

THEORY PROGRAM

FNR – SUGGESTED ANSWERS

FNR: 08

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ATTEMPT. PRACTICE. LEARN. IMPROVE. ACHIEVE.

Part – [A]

Question	Answer	Question	Answer
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Part – [B]**Question [01]**

(A) 'All economic resources are productive resources, but all productive resources are not economic resources'

Do you agree with this statement, **Explain your answer briefly** (03 marks)

Can agree. A productive **resource** is anything used as an input in the process of producing goods and services, required to satisfy human wants. Such production resources shall consist of:

- ✓ **Economic Resources**
 - ✓ **Non-economic (free) Resources**
- Alt:** Land, Labour
Capital, Enterprise

[01 marks]

Production resources which are **limited in supply, in comparison to unlimited wants** of society are termed as '**Economic Resources**' or 'Scarce Resources'. The use of economic resources shall result in the creation of **opportunity cost**. Such economic resources are generally classified into **land, labour, capital and enterprise**.

[01 marks]

Production resources which are **infinite in supply, in comparison to unlimited wants** of society, when the supply is available are termed as '**Free or Non-economic Resources**'.

These are resources on which an **opportunity cost is not incurred**. Common examples: Sunlight, air, rainwater etc.

[01 marks]

[Total 03 marks]

(B) Define and state two examples for each category of economic resources given below:

- 1) Land
- 2) Capital
- 3) Labour
- 4) Entrepreneurship

(02 marks each)

(Technical and standard definition is expected)

(1) 'Land' in economics as a factor of production is any natural resource or gift of nature which is free available, used as an input in the production process.

[01 mark]

Economic price/reward for all land resources used in production is known as '**Rent**'. Production factors are considered as 'Land' when in its natural state and tends to be fixed in supply.

Examples: forest resources, petroleum resources, marine and water resources, atmosphere, all natural resources below and above the surface of the earth.

[01 mark] [Total 04 marks]

(2) Capital in economics as factor of production is any humanmade real asset which assist or aid within the production process.

[01 mark]

Economic price/reward for all capital resources is known as '**Interest**.' Capital is a real and a stock concept. The use of capital tends to increase labour productivity.

Examples:

Plant and machinery, equipment, vehicles, buildings, factories, weapons, defense systems, irrigation facilities, livestock, research, development, computers, software

[01 mark] [Total 02 marks]

- (3) **'Labour' in economics as a factor of production is the mental and physical efforts of the human resource used within the production process.**

[01 mark]

Payment for and earnings from providing labour are **'Wages'** and salaries. The level of labour used or employed in each activity is measured using labour hours.

Examples:

Farmers, Physical labourers, drivers, teachers, lawyers, doctors, engineers, actors, musicians

[01 mark] [Total 02 marks]

- (4) **A special type of human resource who initiates and organizes the process of producing goods and services, by mobilizing land, labour and capital resources.**

[01 mark]

An entrepreneur shall also engage in activities such as making strategic business decisions, introducing innovations on a commercial basis and facing risk. The earning of an entrepreneur is known as 'Profits'.

[01 mark] [Total 02 marks]

Question [02]

- (A) **Define** a Production Possibilities Frontier (PPF) and **state** the principal assumptions upon which a PPF is constructed

A PPF represents a line drawn by connecting the optimum (or maximum) alternative output combinations of two products (or product categories), which can be produced during a given period, when the given economy's total resource endowment (or total stock of resources), at the existing level of production technologies, which is used at productive efficiency (i.e., when using all available resources in production at their productivity).

OR [Alternatively]:

A production possibilities curve (PPC) shows the maximum possible output an economy can achieve during a given period, when all its currently available resources are fully and efficiently employed at the given technology.

[Source: P. Perera, 2020, p45]

[02 marks]

A PPF is based on Four main assumptions:

- The stock of resources of the economy shall remain constant or fixed both in terms of quantity and quality, within the given period of time (given stock of productive resources)
- The production technology shall remain constant or fixed, within the given period of time.
- The economy is producing at productive efficiency, within the given period of time
- The economy shall produce alternative product combinations of only two goods (two types or categories of goods), within the given period of time.

[02 marks] [Total 04 marks]**(B) Define and state the main reasons for Fixed and Increasing Opportunity Cost behaviour along PPFs**

Fixed opportunity cost behavior is a situation where when moving along a PPC, increasing the output of one of the product categories by an equal number of units, the output of the other product is foregone or decreasing by a fixed or consistent number of units

A linear (straight line) PPC implies fixed marginal opportunity cost, upwards or downwards along the curve.

[01 marks]**The Principal Reasons (Assumptions):**

- ✓ The **Homogeneous** nature of **production factors** used within both industries [Perfect mobility and perfectly substitutable resources among industries]
- ✓ The similarity in production methodology and techniques used in both industries.
- ✓ The productivity of production factors used in both industries is consistent or similar

[01 marks] [Subtotal 02 marks]

Increasing opportunity cost behavior is a situation where when moving along a PPC, increasing the output of one of the product categories by an equal number of units, the output of the other product is foregone or decreasing by an increasing or rising number of units.

A concave (outward bowed) PPC implies increasing marginal opportunity cost, upwards or downwards along the curve.

[01 marks]

The Principal Reasons:

- ✓ The **non-homogeneous** nature of **production factors** used within both industries [Job Specific or non-perfectly substitutable resources among industries]
- ✓ The differences in production methodology and techniques used in both industries.
- ✓ The law of diminishing returns or diminishing marginal product
- ✓ The productivity of production factors used in both industries tend to be inconsistent

[01 marks] [Subtotal 02 marks]

[Total 04 marks]

Question [03]**(A) Distinguish** between the following pairs of concepts**(1)** Substitute Goods and Complementary Goods**(2)** Normal Goods and Inferior Goods

[03 marks each]

- (1)** Substitutes are two goods for which, other things equal, an increase in the price of one lead to an increase in the demand for other. Accordingly, there is a **positive or direct relationship** between the change in the price of a substitute good and the demand for the given good.

[01 mark]

In practice, a substitute is a good which can replace another to satisfy the same want.

Examples:

Butter and margarine, Potatoes and sweet potatoes, Tea and coffee, Movie tickets and drama tickets, Bus travel and train travel.

[½ mark, sub total 1 ½ marks]

Complements are two goods for which, other things equal, an increase in the price of one lead to a decrease in the demand for the other. Accordingly, there will be a **negative or indirect relationship** between the change in price of a complementary good and the demand of the given product.

[01 mark]

In a practical sense, a complement is a good which is purchased and used with other goods to satisfy a want.

Examples:

Smart phone and mobile data (or Wi-Fi access), Tea and sugar, gun and bullets, Pen and ink, TV and Satellite Set-top (receiver) Box

[½ mark, subtotal 1 ½ marks]

[Total 03 marks]

- (2) A Normal goods is a good for which, other things equal, an increase in income leads to an increase in demand. Accordingly, any good that has a **positive or direct relationship** with regards to income and demand is a normal good.

There are two main types of normal goods namely, Luxury (or superior) goods and Essential goods (necessities or basic goods).

[1 ½ mark]

An Inferior good is a good for which, other things equal, an increase in income leads to a decrease in demand. These are goods which represent a **negative or indirect relationship** between a change in consumer income and demand.

The distinction between an inferior good and normal good is highly subjective. Therefore, a given product cannot be inferior at all income levels, of a given income earner.

[1 ½ marks] [Total 03 marks]

- (B) **Explain briefly** the link between consumers' future income and price 'expectations' and present demand for iPhones

In terms of the future price expectations, especially in the case of high valued consumer durable such as an iPhone, the relationship between the **future price expected** and the **present demand** tends to **be positive or direct in nature**.

[02 marks]

Question [04]

- (A) **Distinguish** between the economic 'Short run' and 'Long run' stages of production

Economic short run is a stage or time period in production, where a business organization is unable to increase or change certain inputs used in production, when attempting to increase output (i.e., at least one input used in production by the firm remains fixed or unchangeable).

Main Features:

- ✓ Inputs used in the economic short run of production consist of certain fixed inputs, along with variable inputs.
- ✓ The way in which output (product or productivity) behaves in the economic short run is explained based on the '**Law of Diminishing Returns** (AKA: law of variable proportions or law of diminishing marginal returns)'

[02 marks]

Economic long run is a stage or time period in production which is long enough to vary or change all inputs used in the firm's production process.

Main Features:

- ✓ In the economic long run all production inputs become variable inputs, and the business organization shall engage in scaling up production (overall business expansion).
- ✓ The way in which output (product or productivity) behaves in the economic long run is explained based on the '**Law of Returns to Scale.**'

[02 marks] [Total 04 marks]

(B) Define the 'Law of Diminishing Marginal Product' and **outline** the link between a short run firm's Total Product (TP) and Marginal Product (MP) as Labour input is incrementally increased

Law of Diminishing Returns states that as a firm increases output in the short-run by adding **variable inputs** on an **incremental basis**, to its **fixed inputs**, **after a certain point** (*or eventually*), the **Marginal Product** (MP) and then (*or subsequently*) **Average Product** (AP) of the variable input will begin to **diminish**. Ultimately MP could become negative (*and Total Product (TP) may fall*).

OR [Alternatively]:

The Law of Diminishing Returns states that when the variable input is increased with a given amount of fixed input in the short run, the average and the marginal product of the variable input eventually fall beyond a certain point and could become negative.

[Source: P. Perera, 2020; p273]

[02 marks]

Marginal product is the change in TP (ΔTP), when changing **variable inputs** (ΔQ_v) used **incrementally**, one unit at a time:

When (TP) increases at an increasing rate the Marginal Product (MP) will be rising and maximized, and when rate of increase in (TP) decreases the (MP) falls and curve is rapidly downwards sloping. MP shall intersect the Average Product (AP) curve at its maximum price.

Marginal Product (MP) will be zero when (TP) is at its maximum, while when (TP) falls, the (MP) becomes negative.

[03 marks] [Total 05 marks]

(C) What is meant by the ‘Law of Returns to Scale’ and **outline** the three types of returns to scale faced by a long run production firm

In the long run a production firm can engage in production while changing all inputs and total production capacity or scale of production.

The behavior of output following a change in all inputs is defined as The Law of Returns to Scale. Real benefits received through the increase in efficiency of factors due to the expansion of the firm’s capacity are identified as returns to scale.

In long run when all inputs become variable the output may behave in one of three forms namely, Increasing, decreasing or constant returns to scale.

[02 marks]

Increasing Returns to Scale: Output of a firm is **increasing** at a **higher** percentage (more than proportional) than the **rate of increase in all inputs** [$\Delta \text{All Inputs} \uparrow < \Delta \text{Output} \uparrow$]. Principally caused by economies of large-scale production.

Decreasing Returns to Scale: Output of a firm is **increasing** at a **lower percentage** (less than proportional) than the **rate of increase in all inputs** [$\Delta \text{All Inputs} \uparrow > \Delta \text{Output} \uparrow$].

Constant Returns to Scale: Output of a firm is **increasing** at an **equal percentage** (proportionately) to the **rate of increase in all inputs** [$\Delta \text{All Inputs} \uparrow = \Delta \text{Output} \uparrow$].

[03 marks] [Total 05 marks]

Question [05]

(A) What is meant by the Macroeconomic Management Process

Macroeconomic management refers to the process of directing **macroeconomic variables** (macroeconomic agents, activities, and variables) by influencing such variables using a set of deliberate (purposeful) and specific **macroeconomic policy** measures and instruments (macroeconomic policies), with the aim of achieving certain principal **macroeconomic objectives**.

[02 marks]

- (B) **Define** Gross Domestic Product (GDP) and **briefly outline** the Core Five Components of GDP

The aggregate value of gross **value added** generated through **economic activities** conducted by **residential institutional units** functioning within an **economic territory**, during a given year, estimated at market price.

The Core Five Components of GDP:

- (A) Economic Activity
- (B) Economic Territory
- (C) Residency
- (D) Institutional Units
- (E) Gross Value Added (GVA)

[02 marks]

- (A) **Economic production is the process of creating output under the control and responsibility of an institutional unit, using inputs of labour, capital & other goods, and services.**

Economic production should always have a **‘Human Involvement’**. Any activity without any human or institutional involvement is known as a **‘Non-Economic Activity.’**

[01 mark]

- (B) **An economic territory refers to a geographical area under a single (sovereign) government’s effective economic control, within which individuals, goods and capital have freedom of mobility. The jurisdiction (coverage) of an economic territory is not essentially restricted to a given geographical area.**

The economic space of a country shall consist of the following dimensions:

- The Land Area of a country
- The Airspace of a country
- Territorial Waters of a country
- Territorial Enclaves (located in other countries)

[01 mark]

- (C) **Residential Institutional Units refer to institutions engaging in economic activities or representing an economic intent to do so, within a given economic territory for a period not less than a year.** The residency of an individual is decided by residency status of the individual’s household unit.

[01 mark]

- (D) An institutional unit is a residential economic unit with the ability to take ownership and responsibility of different resources and economic activities, while interacting with other institutional units.**

Two main types of instructional units can be identified:

- (A) Household nature units consisting of one or group of individuals
- (B) Units independent from individuals, with legal and social acceptance (Non household, legal and social institutional entities)

OR [Alternatively]

(A) Household Institutional Units [HH]

(B) Non-household Institutional Units

- **Non-Financial Corporations [NFC]**
- **Financial Corporations [FC]**
- **General Government [GG]**
- **Not for Profit Institutions Serving Households [NPISH]**

[01 marks]

- (E) Gross Value Added [GVA]** is a measure of the value of goods and services produced in an area, industry, or sector of an economy. In national accounting this is the residual (leftover) value from gross value of output (GVO), after subtracting the value of Intermediate Consumption (IC), i.e. $[GVA = GVO - IC]$.

Value added can be estimated using a production sources or income sources approach.

[01 mark] [Total 07 marks]