May 2015 - Paper 1

1a) Explain how prices work to reallocate resources in a market.

Signalling, incentivising and rationing mechanisms.

If prices rise, firms are signalled to enter the market, as the rising price reflects rising demand which they can capitalise on. These firms will often leave other markets behind, to enter the more profitable market, which represents their reallocation of resources. Moreover, rising prices incentivise existing firms to produce a higher quantity of goods as they have the potential to reach higher profits. As such, more factors of production will be reallocated to produce this higher quantity of goods. Either way, goods are reallocated.

Similarly, if prices fall, firms are signalled to exit the market, so resources are allocated away. Firms that do not exit the market will at least be incentivised to produce less to avoid making a loss, and so they utilise less resources in their production.

It can be seen therefore, that changes in price cause resource allocation to or from a market.

1b) Discuss the view that overuse of common access resources is best addressed by the government.

Common access resources are resources that are rivalrous but at the same time non-excludable. A typical example is a public pasture. If multiple shepherds all act in self-interest and graze their sheep in the pasture, the pasture will eventually be degraded, becoming muddy and losing its grass. Common access resources become degraded by individuals using it, hence the government should take action preserve it to enable future sustainability of the common access resource. Other stakeholders, such as the shepherds who graze their sheep on the pasture, are not incentivised to invest in the preservation of the common access resource, as their investment will be enjoyed by other free-riders.

The government could take action such as a payment to use the common access resource. Since the common access resource is no longer free, there would no longer exist “infinite” demand for the resource. This is common on common access resources such as roads, where individuals who use the roads are forced to pay tolls. This prevents overuse of the road (which would cause traffic congestion) and permits money to be re-invested into the road to maintain its quality. As such, this prevents the degradation of the resource caused by everyone acting in self-interest.

Equally, governments could put a general tax on its public, the revenue from which they can then direct towards sustaining the quality of common access resources. However, this does not reduce the demand for the good, so can be seen as inferior to a toll tax.

Similarly, governments could simply put a cap on the usage of the common access resource, such as limitations on fishing in the sea, to preserve the number of fish. This ensures long term sustainability and attempts to avoid the overcrowding of the good.

A key limitation of governmental policy is that, often, policy makers overlook long term negative effects, in favour of seeking shorter term political effects. For example, a policy maker may abolish toll roads in an attempt to win favour with the users of the roads in the lead up to an election. As such, the political agendas of members of the government may disrupt the government’s ability to prevent overuse of common access resources.

4a) Explain how business spending on R&D and government expenditure on infrastructure might shift the long-run aggregate supply curve.

The LRAS curve is shifted by either a change in the quantity or the quality of resources available. While R&D and infrastructure investment don't always increase the quantity of resources available, both improve the quality of resources and hence will shift the LRAS curve to the right. In some cases R&D will also contribute to improving the quantity of resources available, hence shifting LRAS to the right.

R&D is typically focused on product innovation and differentiation, with the objective of putting a firm's product above the shoulders of its competitors or with the objective of reducing production costs. Reducing production costs = LRAS.

A large industry where R&D is concerned is the pharmaceutical industry. R&D in the pharmaceutical industry will result in better medication and health treatment for the population, thus saving lives and potentially increasing the quantity of labour = LRAS.

Infrastructure is the medium in which the economy operates, and investing into these medium aids economic activity. For example, the government investing in the Birmingham-London train route improves mobility of labour between the two cities. Companies in one city will also be able to expand their services into the other city, thus it can be seen that

4b) Evaluate the effectiveness of interventionist supply-side policies to achieve economic growth.

Interventionist supply-side policies refer to policy that attempts to increase productivity and shift aggregate supply to the right.

Examples:

- Education / training
- Research and development
- Infrastructure.
- Industrial policy

+ves
Effective
Yield bigger than input

-ves
Takes time
Expensive
Politics interfere