UNDERSTANDING ECONOMICS

For NCEA Level THREE | EXTERNALS

Skills and Activities for the Key Competencies

Dan Rennie

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Understanding Economics for NCEA Level Three: Externals
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Dan Rennie

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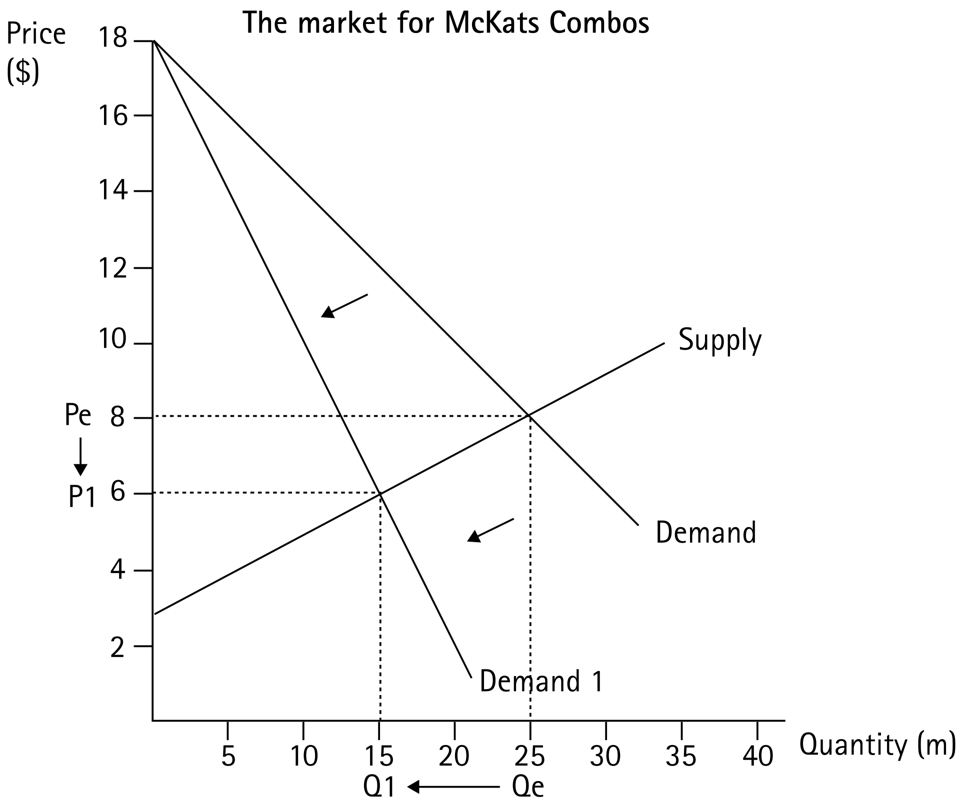
3 Use the graph to answer the following questions.



a Complete the table.

Calculate	Working and answer
(i) CS before	½ × 25m × \$10 = \$125m
(ii) CS after	½ × 15m × \$12 = \$90m
(iii) Change in CS	CS vs CS' = \$35m decrease
(iv) PS before	½ × 25m × \$5 = \$62.5m
(v) PS after	½ × 15m × \$3 = \$22.5m
(vi) Change in PS	PS vs PS' = \$40m decrease

b Explain how market forces move the market for McKats Combos back to the new equilibrium price P1 and quantity Q1.

The decrease in demand causes a surplus (excess supply) at the original price Pe. Producers are willing to accept a lower price to get rid of unsold stock. The price will fall from Pe to P1 and the quantity will fall from Qe to Q1. At Q1 the quantity demanded equals the quantity supplied so the equilibrium is restored.

c Define producer surplus (PS).

The difference between the total earnings of suppliers for a certain quantity sold and the total costs required to put that quantity on the market.

Review questions

1 Firms view the resources used to produce goods and services as costs of production. These form part of a firm's economic and accounting costs.

Compare and contrast economic costs and accounting costs. In your answer you should

- Define accounting costs and give appropriate examples.
- Define economic costs and give appropriate examples.
- Explain why economic cost is greater than accounting cost for some firms than it is for others.

Accounting costs are the actual (or explicit) costs involved in production – mortgage, rent, power, raw materials, wages, and so on.

Economic costs are the actual (explicit) or accounting costs as well as the opportunity costs (implied or implicit) of the resources used. Economic costs would include the lost salary of a teacher who starts a lawn-mowing round. The rent lost by the owner of a factory whose firm currently uses the building is another economic cost. Economic costs include the lost interest that could have been earned by the owner(s) if they had the funds in a bank account rather than in a business. Economic costs are always greater than accounting costs.

Economic costs include accounting costs plus implicit costs. Some producers own a larger proportion of the resources used than other producers, so their economic costs are much greater than their accounting costs.

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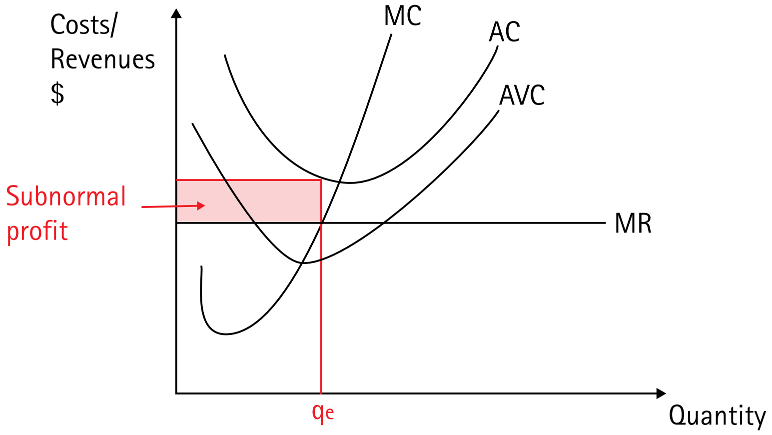
2 In the long run a perfect competitor will earn normal profits.

Explain why perfectly competitive firms make normal profit in the long run. In your answer you should:

- On Graph 1 below label the profit maximising level of output as q_e and shade and label the area of subnormal profit made.
- Explain why the marginal revenue curve for a perfectly competitive firm is drawn as a horizontal line.
- Explain why farmers who entered the dairy industry at the height of the 'boom' face the greatest risk of failure.
- Assuming this firm remains in the industry for the long run, explain how its profit maximising level of output will change.

Graph 1: The perfectly competitive firm



Perfect competitors are too small to affect the price so P = MR = AR, and the marginal revenue curve is drawn as a horizontal line.

Dairy farmers who were the last to enter the industry face increasingly scarce resources (herds, labour, suitable land) and therefore are likely to have relatively high costs/debt/interest payments, consequently, they are likely to be the most vulnerable to falling revenues and prices.

Making a subnormal profit will cause firms to leave the market until normal profit is made in the long run at minimum AC level of output above the current level. The profit maximising level of output increases as marginal revenue increases as a result of firms leaving the industry.

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3 Export receipts look set to increase when new free trade agreements are signed ...

Compare and contrast the impact of increased export receipts on various sectors in the economy. In your answer you should:

- Explain the impact on the producer sector.
- Explain the impact on the consumer sector.
- Explain the impact on the government sector and the overall level of economic activity.

When a free trade agreement is signed export receipts increase as export firms find that demand for their products increases. As export firms increase production/supply to satisfy increased sales they will need to employ additional workers or pay existing workers overtime. Export firms are likely to switch production to the overseas market rather than the domestic market because it is relatively more profitable. Producers in the export sector may have to offer higher wages to attract the workers they need to increase output. As confidence in the export sector rises firms are likely to buy new capital to expand their current production, so investment spending will increase.

Households will have increased income, either as a result of increased employment or because they derive some income from higher profits. Consumption spending is likely to increase.

The government sector will increase its revenue because of increases in direct tax (from greater employment), increases in company tax from increasing profits and higher consumption spending will result in increased GST receipts. Overall as C ↑, I ↑, and X↑ aggregate demand will increase which will cause an increase in real output GDP (economic growth) and an increase in the general price level (inflation).

Self-evaluation review

Tick (✔) which of the following you know the precise economic answers to (go back and learn those that you have not ticked).

	(✔) TICK
Reasons for shifts of the aggregate demand curve and aggregate supply curve.	☐
Reason for the downward slope of the aggregate demand curve.	☐
Reasons for the aggregate supply curve becoming steeper as the economy approaches capacity output.	☐

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