ECO402 - Microeconomics FAQs By www.virtualians.pk

Question: How does opportunity cost relate to problem of scarcity?

Answer: The problem of scarcity exists because of limited production. Thus, each society must make choices about what to produce and how to produce. The opportunity cost of what to produce consists of the goods and services which are sacrificed in order to produce the selected combination of goods and services. For example, the opportunity cost of producing military goods is the quantity of consumer goods that is not available because of decision to produce military goods.

Question: What is the difference between a shift in demand(supply) and a movement along the demand(supply) curve?

Answer: Change in price of a good or service leads to Change in quantity demanded.It causes the movement along the demand curve. Change in income, preferences, or prices of other goods or services leads to Change in demand.It causes the shift of demand curve.

Question: What is the difference between 'scarcity' and 'shortage'?

Answer: 'Scarcity' and 'shortage' have different definitions. In reality, when most of the goods and resources are scarce goods, we called this phenomenon 'scarcity'. On the other hand, 'shortage' is defined as the situation where the quantity demanded is greater than the quantity supplied because the market price is lower than the equilibrium price.

Question: Why does Excess Demand tend to raise the price of a good while Excess of Supply tends to reduce prices?

Answer: Excess Demand is a situation in which the quantity demanded exceeds the quantity supplied. This situation is created when prices are below the equilibrium. Thus, price tends to rise until it reaches the equilibrium where the quantity demanded equals the quantity supplied. Excess Supply is a situation in which the quantity supplied exceeds the quantity demanded, that happens when prices are above the equilibrium. Therefore, price tends to reduce until it reaches the equilibrium.

Question: Define demand.

Answer: Desire refers to people's willingness to own a good. Demand is the amount of a good that consumers are willing and able to buy at a given price.

Question: Is the indifference curve be upward sloping ?

Answer: Indifference curve cannot be upward sloping because if it sloped upward it would violate the assumption that more of any commodity is preferred to less.

Question: Differentiate between arc Elasticity of demand and

Answer: Point Elasticity of demand. Numerical value of price elasticity of demand at a point of a demand curve is known as point elasticity. In Microeconomics formula for point elasticity is as follows: E = (-) dQ/dP P/Q Arc elasticity: Any two points on the demand curve form an arc and the price elasticity between any two points making an arc on a demand curve is known as arc elasticity of demand.

Question: Define “network externalities”?

Answer: Network externalities are the effects on a user of a product or service of others using the same or compatible products or services.

Question: Differentiate between positive and negative network externalities.

Answer: Network externalities can be positive or negative. A positive network externality exists if the quantity of a good demanded by a consumer increases in response to an increase in purchases by other consumers. A negative network externality exists if the quantity of a good demanded by a consumer decreases in response to an increase in purchases by other consumers.

Question: What is meant by utility?

Answer: The satisfaction, or pleasure, that people receive from consuming a good or service. Utility received from consumption of goods or services varies from person to person.

Question: Differentiate between total utility and marginal utility.

Answer: Total utility: the amount of satisfaction received from all the units of a good or service consumed. Total utility is measured in mythical units called "utils." Marginal utility: the change in total utility from one additional unit of a good or service. Marginal utility measures the amount of extra utility received from consuming each additional unit.

Question: In which case MU will be zero and negative?

Answer: Marginal utility is zero when a person receives no satisfaction from consuming an additional unit. Marginal utility is negative when a person receives dissatisfaction from consuming an additional unit.

Question: What is meant by consumer equilibrium? In which case consumer will be in equilibrium?

Answer: A condition in which total utility cannot increase by spending more of a given budget on one good and spending less on another good. A consumer will be in equilibrium if the marginal utility per last dollar spent on each good is equal and the entire budget is spent, total utility is maximized.

Question: Differentiate between explicit cost and implicit cost.

Answer: Explicit costs: Payments to non-owners of a firm for their resources. For example, wages, rent, utilities, etc. Implicit costs: The opportunity costs of using resources owned by the firm. No actual payment is made to outsiders.

Question: What is perfect competition?

Answer: Perfect competition is an economic model that describes a hypothetical market form in which no producer or consumer has the market power to influence prices. According to the standard economical definition of efficiency (Pareto efficiency), perfect competition would lead to a completely efficient outcome. The analysis of perfectly competitive markets provides the foundation of the theory of supply and demand.

Question: What are the conditions of perfect competition?

Answer: 1-Large no of buyers and sellers 2-Free entry and exit 3-Homogenous product

Question: Can perfectly competitive firms earn economic profit?

Answer: In the short run, yes while in the long run the answer is no.

Question: What will be the effect of output tax on MC and output in competitive Firm's output?

Answer: An output tax raises firm's marginal cost by the amount of tax. And firm will reduce output to the point at which the marginal cost plus the tax equal the price.

Question: Differentiate between short run and long run?

Answer: In short run we are restricted as producer. We can not change our fixed factors but in long run a firm can alter all its inputs, including the size of the plant.

Question: What is graph?

Answer: "A graph is a two-dimensional representation of a set of numbers or data".

Question: What does the slope show?

Answer: The slope of the line indicates whether the relationship between the variables is positive or negative.

Question: What are economics resources?

Answer: Economics resources consist of: (1) Land (2) Capital (3) Labor

Question: What is meant by the term opportunity cost?

Answer: When you have a choice between two or more alternatives, you will choose the best alternative. However, choosing the best alternative means you can't choose the next-best alternative. Opportunity cost is the next-best alternative that must be sacrificed in order to get something else you want

Question: What does the production possibility frontier show?

Answer: The production possibilities frontier illustrates concepts of: a.Scarcity - resources are limited. b.Choice - choices in the production of different goods need to be made. c.Opportunity cost - to gain more of a good something else must be given

Question: What is meant by the term economic growth? What are the sources of economic growth?

Answer: Economic growth occurs when the productive capabilities of an economy increase. It is indicated by an outward shift of the production possibility frontier. Indicating that the economy can expand the output of the good in a full-employment economy without decreasing the output of other goods and services. Increases in resources and improved resource skills and technological progress are the sources of economic growth.

Question: What is market?

Answer: "A geographically defined area where buyers and sellers interact to determine the price of a product or a set of products".

Question: Differentiate between income effect and substitution effect.

Answer: Income effect: "The change in quantity demanded of a good or service caused by a change in real income (purchasing power)". As real income increases, the ability to buy goods and services increases, and so demand increases. Substitution effect: "The change in quantity demanded of a good or service caused by the change in its price relative to substitutes". If two goods are substitutes and the price of one good falls compared to the other, consumers will purchase more of the less-expensive good -- demand for the less-expensive good will increase.

Question: What happens to the demand for a good if the price of a Substitute for it rises?

Answer: Let's have coffee and tea, substitute goods. Then, when the price of coffee rise, the demand for tea will rise since some people will switch demand from coffee to tea.

Question: What happens to the demand for a good if the price of a Complement for it rises?

Answer: Let's have cars and tires, complement goods. If the price of cars rises, the demand for tires will decrease.

Question: Define demand curve.

Answer: "The demand curve is a graph illustrating how much of a given product a household would be willing to buy at different prices".

Question: What do a demand schedule and demand curve show?

Answer: A demand schedule shows the quantity demanded of a commodity per unit of time at various alternative prices for the commodity, when every thing else that effects demand is held constant.

Question: What do a supply schedule and supply curve shows?

Answer: A supply schedule shows the quantity supplied of a commodity per unit of time at various alternative prices for the commodity,

Question: What is held constant in drawing a demand curve? What happens if there is change?

Answer: In defining the market demand curve for a commodity, it is assumed that the number of consumers, consumer's tastes, and money incomes, and the price of related commodities remain constant. The market demand curve will increase or shift up if the number of consumers increases, if their money income rises, if price of substitute commodities rises, or if prices of complementary commodities fall. Opposite changes will cause a decrease or downward shift in demand. A commodity's equilibrium market price and quantity will both rise when its demand curve shifts up; both will fall when it shifts down.

Question: What is held constant in drawing a supply curve? What happens if there is change?

Answer: In defining a market supply curve of a commodity, technology, factor prices, and the price of other commodities related in production remain unchanged. If the number and size of producers of the commodity increase, if technology improves, or if the prices of factors or other commodities (related in production) fall, then the entire market supply curve of the commodity will increase(i.e. shift down to the right), leading to a lower equilibrium market price and higher quantity.

Question: What's Equilibrium?

Answer: Equilibrium occurs when the Supply and Demand curves intersect. Market equilibrium is a situation in which the quantity supplied equals the quantity demanded.

Question: Differentiate between shortage and surplus.

Answer: A shortage is a situation in which quantity demanded is greater than quantity sup¬plied. At a price below the equilibrium price there is a shortage which is corrected when price increases. Quantity de¬manded will fall and quantity supplied will increase until equilib¬rium is reached. A surplus is a situation in which quantity demanded is less than quantity sup¬plied. At a price above the equilibrium price there is a surplus that is corrected when price decreases. Quantity de¬manded will rise and quantity supplied will fall until equilib¬rium is reached.

Question: Define elasticity.

Answer: "Elasticity is a measure of the sensitivity of one variable to another". It tells us the percentage change in one variable in response to a one percent change in another variable.

Question: Write down the determinants of elasticity of demand.

Answer: There are three main factors that determine whether a good or service's price is elastic, unitary elastic, or inelastic. 1. Availability of Substitutes 2. Share of Budget Spent on the Product 3. Adjustment to a Price Change over Time

Question: Define income elasticity of demand.

Answer: "The percentage change in the demand for a good resulting from a one percent change in the income of consumers of the good".

Question: What is the elasticity of demand for Giffen good?

Answer: The elasticity of demand for a Giffen good 'should' have the same definition as a good with a downward-sloping demand curve. Since Giffen good NEVER exists, there is no point to discuss about it.

Question: What will happen on a price-taking market in the short-run and in the long-run, if the government imposes a lump-sum tax on all of the firms?

Answer: In the short-run, some firms will leave the market because the lump-sum tax will make them to have losses. In the long-run, the market supply will fall and the market price will rise since the AC curves of firms shift up because of the levy of the lump-sum tax (there is a rise in AFC). Moreover, the total number of firms in the market will fall but each of the firms in the market will produce more than before.

Question: Why is the long-run average cost (LRAC) curve U-shaped?

Answer: The LRAC curve is U-shape because of the 'assumption' of increasing economies of scale of production for a relative small amount of output and decreasing economies of scale of production for a relative large amount of output.

Question: Why is the LRAC curve U-shaped and what is it relationship with SRAC curves?

Answer: First of all, the LRAC is not necessarily U-shaped. For example, if we assume that the production has constant returns to scale, the LRAC will be a horizontal straight line. However the SRAC is still U-shaped because we assume diminishing marginal returns in short run. However the LRAC should 'envelope' to all the SRAC curves, that means, all the U-shaped SRAC curves will be on and above the horizontal LRAC. It is because the LRAC is always the 'lowest' average production cost at all levels of production.

Question: What is Economics?

Answer: "Economics is the study of how people choose to use scarce resources to satisfy their needs and wants; a study of choice".

Question: Why study microeconomics?

Answer: Microeconomics concepts are used by every one to assist them in making choices as consumers and producers.

Question: What are the main branches of economics?

Answer: The two main branches of economics are microeconomics and macroeconomics.

Question: What is meant by economics indicators?

Answer: Economic indicators are events that give information about the economy as a whole. They are used to analyze economic behavior and predict how the economy will act in the near future.

Question: What is the scope of economics?

Answer: Microeconomics is the branch of economics that examines the behavior of individual decision-making units—that is, business firms and households. Macroeconomics is the branch of economics that examines the behavior of economic aggregates— income, output, employment, and so on—on a national scale.

Question: Why economics is a science?

Answer: Science seeks to understand phenomena; it addresses itself solely to the intellect. It gives pleasure and satisfaction only to those who love the truth and enjoy intellectual achievement. Economics deserves to be called a science because it aims at an understanding of business phenomena. Just as does the physicist or chemist, the economist first classifies the phenomena which he wishes to study and then proceeds to inquire into the causal relations existing between them. With him, as with every scientist, the eternal question is "why." In the complex field of business he sees changes constantly taking place, prices and wages rising, interest rates declining, wage earners striking, and he wants to know what causes these things.

Question: Why study economics?

Answer: 1.An important reason for studying economics is to learn a way of thinking. 2.The study of economics is an essential part of the study of society. 3.Economic decisions often have enormous consequences. 4.An understanding of economics is essential to an understanding of global affairs. 5.Voting decisions also require a basic understanding of economics. 6.Opportunity cost is the best alternative that we forgo, or give up, when we make a choice or a decision. 7.Nearly all decisions involve trade-offs.

Question: What is meant by efficient market?

Answer: An efficient market is one in which profit opportunities are eliminated almost instantaneously. There is no free lunch! Profit opportunities are rare because, at any one time, there are many people searching for them.

Question: Why does the problem of scarcity exists?

Answer: Scarcity exists worldwide because people want more goods and services than can be produced by each economy's limited supply of economic resources.

Question: What are different methods of methods of economics?

Answer: There are two methods of economics, 1)Positive economics 2)Normative economics •Positive economics studies economic behavior without making judgments. It describes what exists and how it works. •Normative economics, also called policy economics, analyzes outcomes of economic behavior, evaluates them as good or bad, and may prescribe courses of action.

Question: What is meant by cetris peribus in economics?

Answer: The ceteris paribus device is part of the process of abstraction. Using the ceteris paribus, or all else equal, assumption, economists study the relationship between two variables while the values of other variables remain constant.

Question: What is the criterion for judging economics outcomes?

Answer: Criteria for judging economic outcomes: 1)Efficiency, or allocative efficiency: "An efficient economy is one that produces what people want at the least possible cost". 2)Equity, or fairness of economic outcomes: 3)Economic growth or an increase in the total output of an economy. 4)Economic stability or the condition in which output is steady or growing, with low inflation and full employment of resources.

Question: Why does a monopoly have no supply curve?

Answer: A supply curve is a curve that shows the quantity supplied at different prices, since a monopoly sets the price and the quantity together, there is no combination of quantity supplied and price under a monopoly. The best we can say is that there a 'supply point' that is set by the monopoly.

Question: At which point profit is maximized in perfect competition?

Answer: Profits are maximized at a point where marginal cost is equal to marginal revenue.

Question: What will be the economic rent for a factor market?

Answer: For a factor market, economic rent is the difference between the payments made to a factor of production and the minimum amount that must be spent to obtain the use of that factor.

Question: Define bilateral monopoly?

Answer: Bilateral monopoly A situation in which there is a single seller (a monopoly) and a single buyer (a monopsony.

Question: What are the sources of monopoly power?

Answer: A firm's monopoly power is determined by the firm's elasticity of demand and it is determined by: 1. Elasticity of market demand 2. Number of firms 3. The interaction among firms

Question: Differentiate between intertemporal price discrimination and peakload pricing?

Answer: In Intertemporal price discrimination price depends on the point in time when a good is sold, but production costs do not depend on the point in time when the good is produced and sold. In peak load pricing demand varies over time for a good which cannot be stored, but production capacity does not vary over time. The peak-period price charged by the producer exceeds the off-peak period price.

Question: What is the Dominant firm model?

Answer: In some oligopolistic markets, one large firm has a major share of total sales, and a group of smaller firms supplies the remainder of the market. The large firm might then act as the dominant firm, setting a price that maximized its own profits.

Question: Define price discrimination. Why 1st degree price discrimination is practically difficult?

Answer: Price discrimination: "When a firm charges a different price to different groups of consumers for an identical good or service this situation is called price discrimination". Because in this type first of all we have to estimate the reservation prices of all consumers than we will see the potential consumers than what are their reservation prices and charge reservation price to each consumer practically is difficult.

Question: What is bandwagon effect? Write down the example of bandwagon effect.

Answer: The Bandwagon Effect: This is the desire to be in style, to have a good because almost everyone else has it, or to indulge in a fad. This is the major objective of marketing and advertising campaigns (e.g. toys, clothing).

Question: What is the application of production possibility frontier?

Answer: Applications of the Production Possibilities Frontier: 1.Inefficient Use of Resources 2.Expansion of the Economy's Productive Capacity 3.A Contraction of the Production Possibilities Frontier 4.The tradeoff between Current Consumption and Capital Investment 5.The tradeoff between Current Consumption and Improved Environmental Quality

Question: Differentiate between real and nominal prices with example.

Answer: Nominal price is the absolute or current dollar price of a good or service when it is sold. Examples: Nominal wages, interest rates and gross domestic product (GDP) Real price is the price relative to an aggregate measure of prices or constant dollar price. Examples: Real wages, interest rates, and GDP - are corrected for the effects of inflation.

Question: What are the two effects which are caused by the fall in the price of a product?

Answer: A fall in the price of a product has two effects income and substitution effects. Price effect = Income effect + substitution effect

Question: What are a Normal good and an Inferior good?

Answer: If a rise in income raises the demand for a good, then it is a Normal good. If a rise in income reduces the demand for a good, then it is an Inferior good.

Question: Differentiate between demand and quantity demand?

Answer: The ability and desire to purchase goods and services is known as demand". Changes in income, wealth, other prices, tastes, or expectations affect demand. "The amount of a good or service that consumers plan to buy during a given time period at a particular price". Changes in price affect the quantity demanded per period.

Question: What is meant by break-even point?

Answer: The output level at which the firm's total revenue equals its total cost, and its total profits are zero is known as break - even point.

Question: How can monopoly power of a monopolist be measured? What is the basic incentive behind monopoly power?

Answer: Monopoly power depends on elasticity of demand and basic incentive behind the monopoly power is to earn more profit.

Question: Define natural monopoly. Why natural monopoly exists?

Answer: A natural monopoly is a monopoly that arises in industry where economies of scale are so large that a single firm can supply the entire market without exhausting them. Natural monopolies occur because of extensive economies of scale.

Question: What basic assumption do we make in order to determine the pure monopolist's best level of output?

Answer: In order to determine the pure monopolist's best level of output we assume (as in the case of perfect competition) that the monopolist wants to maximize total profits. We can look at this either from the total revenue-total cost approach or from the marginal revenue-marginal cost approach

Question: Differentiate between monopoly and monopsony.

Answer: In monopoly market there is a single producer for a product.While in monopsony there is a single consumer for a product.