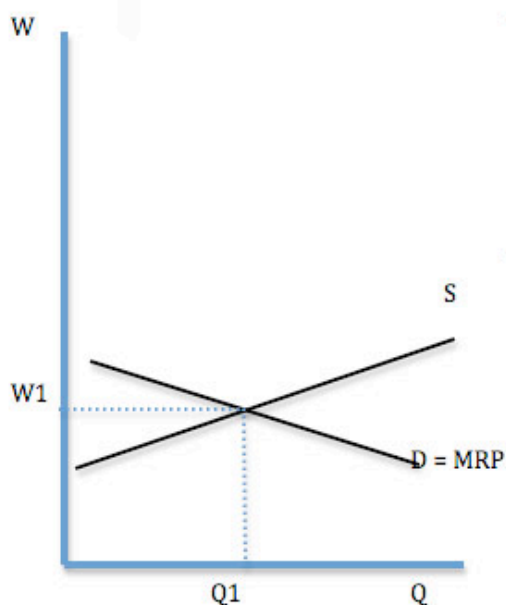
## Labour Markets - Section

**Footballers receive high pay, while those in disagreeable occupations, such as road sweepers, are among the most lowly paid.**

### 1. How does economic theory explain such differences in pay?

Economic theory suggests that wages are determined by factors such as marginal revenue product, and the supply of labour.

Jobs such as road sweepers do not need qualifications or specialised skills. Most people are able to do that job. Therefore the supply curve is elastic, meaning many are willing to work at relatively low wages.



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Cleaners – Elastic supply Low wages

- Footballers inelastic supply, higher wages

However, jobs such as being a top footballer are highly skilled. Only a small % of the population is able to be a good footballer, therefore supply is inelastic. Because of the inelastic supply curve, footballers find it easier to bargain for higher wages.

As well as differences in supply, footballers will have a higher marginal revenue product. Marginal Revenue products depends on marginal product (the productivity of workers) and Marginal revenue of last good sold (this depends on the price of the good sold. Footballers can affect the revenue of their club significantly. Therefore, the MRP of footballers is high, a good footballer can make a lot of revenue for his team, in terms of advertising revenue and gate money; therefore because MRP is high, wages will be high. Road sweepers, however, do not have a high marginal revenue product. The council doesn't gain extra income from cleaning the streets. It is seen as a service rather than revenue-generating job; therefore, it is seen as a job with a low MRP.

Another reason could be that road sweepers face monopsonistic firms who are able to cut wages. Footballers have agents to help them get higher wages. Also public sector workers like road sweepers tend to be lower paid than private sector workers.

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## **2. Assess the case for and against the government intervening to raise the disposable income of workers on low pay.**

The government could intervene through increasing minimum wages and / or offering means tested benefits. The two different strategies will have different effects.

The first reason for raising the pay of low-income workers is to reduce relative poverty. Relative poverty reflects inequality in society. Often this inequality stems from unequal opportunities such as middle class parents can afford to get better education for their children so they get higher pay. By increasing incomes of the low paid, the government is helping to reduce inequality.

Reducing inequality also has some practical economic arguments, as well as moral justifications. Income inequality could aggravate feelings of social alienation; this could cause problems such as crime, vandalism and tensions within society.

Increasing the incomes of workers on low pay may create greater incentives for low paid workers to move from benefits to paid work. If wages are low, it may encourage people to remain on unemployment benefits and income support. Increasing wages, could save the government paying out benefits and reduce the poverty trap.

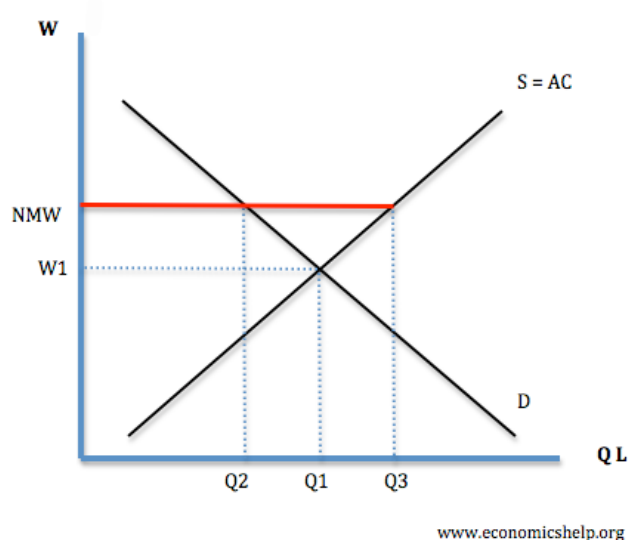
Higher wages may increase worker productivity, motivation and loyalty to the company. This is known as the efficiency wage theory. It is argued if wages are too



low, people don't mind if they get made redundant. Higher wages increases worker loyalty and therefore productivity.

Finally, workers low pay may be due to monopsonistic employers who want to exploit their monopoly power to pay lower wages than market forces. Therefore, if the government increases wages through minimum wages then it will not cause unemployment.

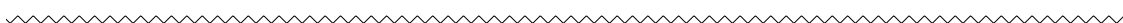
However, there are practical problems to intervening to raise disposable incomes of workers. If the government increase wages by imposing a higher minimum wage, there is the scope for creating real wage unemployment. If wages rise, firms may not be able to afford the workers, especially if the job is traditionally low paid work in the service sector.



However, this analysis assumes labour markets are competitive. In the real world, employers often hold a degree of monopsony power. This enables the employers to set lower wages and exploit workers. In this case, a minimum wage helps to overcome the effect of monopsony employers and won't cause unemployment.

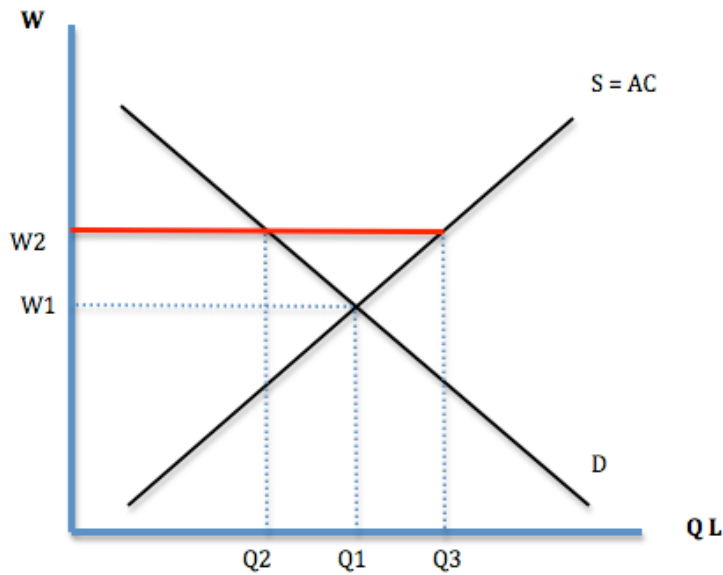
If the government increase wages through offering means tested benefits then this may create a poverty trap. Basically, means tested benefits may discourage workers from working longer hours or getting better paid jobs. This is because the gain in income is limited due to the means tested benefits for low paid jobs. Also, means tested benefit may encourage firms to pay lower wages knowing that the government will top up the wages. A better solution may be to offer lower taxes for low paid workers.

Another solution would be to offer benefits in kind, such as housing benefit and cheaper prescriptions e.t.c. This increases their disposable income without distorting labour markets.



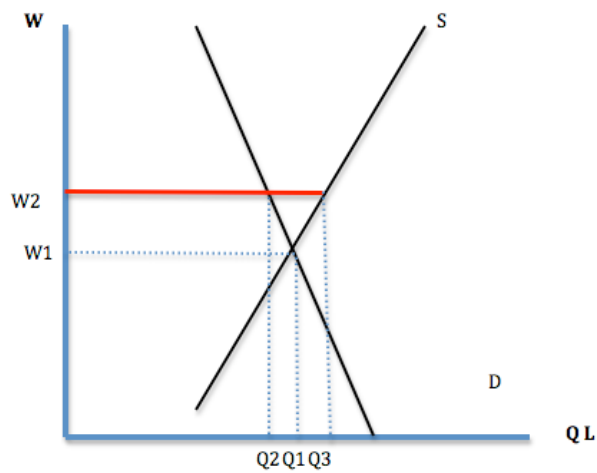
**3. Do you agree that if a trade union persuades employers to increase wages in a labour market, employment must inevitably fall in that labour market? Justify your answer?**

If the labour market is competitive, i.e. good information, many employers, then in theory an increase in wages above the equilibrium will cause a fall in employment. The diagram below shows that a rise in wages to  $W_2$  (through trade union pressure) causes a fall in employment from  $Q_1$  to  $Q_2$ .



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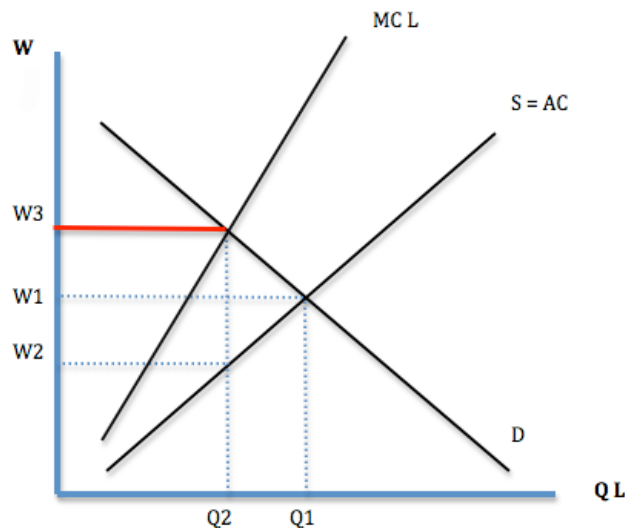
If demand for labour is inelastic, then the fall in employment will be relatively small. Some labour markets may have inelastic demand if – labour is a small % of total costs or the workers are indispensable part of the production process.



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If demand for labour is perfectly inelastic then an increase in wages will not cause any fall in demand for labour. However, if demand for labour is elastic, then higher wages could lead to a big fall in demand for labour.

There are other reasons why employment might not fall. Firstly, if the employer has monopsonistic power, it is able to pay workers a wage below the market equilibrium. The diagram below shows that increasing the wage from  $W_2$  to  $W_3$ , will actually keep employment the same at  $Q_2$ . If trades unions increase wages from  $W_2$  to  $W_1$ , then employment levels will rise from  $Q_2$  to  $Q_1$ .



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Arguably many employers in the UK have a degree of monopsonistic power; workers find it difficult to move and therefore employers can keep wages lower. This is especially the case in the service sector where workers work part time and have weak contracts.

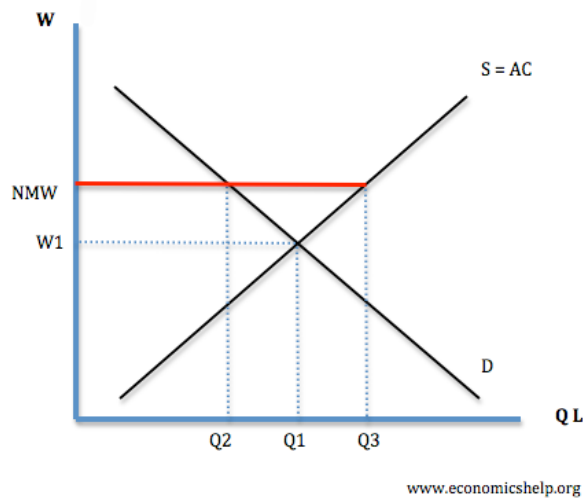
Another issue is labour productivity. It is argued that paying higher wages may increase the loyalty of workers to the firm; this is known as the efficiency wage theory, and if workers are more loyal they will have greater productivity. A more likely scenario is that trades unions argue for a productivity deal. This is when they bargain for higher wages in return for new working practises, which increase labour productivity. If labour productivity and MRP of workers increase then firms will be able to afford the higher wages.

Another possibility is that if real wages increases, there will be an increase in aggregate demand causing higher output and higher demand for workers. On the other hand this increase in wages may just cause inflation. Also, on a micro level, higher wages in one sector will not affect the macro economy significantly.

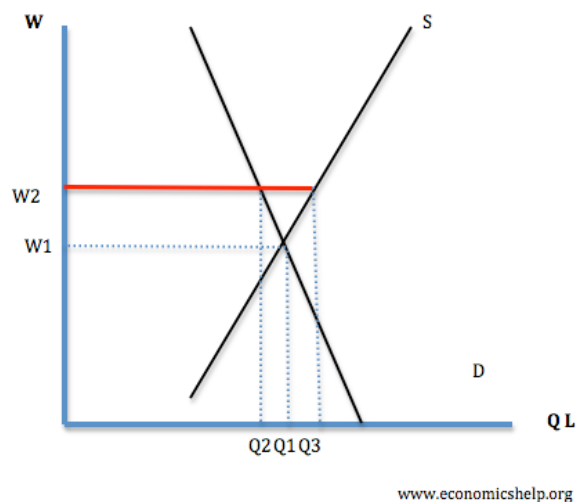
Empirical evidence in the UK, suggests that since the minimum wage was introduced in 1997, it hasn't caused unemployment, this is despite the fact the minimum wage has increase faster than inflation.

**4. Assess three labour market policies which might be used to increase the level of employment amongst incapacity claimants and lone parents on benefits.**

An increase in the minimum wage might increase the incentives for people to take a job rather than stay on benefits. If wages are low, there may be little incentive for people to take a job rather than stay on benefits. However, higher minimum wages may increase unemployment. Firms may reduce demand for workers because they cannot afford the higher wages. A NMW can lead to unemployment of  $Q3 - Q2$ .



However, the UK minimum wage has been increased without any obvious fall in employment levels. This could be due to the fact employers have monopsonistic power and can afford to pay higher wages. Alternatively demand for labour may be inelastic.



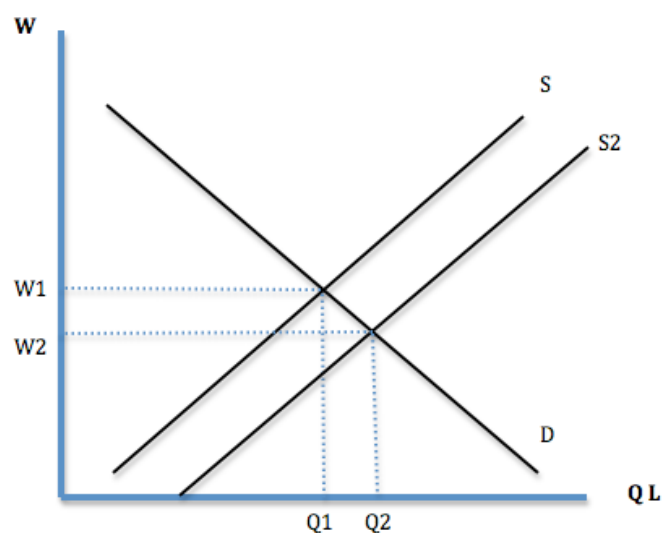
If demand is inelastic, the fall in employment will be small.

Another policy is for the government to provide targeted training schemes for those on incapacity benefits. The government could train them in using computers and IT. This may enable them to work online from home. This makes them employable, despite their disabilities. However, it is not clear how successful these schemes would be. For example, even with better IT skills, it may be difficult to find jobs which enable you to work from home. Lone parents on benefits may not have time to take out training schemes because they need to look after children.

Better child-care provision. If the government offer free or subsidised childcare, then lone parents will be able to go out and work, saving the government benefits. However, the cost of providing childcare may be as expensive as providing benefits. Also, the government cannot guarantee that lone parents will actually take out the opportunity to leave children in child-care. The real difficulty may be finding a job or the low differential between wages and benefits.

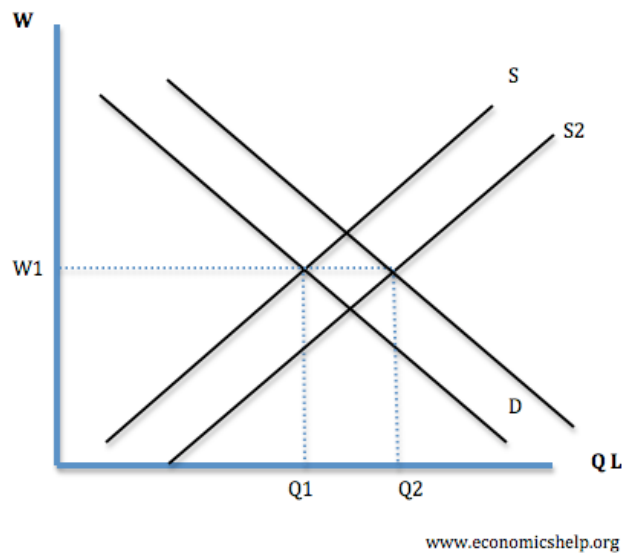
### 5. Discuss the impact of net migration on UK labour markets

Net migration will increase the supply of labour, possibly causing wages to fall. This effect will be most noticeable in areas where migrants concentrate e.g. London and the South East. The effect will also be most noticeable in industries where migrants tend to work; this could be fruit pickers, builders or plumbers.



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However, although the supply of labour increases, it is important to bear in mind, that an increase in the population will also cause an increase in economic growth and increase in demand for labour. The extra supply of labour should be met by the extra demand for labour. Therefore, the real wage rates could stay the same.



The impact of migration also depends on the skills and qualifications of migrants. If the migrants don't speak English and have low skills, they may struggle to find employment in the UK labour market. Therefore, it could cause a rise in structural unemployment.

If the migrants do speak English and have skills which are in short supply, it can help deal with labour market shortages that do exist. For example, recently the government said it would be setting migration policy to allow workers with specific skills to enter; for example, maths teachers and nurses. This helps to fill gaps in the labour market. Note, it is unlikely to depress wages in these sectors because the wages are set by the government and not market forces.

It is also possible, that migrants, especially if illegal migrants are more likely to work in the black market. For example, workers from low wage countries may be more willing to accept wages below the official minimum wage. This could lead to a bigger underground (unofficial) labour market and economy. However, there is no guarantee migrants will gravitate to the unofficial labour market, by nature it is hard to quantify.

## 6. Discuss the relative merits of welfare benefits and taxes for reducing relative poverty in the UK

Relative poverty occurs when people receive an income significantly less than the average in society. For example, one definition may be a monthly income of less than 50% of the average monthly income.

Welfare benefits include; job seekers allowance, income support, child benefit and pensions. The biggest cause of poverty is unemployment because relying on unemployment benefits gives a relatively low income; therefore increasing JSA would increase equality of distribution and make people on low incomes better off. However, there is a risk that higher benefits may increase voluntary unemployment; this is because income from benefits may be similar to the income from a job,

therefore there becomes a disincentive to take a job. If higher benefits do discourage people from taking a job, it will increase cost of benefits to the government and also mean that people become economically inactive and lose motivation to work. However, it depends how much benefits were increased compared to the level of wages. It might be possible to increase welfare benefits but maintain an incentive to work. For example, if you take a low paid job, you could retain some income support. Also the minimum wage helps to increase the incentive to work in the UK.

Income support or family credit involves giving means-tested top up benefits to those on low wages; this will help reduce income inequality. But, similar to unemployment benefit, there is a danger of creating a disincentive to work. However, at least means-tested benefits are cheaper than universal benefits. Also the government can try grade the means tested benefits, so there isn't a cut off point which discourages people working longer hours

A higher state pension would also help reduce inequality amongst pensioners; however, it would be very expensive to increase the universal state pension, especially because there are increasing numbers of OAPs in the UK. Therefore, it may be more effective to target pensions to those who need it most, i.e. use means tested benefits. This could involve an extension of the govt minimum income guarantee for pensioners. The only problem of this is that it may discourage workers from saving for a private pension, because, they will not then get as much from the govt.

A switch from regressive to progressive taxes would help improve income distribution, e.g. cutting cigarette tax and increasing income tax. A progressive tax takes a higher % of income from the rich. E.g. a top band of income tax could take 40% of incomes over £27,000. If the govt increased the top rate, this would cause a reduction in income inequality because it would reduce take home pay of high earners; also the revenue could be spent on increasing benefits to those on low incomes. However, this would cause problems because higher taxes may discourage people from working harder. Therefore, higher rate of income tax may cause lower AS and not increase revenue for the govt. However, the extent of this depends upon the income and substitution effect. For example, some people need to maintain a certain level of income; therefore, if taxes increase the income effect means that they need to work harder to earn more. It depends how much the tax rate is increased. Often it is the very wealthy who feel it is worth living in another country if tax rates become too high.

Other policies, which may be more effective, could include an increase in the Minimum wage; this increases the wages of those on low pay. However, it may cause unemployment if the labour market is competitive. Also, it will not help the poorest on unemployment benefits. But, if labour markets are monopsonistic then a minimum wage will not cause unemployment. Also a min wage could increase labour productivity and incentives to get a job. Empirical evidence suggests a min wages does not cause unemployment.

To conclude, it may be possible to reduce income inequality by increasing income tax rates and means tested benefits such as income support. However, there is a danger that if they are increase too much they may cause disincentive within the economy, this is something the govt will have to be careful about. There is a conflict between

reducing relative poverty and damaging incentives to work. Policies are likely to be more effective if used in conjunction with general policies to reduce unemployment, which is one of the biggest causes of relative poverty.

## Section – Transport and Market Failure.

### **1. Discuss whether Cost-benefit analysis is a practical way to decide whether projects, such as new roads, should go ahead.**

Cost-benefit analysis is a way to evaluate potential projects and decide whether they are in the interest of the public. Cost-benefit analysis studies involve calculating the social costs and social benefits to a particular project. If the social benefits exceed the social costs, it is indicative that the project is desirable.

The first stage of cost-benefit analysis is to identify all the different costs and benefits. These include the monetary costs such as materials to build road, and pay workers. But, also in building a road there are external costs, such as, damage to the environment, noise pollution and air pollution. These external costs are harder to identify and give a monetary value to. For example, you could ask people involved in project or living near road. However, it is difficult for people to give unbiased opinions and they are likely to put their own perspective onto the evaluation or survey.

When a monetary value has been placed on all the benefits and costs, it becomes easier to decide whether the project should go ahead or not.

The first problem encountered in using cost-benefit analysis is that it can be difficult to put a value on certain costs and benefits. For example, building a new airport may cause noise pollution, but it is hard to put an economic value on this. You could ask people, but this is unreliable and people may give different figures. Therefore, guestimates need to be used, but they may be wrong.

A second problem is that it is hard to identify all potential costs and benefits. For example, building a nuclear power station it might be hard to know potential future problems. For example, the Chernobyl nuclear accident would be something not included in a cost benefit analysis. In any planning there is an element of unpredictability and so it is hard to come to meaningful conclusions.



There may also be a debate about which costs to include in a cost benefit analysis. For example road user groups may not consider impact on environment, whereas, for local activists, environmental concerns may be very important.

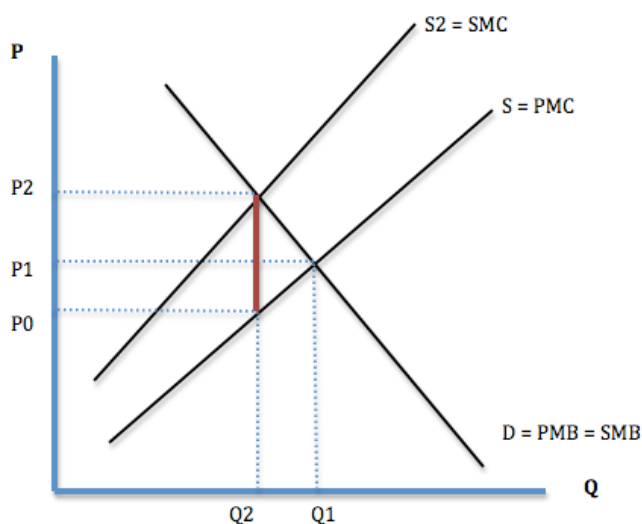
Another issue is that of pareto improvement. A cost-benefit analysis may find that overall social benefits are greater than social costs, and therefore, it should go ahead. But, despite a net gain, some (e.g. living near road) may be worse off. This is not a Pareto improvement. A project can go ahead, but some may lose out considerably. However, if a project does give a net gain, it may be possible to compensate those who lose out, to make sure everyone is better off after the project has been completed; for example, you could give financial compensation to those living near the road.

Cost-benefit analysis certainly has many limitations, but there are not many alternatives. If you make no attempt to weigh up costs and benefits, it is hard to get a better idea of whether project should go ahead. The best thing is to try hard to implement a cost-benefit analysis with greatest care to foresee possible costs and benefits and give a fair value to different externalities.

## 2. Discuss the case for a toll on motorway travel.

Driving on a motorway creates negative externalities. Driving creates pollution and can contribute to the problem of congestion. Therefore, the social cost of driving on a motorway is higher than the private cost. In a free market this will lead to overconsumption of driving on a motorway. We get the market failure of congestion on the roads and too much pollution causing health problems.

In the diagram below, the output in a free market would be at  $Q_1$ . However, this is socially inefficient because the social marginal cost is greater than the social marginal benefit.



Therefore, there is a strong case for putting a tax on the good. This raises revenue for the government and helps to reduce demand to  $Q_2$ , which is the socially optimal level of motorway traffic. The tax revenue could be spent on subsidising alternative forms of transport.

However, there are some difficulties with putting a tax on motorway travel. Firstly, it is inconvenient to collect the tax. People would have to pay at a motorway toll station. This is expensive and also slows down the drivers. This might negate the savings from less congestion.

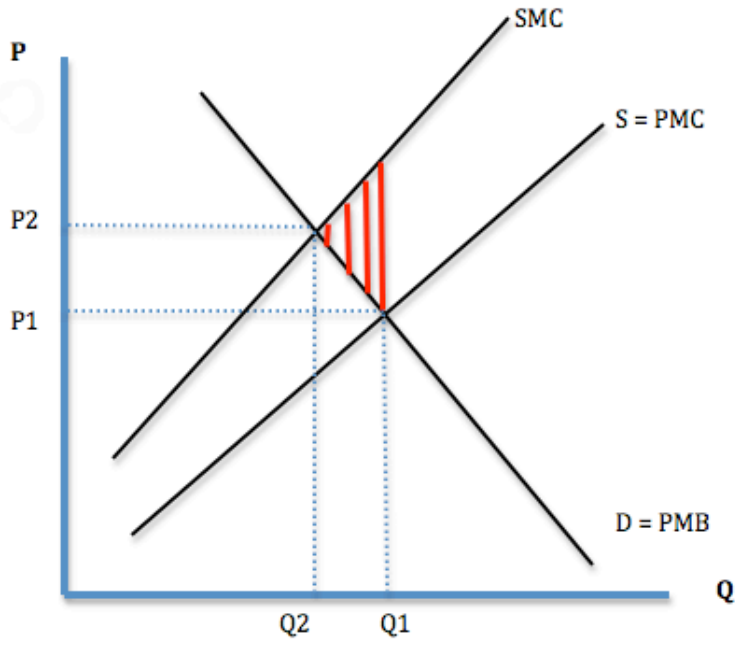
A tax on motorway travel is regressive. This means people on low incomes pay a higher % of their income on tax. It could be said to increase inequality.

Another problem with tax is that it might move the congestion onto other road. If people have to pay a motorway tax, it will encourage them to travel on minor A and B roads. Travelling on A and B roads is actually more dangerous and could easily increase congestion on these single lane roads. Therefore, overall society would not benefit from lower congestion.

### **3 Discuss whether giving increased subsidies to firms providing bus services would correct the market failure arising from urban road congestion.**

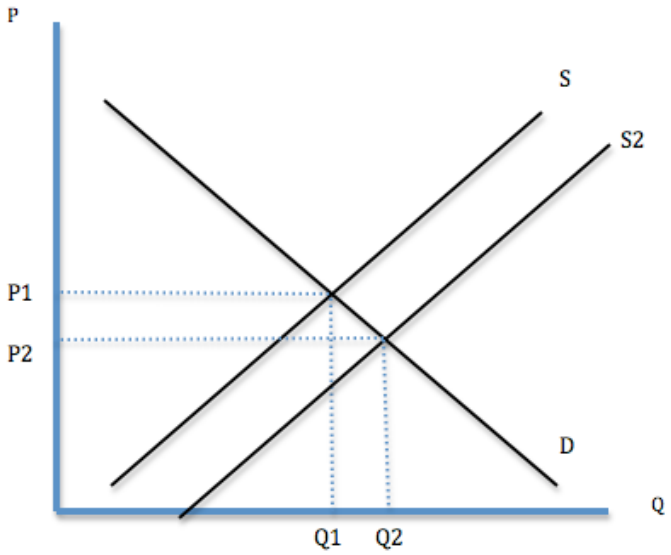
Urban road congestion is an example of market failure because drivers waste time stuck in traffic jams. Market failure means an inefficient allocation of resources in a free market; in this case it is because of the negative externalities of driving that motorists don't take into account when deciding to drive.

In a free market, there is likely to be over-consumption of driving at rush hour. Driving has a negative externality - slower traffic speeds because of too many cars. Therefore, the social cost of driving is greater than the private cost. In a free market, the equilibrium will be at  $Q_1$ , where  $D=S$ . However, at this output, the Social Marginal Cost (SMC) is greater than the social marginal benefit (SMB). This leads to deadweight welfare loss (red shaded area) and overconsumption.



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If more people took the bus rather than drove a car, there is likely to be a reduction in congestion. A bus may take 60 people, and therefore reduce the number of cars on the road. If buses are subsidised, fares will be lower creating greater demand.

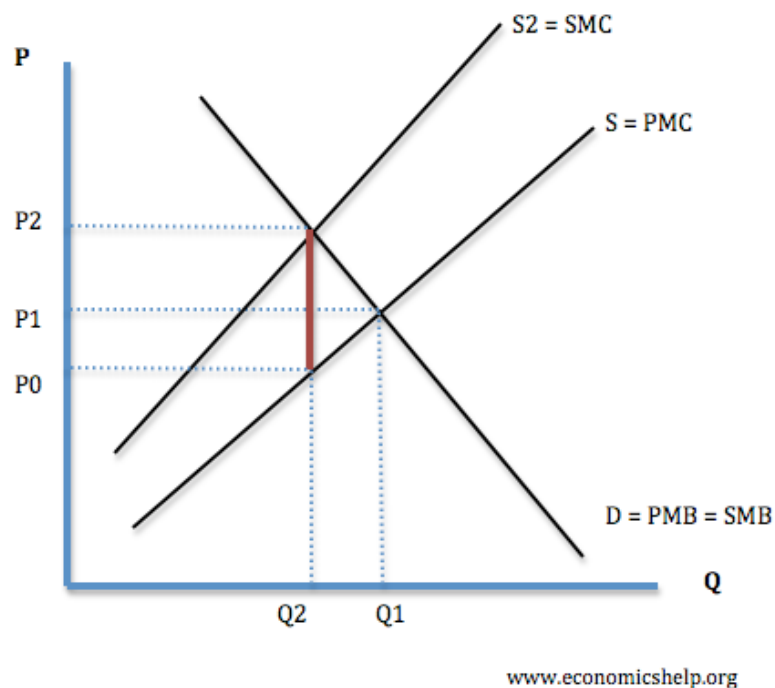


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However, if demand is price inelastic, reducing the price of bus fares may have little impact on increasing demand. For many drivers, they will see buses as a poor substitute to the comfort of driving; lower bus fares may prove insufficient. The policy may be more effective if bus subsidies were combined with higher taxes on cars; this would have added benefit of paying for subsidies, but higher motoring costs

may be necessary to get people out of their cars. Another issue is that it depends on the quality of bus services. If bus services are infrequent or don't go to certain destinations, making them cheaper will not increase demand. As well as subsidising lower fares, it may be necessary to improve quality of bus journeys, for example, providing bus lanes may make buses more attractive because they will be able to go quicker than cars.

Subsidising buses alone is unlikely to solve the market failure arising from congestion. A more effective solution would be to tax car users for the social cost of driving at peak time. If the government implements higher tax and subsidises buses, they may have a greater impact in reducing congestion.



Tax on car use, reduces demand.

## General Tips For Micro Essays

1. At the end of each paragraph check you are answering the question directly.
2. Consider which, if any diagram, could help your answer.
3. Use mixture of economic theory and application to market in question.

## Potential Evaluation

- Elasticity of Demand. E.g. the impact of an increase in price depends on the price elasticity of demand. If demand is inelastic, a tax rise will have little impact in reducing demand.
- Time Lags. Any issue may have a time lag, e.g. a price war may be beneficial for consumers in short term, but not long term if firms are forced out of business.

- Depends on industry in question. E.g. a merger could lead to economies of scale. This is more likely to occur if there are high fixed costs in the industry. The benefits of a merger will be different in oil industry to supermarkets.
- Market structures are only theories. For example, the kinked demand curve is a possible outcome, but in practice many other factors determine oligopolies.
- Depends on Objectives of firms. Economics usually assumes firms are profit maximisers. But, in practice, there may be many other issues at stake – sales max, revenue maximisation, profit satisficing.
- Significance of a Factor. One advantage of monopoly economies of scale may outweigh the small disadvantage of productive inefficiency in the short run.