

WJEC (Wales) Economics A-level **Microeconomics**





Topic 1: Costs, Revenue and Profits

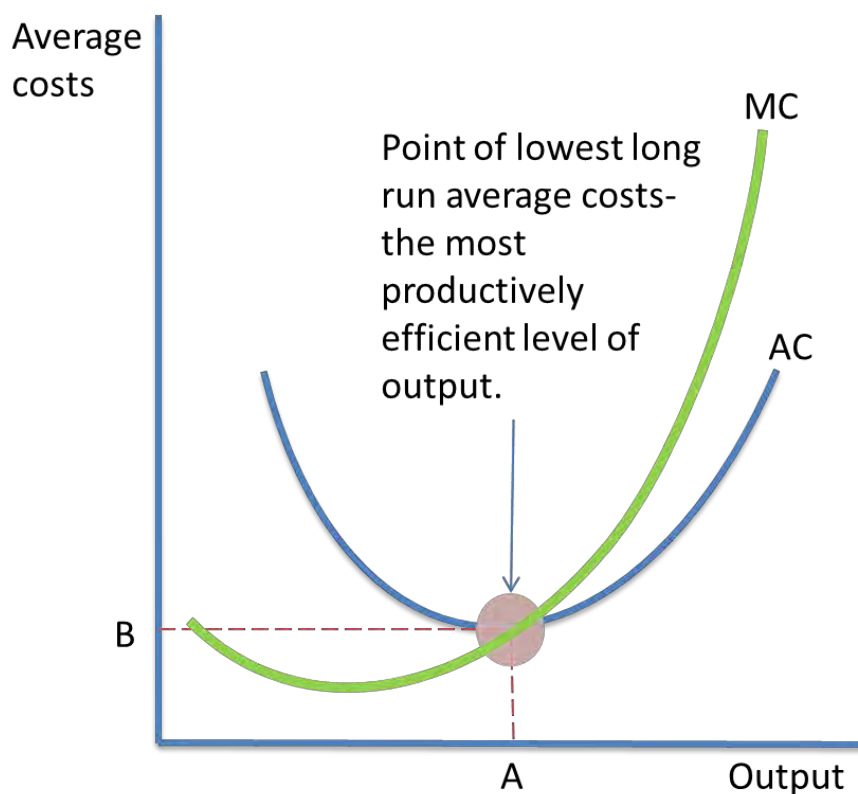
1.3 Efficiency



Notes



Productive and allocative 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.
-  This is when firms produce at the lowest point on the average cost curve. Since the MC curve cuts the AC curve at the lowest point, $MC = AC$ is a point of productive efficiency. All points on the PPF curve are productively efficient.





-  **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.




It exists at $P = MC$, which means that consumers pay for the value of the marginal utility they derive from consuming the good or service. Free markets are considered to be allocatively efficient.


Pareto optimality


 **Pareto efficiency (also: optimality)** occurs when resources are allocated optimally, so every consumer benefits and waste is minimised. At this point, it is impossible to allocate resources to benefit one person, without making another person worse off.


 This occurs on the PPF, so there is a trade-off between producing two different goods and services.

Dynamic efficiency:

 This is when all resources are allocated efficiently over time, and the rate of innovation is at the optimum level, which leads to falling long run average costs. The market is dynamically efficient if consumer needs and wants are met as time goes on. It is related to the rate of innovation, which might lead to lower costs of production in the future, or the creation of new products.

 Dynamic efficiency is affected by short run factors such as demand, interest rates and past profitability.

 Short run costs might be increased in order to cause long run costs to fall.

 Dynamic efficiency can be evaluated by considering the long time lag between making an investment and having falling average costs and by considering how factors change in the long run. Moreover, some firms will face a trade-off between giving their shareholders dividends and making an investment.

