OCR Economics A-level

Microeconomics

Topic 2 – The Role of Markets

Definitions and Concepts

2.1 – Specialisation and trade

Specialisation - The production of a limited range of goods by a company/country/individual so they aren't self-sufficient and have to trade with others.

Division of labour - When labour becomes specialised during the production process so workers carry out a specific task in co-operation with other workers.

2.2 – Demand

Competitive demand - When goods are substitutes, so buying one means you don't buy the other.
Composite supply - When a good or service can be obtained from different sources.

Demand - The quantity of a good/service that consumers are able and willing to buy at a given price during a given period of time.

Individual demand - Demand of an individual or firm, measured by the quantity bought at a certain price at one point in time.

Joint demand - When goods are bought together.
Market demand - Sum of all individual demands in a market

2.3 – Supply

Competitive supply - When a business could make more than one good with its resources, and producing one means they can't produce the other.

Composite supply - When a good or service can be obtained from different sources.

Individual supply - Supply of a single firm.
Joint supply - Increasing supply of one good causes an increase in the supply of a by-product.

Market supply - Sum of all individual supplies in the market.

Supply - The ability and willingness to provide a particular good/service at a given price at a given moment in time.

2.4 – Consumer and producer surplus

Consumer surplus - The difference between the price the consumer is willing to pay and the price they actually pay.

Producer surplus - The difference between the price the producer is willing to charge and the price they actually charge.

2.5 – The interaction of markets

Derived demand - The demand for one good is linked to the demand for a related good.

Excess demand - When price is set too low so demand is greater than supply.

Excess supply - When price is set too high so supply is greater than demand.

Market - Where demand and supply interact; the collection of many sub-markets.

2.6 – Elasticity

Complementary goods - Negative XED; if good B becomes more expensive, demand for good A falls.

Cross elasticity of demand - The responsiveness of demand of one good (A) to a change in price of another good (B), calculated by: %change in QD of A divided by %change in P of B

Elasticity - How responsive demand or supply is to a change in price.

Income elasticity of demand - The responsiveness of demand to a change in income, calculated by:

Inferior goods - YED<0; goods which see a fall in demand as income increases.

Luxury goods - YED>1; an increase in incomes causes an even bigger increase in demand.

Normal goods - YED>0; demand increases as income increases.

Perfectly price elastic good - PED/PES=Infinity; quantity demanded/supplied falls to 0 when price changes.

Perfectly price inelastic good - PED/PES=0; quantity demanded/supplied does not change when price changes.

Price elastic good - When PED/PES>1; demand/supply is relatively responsive to a change in price so a small change in price leads to a large change in quantity demanded/supplied.

Price elasticity of demand - The responsiveness of demand to a change in price, calculated by: %change in QD divided by %change in P.

Price elasticity of supply - The responsive of supply to a change in price, calculated by: %change in QS divided by %change in P

Price inelastic good - When PED/PES<1; demand/supply is relatively unresponsive to a change in price so a large change in price leads to a large change in quantity demanded/supplied.

Substitutes - Positive XED; if good B becomes more expensive, demand for good A rises.

Unrelated goods - XED=0; if the price of good B changes, it has no impact on the demand for good A.

2.7 – The concept of a margin

Diminishing marginal utility - The extra benefit gained from consumption of a good generally declines as extra units are consumed; explains why the demand curve is downward sloping.

Margin - The effect of an additional action.

2.8 – Market failure and externalities

Externalities - The cost or benefit a third party receives from an economic transaction outside of the market mechanism.

Marginal external benefit - The extra benefit to a third party not involved in the economic activity, per unit consumed

Marginal external cost - The extra cost to a third party not involved in the economic activity, per unit consumed, expressed by: marginal social cost- marginal private cost.

Marginal private benefit - The extra benefit to the individual per unit consumed.

Marginal private cost - The extra cost to the individual per unit consumed.

Marginal social benefit - The extra benefit to society per unit consumed, expressed by: marginal external benefit + marginal private benefit.

Marginal social cost - The extra cost to society per unit consumed, expressed by: marginal external cost + marginal private cost.

Market failure - When the free market fails to allocate resources to the best interest of society, so there is an inefficient allocation of scarce resources.

Negative externalities of consumption - Where the social benefits of consuming a good is less than the private benefit of consuming a good.

Negative externalities of production - Where the social costs of producing a good are greater than the private costs of producing the good.

Positive externalities of consumption - Where the social benefits of consuming a good are larger than the private benefits of consuming that good.

Positive externalities of production - Where the social costs of producing a good are less than the private costs of producing a good

2.9 – Information failure

Asymmetric information - Where one party has more information than the other, leading to market failure.

Demerit goods - Goods with negative externalities.

Information failure - When an economic agent lacks the information needed to make a rational, informed decision.

Merit goods - Goods with positive externalities.

Moral hazard - Where individuals make decisions in their own best interests knowing there are potential risks for others.

2.10 – Public goods

Free rider problem - People who do not pay for a public good still receive benefits from it so the private sector will under-provide the good as they cannot make a profit.

Non diminishability/ non-rivality - A characteristic of public goods; one person's use of the good does not prevent someone else from using it.

Non-excludability - A characteristic of public goods; someone cannot be prevented from using the good.

Non-rejectability - A characteristic of public goods; people cannot choose not to consume the good.

Private goods - Goods that are rival and excludable.

Public goods - Goods that are non-excludable, non-rivalry, non-rejectable and have zero marginal cost.

Quasi-public goods - Goods which aren't perfectly non-rivalry/non-excludable but aren't perfectly rivalry/excludable.

State provision - When the government provides public goods or merit goods which are underprovided in the free market.

2.11 – Government intervention

Buffer stock schemes - The introduction of both a maximum and minimum price in the market to prevent large fluctuations in prices.

Competition policy - Government action to increase competition in markets.

Government failure - When government intervention leads to a net welfare loss in society.

Indirect tax - Taxes on expenditure which increase production costs and lead to a fall in supply.

Information provision - When the government intervenes to provide information to correct market failure.

Maximum price - A ceiling price which a firm cannot charge above.

Minimum price - A floor price which a firm cannot charge below.

Public/ private partnerships - When the government and the private sector work together to build and operate projects.

Regulation - Laws to address market failure and promote competition between firms.

Subsidy - Government payments to a producer to lower their costs of production and encourage them to produce more.

Tradable pollution limits - Licenses which allow businesses to pollute up to a certain amount. The government controls the number of licenses and so can control the amount of pollution. Businesses are allowed to sell and buy the permits which means there may be incentive to reduce the amount they pollute.