

THEORY PROGRAM

FNR – SUGGESTED ANSWERS

FNR: 07

Viewed SA (VR) on:

2024 A/L

ATTEMPT. PRACTICE. LEARN. IMPROVE. ACHIEVE.

Part – [A]

Question	Answer	Question	Answer
01		14	
02		15	
03		16	
04		17	
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13			

Part – [B]**Question [01]**

Match the relevant concept with the appropriate statement [01 marks each]

Long run	Supply curve	Price Elasticity	Producer surplus
Change in demand	Short run	Price Ceilings	Equilibrium price
Excess demand	Excess supply	Price Floors	Consumer surplus

	Statements [Concept Description]	Concept
1	The price that equates quantity demanded to quantity supplied.	Equilibrium Price
2	A stage in production in which all inputs can be changed with output	Long Run
3	A change in the quantities demanded at each given price	Change in Demand
4	Quantity demanded greater than quantity supplied at a price.	Excess Demand
5	A curve that relates price and quantity supplied.	Supply Curve
6	A stage in production in which some or one inputs cannot be changed with output	Short Run
7	Difference between total revenue and the total variable cost of all the firms in the market	Producer Surplus
8	The aggregate value of the utility that a consumer enjoys by paying less than he or she is willing and able to pay for a good.	Consumer Surplus
9	Quantity supplied greater than quantity demanded at a price.	Excess Supply
10	The answer obtained by multiplying the price coefficient of demand or supply by the price quantity ratio	Price Elasticity

[Objective: Spot Recap of Key Concepts]

Question [02]

Distinguish between the following pairs of concepts

Hint:

Simply provide a technical and standard definition for each concept (with examples as appropriate)

- (1)** A Good and a Bad
- (2)** An Economic goods and a Non-economic (or Free) good
- (3)** A Capital good and a Consumer good

[03 marks each]

- (1) A **good** refers to anything (tangible) which provides a **positive satisfaction** or **utility**. Positive demand (or demanded) at zero price.

(01 mark)

In the study of economics goods are broadly classified as economic goods and free goods, which economic goods are further classified into capital and consumer goods, based on usage.

(½ mark) (Subtotal 1 ½ marks)

An economic **bad** is anything which provides a **negative utility** or **dissatisfaction** (disutility). Such bads or nuisance goods have a negative demand at zero price.

(01 mark)

Examples: **garbage, wild weeds, and prolusion**

(½ mark) (Subtotal 1 ½ marks)

(Total 03 marks)

- (2) **Economic goods refer** to goods which are **limited in supply**, with an opportunity cost in production.

Economic goods are a result of a **human involved production process**, which uses **limited resources** with alternative uses. Therefore, the production of economic goods shall result in a **positive opportunity cost and marginal cost**. While economic goods have a price, they may be offered with or without a price.

Examples: clothes, food, vehicles, furniture etc

[1 ½ marks]

Non-economic or free goods refer to goods available in **abundance** (infinite in supply) at **zero price**, when the supply is available.

Free goods do not represent a human involved production process or use of limited resources, therefore **do not represent a resource cost** (zero opportunity cost, zero marginal cost).

Examples: fresh air, rain or river water, sunlight

[1 ½ marks, total 03 marks]

Additional: Economic goods will not become non-economic goods under any circumstance, but free or non-economic goods can become economic goods in certain situations [bottled **water**, **oxygen** used by diver or provided to a patient]

- (3) **Capital Goods are goods used to produce other goods and services.**

Capital goods are produced and are used in the process of producing consumer goods. Capital good tend to be durable assets, subject to depreciation.

General examples:

Commercial buildings, machinery, equipment, commercial vehicles

[1 ½ marks]

Consumer Goods are goods which are not used to produce other goods, rather for final use of (personal) consumption.

Can be both durables and non-durable in nature.

General examples include:

Food items, medicine, clothes, consumer electronics, personal accessories

[1 ½ marks] [Total 03 marks]

A certain good can be both a capital and consumer goods, this is because the capital or consumer nature of a good essentially depends on the 'usage' of the good.

Question [03]

(A) Distinguish by 'Defining' the following concepts connected to Supply Theory:

- (1) Supply (i.e., Effective Supply) and Quantity supplied**
- (2) Institutional Supply and Market Supply**

[04 marks each]

(B) State the specific and generic factors determining the quantity of Fresh Milk supplied by dairy farmers in Sri Lanka

[05 marks]

(A) (1)

Supply in economics is effective supply.

Supply is the different quantities of a given product producers are **able** (have the resources and technology), **willing** (have the potential to earn profits) and **planning** to **produce** and **supply**, under alternative **prices** in the market, when all **other factors** affecting supply **remain constant, during a given period of time.**

(02 marks)

Quantity supplied essentially refers to the **amount of a good** that sellers are **able** and **willing** to **supply**, at a **specific price**. While supply is indicated by the entire supply schedule curve (or function) of a product, quantity supplied is indicated by a given point of the supply schedule or curve.

(02 marks) (Total 04 marks)

(2) Individual supply is the quantities of a **given product, an individual firm operating** in the market has the **ability to produce**, has the **potential to earn profits** by supplying and has **planned** to produce and supply, under **alternative market prices**, while **other factors** affecting supply remain **constant, during a given period of time.**

Market supply is the **sum** (or total) of the **quantities** of a **given product**, **all the firms** operating in the market are having the **ability to produce**, has the **potential to earn profits** by supplying and has **planned** to produce and supply, under **alternative market prices**, while **other factors** affecting **supply** remain **constant**, during a **given period of time**.

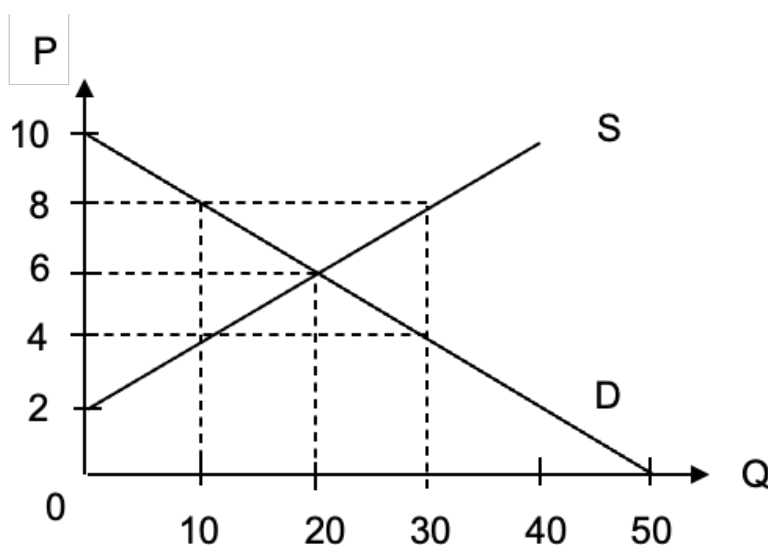
(B)

- Market **price** of Fresh Milk
- **Cost** or price of cattle feed, medicine and other inputs
- Market price of **production substitutes** such as youget, cheese, butter and **complements** such as fertilizer and bio fuel
- Changes in **technology** used in the cattle farming industry
- **Expectations** of cattle farmers in terms of future price, government support and market dynamics
- **Natural** factors and changes in **weather conditions**
- **Government policies** (tax, subsidies and interventions specific to the dairy industry)
- **Number of dairy farmers** in the market
- Other relevant factors

(01 mark each, total 05 marks)

Question [04]

(A) Assume the diagram given bellow is for an essential commodity and the government implements a Maximum Legal Price (MLP) of Rs. 4.00



Estimate the following 'after' the government MLP:

- 1) Total Consumer Surplus
- 2) Total Producer Surplus
- 3) Deadweight Loss
- 4) Maximum total Consumer outlay at the Black Market
- 5) Net Gain or Loss to the Consumers
- 6) Government expenditure to make the MLP meaningful.

[02 marks each]

(1)

$$= \{[(10-4) + (8-4)] \div 2\} \times 10$$

$$= [10 \div 2] \times 10$$

$$= \text{Rs. 50} \qquad \qquad \qquad \text{(02 marks)}$$

(2)

$$= [(4 - 2) \times 10] \div 2$$

$$= 20 \div 2$$

$$= \text{Rs. 10} \qquad \qquad \qquad \text{(02 marks)}$$

(3)

$$= [(8 - 4) \times (10 - 20)] \div 2$$

$$= -40 \div 2$$

$$= -20 \text{ OR (Rs. 20)} \qquad \qquad \qquad \text{(02 marks)}$$

(4)

$$= 8 \times 10$$

$$= \text{Rs. 80} \qquad \qquad \qquad \text{(02 marks)}$$

(5)

$$= \text{Consumer Gain} - \text{Consumer Loss}$$

$$= [(6 - 4) \times 10] - \{[(8 - 6) \times (20 - 10)] \div 2\}$$

$$= 20 - 10$$

$$= \text{Rs. 10 (Net Gain)} \qquad \qquad \qquad \text{(02 marks)}$$

(6)

$$= 4 \times (30 - 10) \qquad \text{OR} \qquad = (8 - 4) \times 30$$

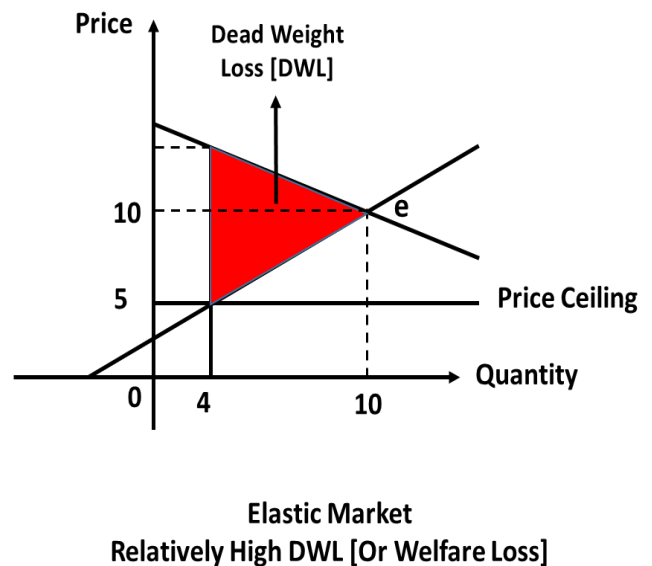
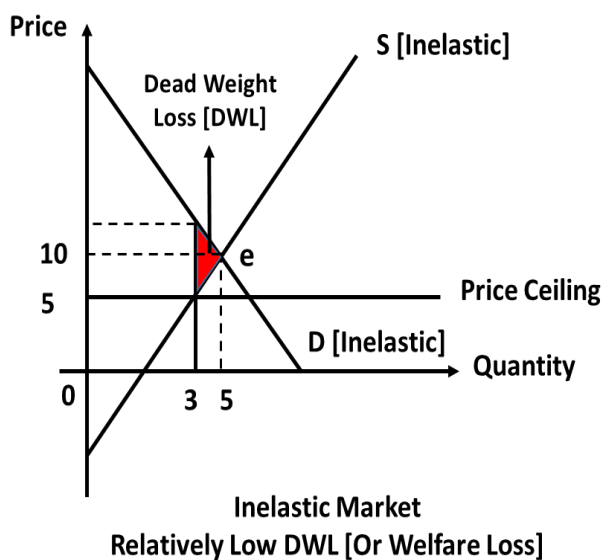
$$= \text{Rs. 80} \qquad \qquad \qquad = \text{Rs. 120} \qquad \qquad \qquad \text{(02 marks)}$$

(B) Briefly outline the link between a market's elasticity and degree of allocative inefficiency (Deadweight Loss – DWL) resulting from a government Price Ceiling

[02 marks]

The size or value of the economic inefficiency i.e., deadweight loss (reduction of economic surplus) caused by a government maximum legal price (price ceiling) measure, shall depend on 'elasticity' of the market demand and supply curves.

The size of such **economic inefficiency** is **comparatively larger** in **elastic market** than in inelastic markets.



(C) State the main forms of 'Non-price Rationing Methods'

[04 marks]

- 1) Queueing Systems (First Come First Served basis)
- 2) Application of Coupons or Stamps (Rationing Cards)
- 3) Rationing through Bribes
- 4) Combine with other goods and distribute (Bundling Products) and Favored Customers (Long-term customers, friends, relatives)
- 5) Formation of Black Markets
- 6) Demand or need based allocation (e.g. QR Code based system)
- 7) Lottery System (distribution based on Chance or Luck)

(01 mark each, total 04 marks)

