Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.1 Competition and Market Power

4.1.5 Productive and allocative efficiency

Notes

The distinction between allocative efficiency and productive efficiency

- **Productive efficiency** occurs when resources are used to give the maximum possible output at the lowest possible cost.
- This helps maximise consumer welfare, but it can be wasteful if the goods and services consumers want are not produced.
- Moreover, benefiting one consumer by allocating more resources to them means another consumer loses out. This is because all resources are used to their maximum productive potential, so there is no spare capacity.
- Productive efficiency could be achieved by improving management techniques or employing more advanced technology.

- **Allocative efficiency** occurs when resources are allocated to the best interests of society, where there is maximum social welfare and maximum utility.
- The goods and services consumers want might be produced where there is allocative efficiency, but they also need to be affordable. Productive efficiency helps keep the price down.
- Firms are more allocatively efficient when they produce the goods and services which meet consumer preferences. This helps to maximise consumer satisfaction. Firms which are market-orientated meet this outcome and increase allocative efficiency.

The significance of the margin; opportunity costs, trade-offs and allocative efficiency

- Thinking at the margin means thinking about the effect of an additional action.
- An action could involve a marginal increase in product or a marginal cost. For example, working for one extra hour could produce 6 more units of output. However, each extra unit of output costs 10 minutes.
- Thinking at the margin is important, because it allows consumers to keep thinking ahead. It prevents consumers thinking about things they have already done, and allows them to consider how to maximise their utility now or in the future.
- When making choices, margins can also increase productivity, since the most important tasks which maximise utility the most, are the ones which are prioritised.
- Marginal utility is the extra satisfaction derived from consuming one extra unit of the good.

- The demand curve is downward sloping because of **diminishing marginal utility.** The law of diminishing marginal utility suggests that consumer surplus generally declines with extra units consumed. This is because the extra unit generates less utility than the one already consumed. Therefore, consumers are willing to pay less for extra units.
- Every time a consumer makes a decision, they face an opportunity cost. Since resources are scarce, choices which meet consumer needs and wants should be made, since this will help to increase allocative efficiency.

- **Increasing productivity to reduce average cost through greater efficiency by improving:**

Productivity is defined as output per unit of input (e.g. worker) per period of time (e.g. hour).

Being more productive means the same input, such as the number of workers, produces more output, over the same period of time. This lowers the average cost per unit of output. Being less productive requires a larger input to produce the same quantity of output.

Productivity is most commonly measured with labour productivity. Labour productivity is a measure of output per worker per hour. It is equivalent to how much real GDP is produced per unit of labour per hour. This can be used as a measure to compare the efficiency of countries on an international level.

The impact of increases in productivity includes a lower average cost of production. This might result in lower prices for consumers, which in turn might increase demand in the economy and result in higher levels of employment. Moreover, the firm might become more internationally competitive, especially if they are more productive.

Higher profits that are earned as a result of high levels of productivity could be used for investment. This could mean the firm can support its growth in the long term as well as potentially become even more productive.

There could also be improvements in the standard of living if businesses can earn higher profits. This is because they are able to pay their workers higher wages. Higher levels of productivity also result in higher rates of economic growth, since the rate of production in the economy increases, and as a result, GDP increases.

Productivity can be increased by training workers or using more advanced capital machinery. Larger quantities of capital stock could lead to increases in productivity.

Human capital refers to the workers who are employed by a firm, and their productivity can be improved through investment in their education, training and health.

Changes in the level of investment can affect how productive a firm is. If a firm has easy access to credit, they are more able to make investments and therefore improve their long term productivity. Productivity can also be increased by innovation in the process of production, since there will be an increase in allocative efficiency. Moreover, when there is technological innovation, productivity often increases.

Since productivity influences the cost of producing each unit of output, it is directly linked to how competitive a business is. This is because if the average costs of production are high, the business will have to charge high prices in order to cover their costs. This makes them less competitive against other firms, which might be able to charge lower prices if they are more efficient.