Script H – Paper 4

1a There are barriers to competition which it prevents consumers from switching in demand. Thus, the cost of entry is relatively high, as it requires $60 million for a supermarket. Also, supermarkets have a slight degree of market power. The firm will be able to raise prices to fund the costs without losing all its consumers. The consumer may not have perfect information on the products.

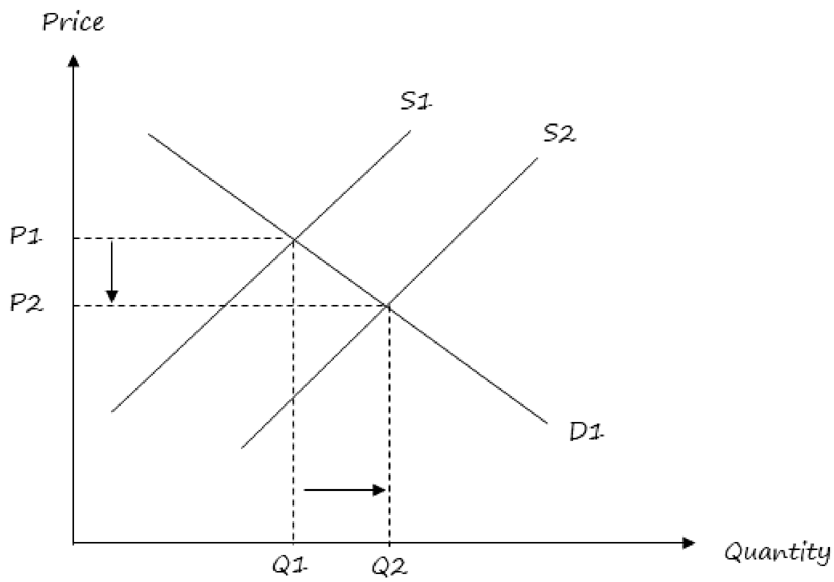
1b Price elasticity of demand is the change in quantity demanded over the change in price. A profit-maximising retailer might be interested in the link between consumers' loyalty and the price elasticity of demand. This is because once a consumer is loyal to their specific brand, they rarely ever change their brand, and it creates a habit-forming effect to only consume from that brand. This also indicates that the demand for that good is price inelastic. When the product is price inelastic firms are able to increase the price whilst increasing their revenue and maximise their profit.

1c There is conflicting evidence in the article about the effectiveness of loyalty cards which offer price discounts. This can be seen when the article states that loyalty cards allow retailers to know more about the consumer's tastes and preferences and their spending patterns. Therefore, through loyalty cards, retailers are able to know which products should give discounts and which is not. However, it also states that many purchases are based on habit and consumer research is imprecise. If the consumer has low emotional involvement there will be less loyalty towards the retailers.

1d Indifference curve assumed that the consumer consumes only two goods. There is always the possibility for them to substitute one good for another good to maximise their own private benefits which is satisfaction. Not only that, consumers make their choices of consumption under the condition of ceteris paribus in which all other factors such as quality of the product, confidence level to spend, and knowledge about the product remain constant. A higher indifference curve indicates a higher satisfaction level, whereas, a lower indifference curve indicates a lower satisfaction level. Lastly, consumers are assumed to know their satisfaction level and compare their satisfaction level to price all the time.

2 Market failure is a situation in which the free-market equilibrium does not lead to a socially optimal allocation of resources, such as when a good is over or under-consumed or produced. Positive externalities are when a good is consumed, there will be larger benefits to the third parties rather than the ones consuming the good/service. When market failure occurs, governments will have to intervene to correct the market failure. When market failure is caused by positive externalities it is often caused by the underproduction and consumption of a merit good. To correct this governments can provide subsidies to the firms. The subsidies will lower the costs of production, which allows the firms to supply more goods and services at a lower cost. The reduction in price will make the good/service more attractive to consumers, making them consume more of the good which will ultimately increase the demand for the good.

This can be seen in the diagram below where S1 shifts parallel to the right to S2 causing a decrease in price but an increase in the quantity demanded.



However, there is a disadvantage to this type of government intervention as it is very costly and the positive externalities are difficult to measure. That is why governments will have difficulty deciding correctly which and how subsidy should be given.

Government can also encourage and educate consumers to consume more of these goods as sometimes consumers will have imperfect knowledge of these goods. This can be done through advertising, which will increase demand and consumption. This will further cause the output to increase and achieve allocative efficiency. However, advertisements are not certain and are not always successful. In addition to that they are relatively expensive.

To conclude this government intervention is able to correct market failure and inefficiency however, there are risks involved and they may not always be successful.

5 Foreign direct investment is undertaken in one county by foreign companies based in other countries. It ultimately encourages multinational companies to set up their production in foreign countries and is a long-term investment. Low-income countries are countries that have high poverty and a large gap between the rich and poor. They often lack basic necessities such as food and water. To improve the situation of these low-income countries they would need to improve their economic activity, and this can be measured by the increase in CGP.

Low-income countries lack savings to finance investment, foreign direct investment can overcome this shortfall and MNCs can purchase capital equipment and help to develop the country's infrastructure as well as training to have skilled workers. This in the long run will boost economic activity and will cause a rise in employment and output.

MNCs' activities on the economics of those countries can bring in new technology, and ideas and can add to GDP and exports to generate employment. However, not all MNCs are perceived well in the countries where they invest as, MNCs may not create higher employment and higher incomes if they replace domestic firms, they may have negative effects instead. The income generated may be sent back and most of their profits back to their home countries and may employ foreign rather than home labour, especially in the higher income earning jobs. In addition to that, some of the products (such as cigarettes and alcohol) they sell may not improve people's living standards and may not be necessary to boost economic activity in low-income countries.

In consideration, MNCs may not make significant use of local labour. They may hire local unskilled labour but use emigrant skilled workers as managers. They may also be highly capital-intensive in their production methods which won't increase employment rates and create spill-over effects on the MNCs.