Nornatasha Binti Ahmad
Assoc. Prof. Dr. Gazi Md. Nurul Islam
GCEO5113 – Business Economics
18th May 2021

SHORT ANSWER QUESTION (1)

Question 1:

a) There is a difference between Accounting Profit and Economic Profit. What is economic profit?

"Economic Profit is the difference between the revenue received (from the sale of an output) and the cost of all input used (explicit cost) as well as any opportunity cost. In calculation of economic profit, explicit costs and opportunity costs are deducted from revenues earned."

Economic Profit = Revenue – Costs (*explicit cost and opportunity cost****)***

Accounting profit is based on explicit numbers and can in its periodic repeating character provide trend analyzes (based on hard figures). The Accounting Profit is the base for Economic Profit. This outcome does not provide answers to external economical influencers.

Economists add to Accounting Profit the results of influencing factors to the market to which the company belong to, its position in the market and its position toward suppliers and customers to the basic Accounting profit. In this function Economic Profit provide a **value-added outcome** which does support (next to its base) the company in the need to anticipate future effects to its present operation.

b) Do you think that the economic profit increase when more firms enter an industry?

No. Existence of economic profit attracts new firm to the industry (entry) in the long run. Firms keep on entering until economic profit is zero (industry perfectly competitive), which significant impact of economic losses lead to exit in the long-run equilibrium. If firms experience profit decreases, some firm will leave and continue to leave until remaining firms are meeting at minimum their breakeven point and profitability is met.

New entry → Supply (Ss) ↑, Profit ↓ / (Losses ↑)

Impact to existing firm → Supply (Ss) ↓, Profit ↑ / (Losses ↓)

*** If New Entry* **>***, Economic Profit ↓ / If New Entry* **<***, Economic Profit ↑*

<u>Question 2:</u>

If tea and coffee are substitutes and both are normal goods, what would happen to the consumption of tea and coffee if:

a) The price of tea increased.

Consumption of tea decrease and consumption of coffee increase (consumer shift to substitute item)

b. consumer incomes increased.

The consumption of tea and coffee will also increase as consumer has more spending power.

<u>Question 3:</u>

a) What is Consumer Surplus and the "Deadweight loss" in the market?

i). <u>Consumer Surplus in the market</u>

Consumer surplus is an economic measurement of consumer benefits. A consumer surplus happens when the price that consumers pay for a product or service is less than the price, they're willing to pay. It is a measure of the additional benefit that consumers receive because they are paying less for something than what they were willing to pay.

It is based on the economic theory of marginal utility, which is the additional satisfaction a consumer gains from one more unit of a good or service and it always increases as the price of a good falls and decreases as the price of a good rises.

ii) *<u>Deadweight loss in the market</u>*

A deadweight loss is a cost to society created by market inefficiency, which occurs when supply and demand are out of equilibrium. It arises from an inefficient allocation of resources, created by various interventions, such as price ceilings, price floors, monopolies, and taxes.

Those factors lead to the price of a product not being accurately reflected, meaning goods are either overvalued or undervalued. If the price of a product is not reflected accurately, this leads to changes in consumer and producer behavior, which usually has a negative impact on the economy.

b) Why this loss is the society's loss?

Market gets confronted with production related external circumstances leading into a loss in quantity for consumers. Short term price increase heavily, affects huge marginal cost, people search other substitute and economy get halt (limitation to produce according to demand). Effect of ´deadweight loss´ leads to economy turbulence in term of supply (under supply leads to losses).

When consumer does not feel the price of good or services justified when compared to the perceive utility, they are less likely to purchase the item/services offered.

Minimum wage and living wage laws can create a deadweight loss by causing employers to overpay for employees and preventing low-skilled workers from securing jobs.

Price ceilings and rent controls can also create deadweight loss by discouraging production and decreasing the supply of goods, services, or housing below what consumers truly demand. Consumers experience shortages and producers earn less than they would otherwise, and it affects the price (high).

Taxes also create a deadweight loss because they prevent people from engaging in purchases they would otherwise make because the final price of the product is above the equilibrium market price. If taxes on an item rise, the burden is often split between the producer and the consumer, leading to the producer receiving less profit from the item and the customer paying a higher price.

Monopolies and oligopolies also lead to deadweight loss as they remove the aspects of a perfect market, in which fair competition accurately sets a price. Monopolies and oligopolies can control supply for a specific good or service, thereby falsely increasing its price. This would eventually lead to a lower amount of goods and services sold.

Price will go rocket sky within the available quantity of supply, this results in lower consumption of the item than previously, which reduces the overall benefits the consumer market could have received while simultaneously reducing the benefit the company may see in regard to profits.

<u>Question 4:</u>

When the price of rice was "low," consumers in Thailand spent a total of $8 billion annually on its consumption. When the price halved, consumer expenditures DECREASED to $6 billion annually. What does this indicate: the demand for rice is elastic or the demand for rice is inelastic?

Above equation witnessed that changes of price of $4b while the quantity demand only change for 2b.

The rule of economy is, when the demand of the product does not change much as the price change, inelastic of demand occurs. Thus, in this case, *<u>the demand for rice is inelastic.</u>*

Example of Inelastic products are necessities goods or services and usually, do not have substitutes they can easily be replaced with, like rice, electricity, water etc.

However, when there`s substitute (alternative) of product within the same cluster of goods and services offers exist in the market (due to awareness, advance lifestyle, education, health, etc.), the earlier or the original necessity products have its own range of substitute, thus, the demand of the first necessity product will be elastic. As an example, grain and wheat are the substitute to rice. As price of rice change, the demand of rice also change that experience slight shift to the substitute (wheat/grain, etc.). In this case, the demand of rice is elastic.

<u>Question 5:</u>

a) What is the concept of diminishing marginal utility of consumers?

Diminishing marginal utility is an important concept to determine consumer preferences. It is the decrease in satisfaction a consumer has from the consumption of each extra unit of goods or services (when it reaches the satisfaction level).

~ satisfaction decrease when consumption increase (level of satisfaction exceeded the maximum point that makes consumer forgo/ eliminate the goods from its preferred choice and change his option to other product ~

b) How consumer use Marginal Rate of Substitution to reach consumer equilibrium?

Consumer equilibrium is when consumer buys commodity up to that amount which its price is equal to its marginal utility (P=MU).

Marginal Rate of Substitution (MRS) reaching equilibrium level when consumer giving up some amount of good in exchange for another good while maintaining the same level of utility (new goods equally satisfying with the one before), and it is identical.

Let me answer the question under the use of next example.

For example, customer budget is RM100 to get the 10kg of either rice or noodles which product served the same purpose and gives the same level of satisfaction for instance. The customer will make the best selection out of those two products to get 10kg supplies with max RM100 to spend. In this case, budget and kilogram is leading while rice and noodles are the variable and substituted to one another and the consumer has to choose either the best combination out of two or one only, to reach its satisfaction within the same value and quantity.