



Worksheet 1: Economic terms answers

1	Absolute poverty <i>Absolute poverty is when a person does not have enough money to afford basic necessities.</i>	Relative poverty <i>Relative poverty is the comparison of the standard of living of one person with another.</i>
2	Actual production <i>Actual production can be raised by utilizing already available resources. Graphically, it can be shown by a movement from inside a production possibility curve (PPC) towards a point on the PPC.</i>	Production potential <i>Potential output rises when the quantity or quality of resources improves. Graphically, it is shown by a rightward shift in PPC or the long run (LRAS).</i>
3	Ad valorem tax <i>Ad valorem tax is when the tax is based on the value of the product, for example a tax of 15% of the price. The higher the price of the product, the higher the tax amount per unit would be.</i>	Specific tax <i>Specific tax is when the tax amount per unit is a fixed amount, for example \$0.20 per unit. Though both are examples of indirect taxes, ad valorem tax is based on the value of the product whereas specific tax is based on the number of units purchased.</i>
4	Asymmetric information <i>Asymmetric information arises when one of the parties in a transaction has more information than the other. For example, a seller probably knows more about the quality of his used car than the potential buyer and a person buying insurance is probably more aware of his health issues and life style than the company selling the insurance.</i>	Moral hazard <i>A moral hazard arises when a person changes his behaviour after an agreement between the buyer and seller has already been reached. For example, after getting home insurance, a person may get a little careless about the security of his house, knowing that any loss because of a theft will now be covered by the insurance company.</i>
5	Devaluation of currency <i>While both devaluation and depreciation of currency reflect a decrease in exchange rate, devaluation is because of the actions of the government, whereas depreciation of currency is due to market forces. An increase in exchange rate, if due to government intervention, is known as revaluation and appreciation is because of the market forces of demand and supply.</i>	Depreciation of currency



6	Direct taxes <i>Direct taxes are directly paid by the tax payers to the government, e.g. income tax. Higher direct taxes reduce disposable income, leading to lower consumption and shift the Aggregate Demand (AD) curve to the left.</i>	Indirect taxes <i>Indirect taxes are levied on expenditures, e.g. sales tax and excise duties. They raise the cost of production and shift the supply curve to the left. Producers often shift the burden of these taxes to the consumers by raising prices, so these taxes usually affect real income.</i>
7	Economic growth <i>Economic growth is an increase in the real output of an economy.</i>	Economic development <i>Economic development is a more comprehensive term and occurs when the quality of life and general well-being of the citizens, as indicated by literacy rate and life expectancy, improve.</i>
8	Economics of scale <i>Economies of scale are a decrease in the long run average cost due to an increase in business size.</i>	Increasing returns to scale <i>Increasing returns to scale happen when the percentage change in output exceeds the percentage change in inputs.</i>
9	Equality <i>Equality is when everyone receives the same outcome/income.</i>	Equity <i>Equity is fairness and means that everyone receives income as per their contribution. Equity may be described as the ratio of reward and effort.</i>
10	Free goods <i>Free goods are resources, e.g. sunshine, which is not scarce and there is no economic cost involved in their provision. They are a gift of nature.</i>	Economic goods <i>Economic goods are not only desirable but also scarce. Usually, a price must be paid to have economic goods. All public and private goods, as well as merit and demerit goods, are examples of economic goods.</i>
11	Free trade area <i>Free trade area is one which abolishes all trade barriers for its members but allows them to independently decide tariffs for non-members.</i>	Custom union <i>A custom union not only removes all trade restrictions for members but also maintains a uniform tariff policy for non-members.</i>



12	Government borrowing	National debt	
	Government or public sector borrowing is needed to finance a budget deficit. It is a flow concept that is for a period of time.	National debt is a cumulative number and a stock concept. Rising public sector borrowings raise national debt and the decision of the government to repay loans reduces it.	
13	Inflation	Disinflation	Deflation
	Inflation is a persistent increase in general price levels. Price levels rise when there is positive inflation.	Disinflation is when inflation rates fall. Price levels still rise but at a slower rate when there is disinflation.	Deflation is when the inflation rate is negative and price levels fall.
14	Internal value of money	External value of money	
	Internal value of money is the purchasing power of money to buy goods and services. It falls whenever the inflation rate is positive (e.g. when price levels rise).	External value of money is the exchange rate, e.g. how many units of a foreign currency can be purchased with a given amount of national currency. Changes in external value of money are either depreciation or appreciation.	
15	Kinked demand curve	The Kuznets curve	
	Kinked demand curve shows an interdependence of firms. In a market dominated by a few large firms, the outcome of the decision of a firm to change price depends on the reactions of its competitors and vice versa. Kinked demand curve assumes that the decision of a firm to raise its price is not matched by its competitors, resulting in a proportionately larger fall in its quantity demanded. Therefore, firms choosing to raise prices face a flatter, price elastic demand curve. However, the decision to reduce prices is followed by the competitors, resulting in a negligible rise in the quantity demanded. Therefore, the demand curve faced by the firm choosing to lower its price is a steeper one, showing price inelastic demand. The demand curve is kinked at the point of initial price and quantity.	The Kuznets curve shows the relationship between per capita income and income inequality. According to this curve, a rise in per capita income initially raises income inequalities, but eventually income inequalities begin to fall.	



16	Laffer curve	Lorenz curve	
	<p>A Laffer curve shows the relationship between tax rates and tax revenues. According to this curve, an increase in tax rates initially raises tax revenues, but eventually tax receipts begin to fall. Very high tax rates discourage incentives to work, resulting in a slowdown of economic activity and instead of raising tax revenues, result in a loss of tax revenues. High tax rates also raise the possibility of tax evasion, which may also lead to lower tax revenues.</p>	<p>A Lorenz curve is the graphical representation of income or wealth inequality. The further the Lorenz curve is from the line of equity (a 45-degree line), the greater would be the Gini coefficient and income disparities.</p>	
17	Liquidity trap	Poverty trap	
	<p>Liquidity trap is a situation where interest rates are very low, and savings are high. Expansionary monetary policy becomes ineffective, as lowering interest rates cannot encourage people to spend or invest more.</p>	<p>Poverty trap is a situation where the benefits of rising income are offset by the removal of means tested benefits, leaving that person no better off.</p>	
18	Market equilibrium	Consumer equilibrium	
	<p>Market equilibrium is when demand equals supply and there is no tendency to change in equilibrium price and quantity.</p>	<p>Consumer equilibrium is achieved when a consumer maximizes his total utility by equating the marginal utility per dollar for the last units of all commodities.</p>	
19	Money	Cheques	Credit cards
	<p>Money is used to buy goods and services and is an instrument to settle debts. Though coins and currency notes are popular forms of money, more and more people are shifting to online payments. In a modern economy, bank deposits and online payments are also examples of money.</p>	<p>Cheques do not represent any value, so they cannot be considered as money.</p>	<p>Although credit cards help in buying goods and services, they cannot be regarded as money, as they are a borrowing instrument and represent no value. They are money substitutes.</p>



20	Multiplier	Accelerator	
	An expenditure multiplier shows the relationship between changes in autonomous expenditures and national income. Any change in autonomous expenditures results in a larger change in national income because of the multiplier.	An accelerator is the relationship between changes in income and induced investment.	
21	Normal goods	Inferior goods	Necessities
	Normal goods, e.g. fine dining, are goods whose demand rises with income.	Inferior goods, e.g. public transport, are those whose demand falls when income rises.	Demand for necessities, such as fuel, does not change much when income changes.
22	Price elasticity of demand	Price elastic demand	
	Price elasticity of demand measures the degree of responsiveness of the quantity demanded to a change in the own price of the product.	A product is said to have price elastic demand when a change in price causes a more than proportionate change in the quantity demanded.	
23	Primary income	Primary sector	
	Primary income is income earned from providing factor services in other countries. Examples include wages, rent, interest payments and dividends.	Primary sector involves extracting natural resources and raw materials. Examples include agriculture sector, livestock, mines, and forests.	
24	Production	Productivity	
	Production is the number of units a firm produces.	Productivity is the ratio of output produced and inputs employed. Higher productivity does not necessarily guarantee higher output, as highly productive firms may still be producing fewer units if they have fewer workers than less productive firms.	
25	Profits	Profitability	
	Profit is the excess of total revenues over total cost.	Profitability is the ratio of profits and sales, or capital employed. A business may be earning more profits yet be less profitable.	



26	Public goods	Private goods
	Public goods are non-excludable and non-rival. Non excludability means that no one has a legal right to stop others from using a product, whereas non rivalry means that the use of a product by one does not affect its consumption by others. National defence, streetlights and lighthouses are good examples of public goods. It is not possible to charge a price and make a profit from providing these goods, so only a government can provide them.	Private goods are excludable and rivals. Merit, demerit, consumer, and capital goods are examples of private goods. Since the use of these products may be restricted to only those who pay the price, the private sector may provide them to earn profits. Public parks, public libraries and roads are also not pure public goods, as they are excludable (a toll may be charged for using a road) and rival (for example, road congestion).
27	Qualities of money	Functions of money
	Qualities of money are features of money that help it perform its functions effectively. Some of the qualities of money are general acceptability, portability, divisibility, homogeneity, durability, and scarcity.	Functions of money are the roles money needs to perform, such as medium of exchange, store of value, unit of value and a standard for deferred payments.
28	Real income	Disposable income
	Real income is the purchasing power, e.g. the amount of goods and services one can buy with given money income. It falls when prices rise.	Disposable income is income minus direct taxes. It falls when direct taxes, such as income taxes, are raised.
29	Secondary income	Secondary sector
	Secondary income is a payment received from another country, against which, no production activity takes place. Examples include pensions and donations.	The secondary sector involves producing goods and services. Automobiles, steel, textiles, and electronics are some examples of the secondary sector industries.
30	Social cost	External cost
	Social costs include both the private and external costs of an economic transaction.	External costs, such as pollution, are borne by outsiders to a transaction, whereas private costs, such as the rent of a building, are borne by the members of the transaction.



31	Tax rate	Tax amount
	<p>Tax rate is the ratio of tax amount and income. The tax system is progressive when the tax rate rises with income, proportionate when the tax rate does not change with income and regressive when the tax rate falls when income rises.</p>	<p>Tax amount is the product of tax rate and income earned. The tax amount rises faster than income when the system of taxation is progressive. In a proportionate system of taxation, the tax amount rises in line with income, while in a regressive tax system, the tax amount rises slower than income or may even fall. Since the tax amount may rise with income in all three taxation systems, it is the tax rate that differentiates a progressive system of taxation from the other two.</p>

32	Terms of trade	Balance of trade
	<p>Terms of trade are the ratio of average export price and average import price. Higher terms of trade may be caused by a comparatively higher inflation rate or a stronger currency. It may lead to rising trade deficit if the PED (price elasticity of demand) for net exports exceeds 1.</p>	<p>Balance of trade is the difference between exports and imports of goods. It is one of the four components of a current account. Trade is balanced when exports of goods equal their imports. Trade surplus means exports of goods exceed imports of goods, while a trade deficit is when exports of goods are less than their imports.</p>

33	Trade creation	Trade diversion
	<p>Trade creation occurs when trade shifts from a less efficient/high cost producer country to a low cost/more efficient country. It happens when a trade agreement is signed between countries allowing tariff-free imports from efficient countries.</p>	<p>Trade diversion takes place when trade shifts from a more efficient country to a less efficient one. It happens when a country signs a trade agreement with a less efficient country, allowing tariff free imports from it at the expense of imports from a more efficient non-member country.</p>

34	Trade deficit	Budget deficit	Current account deficit
	<p>Trade deficit is when the export of goods falls short of their imports.</p>	<p>Budget deficit is when government expenditures exceed tax revenues. Budget deficit raises Aggregate Demand (AD), whereas trade deficit reduces it.</p>	<p>Current account deficit arises when inflows from exports of goods and services, factor incomes and net transfers fall short of outflows for the same.</p>



35	Transfer payments	Transfer earnings
	<p>Transfer payments are payments against which no production activity takes place, for example pension and unemployment allowances. They are payments received but not earned.</p>	<p>Transfer earnings are the minimum payment one requires to continue in the existing profession. These are the earnings possible from the next best alternative occupation.</p>
36	Universal benefits	Means tested benefits
	<p>Universal benefits, such as medical care, public schooling, and pensions, are unconditional and given to everyone, irrespective of their income.</p>	<p>Means tested benefits are given to individuals and families based on their income and resources. These benefits are gradually withdrawn when income rises.</p>
37	X-efficiency	Dynamic efficiency
	<p>X-efficiency is the degree of efficiency maintained by firms in imperfect markets. Since the pressure on firms to be efficient is less in less competitive markets, the firms tend to be X-inefficient. X-inefficiency is the gap between actual efficiency and potential efficiency.</p>	<p>Dynamic efficiency involves improving efficiency over time. It can either be achieved by developing new and better products or by discovering better techniques to produce goods at lower costs.</p>