MICROECONOMICS

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Assignment
Mid Term Paper

Submitted to
Ms. Wajiha Amin

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DEPARTMENT OF BUSINESS ADMINISTRATION
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Mid term-Summer Semester 2020

Course Code: ECO 116 **Course Title: Microeconomics/Intr.to economics**

Instructor: Ms. Wajiha Amin

Total Marks: 30

Attempt all questions.

Q1: (a) Discuss briefly the concept of ***opportunity cost*** in Economics. **(6)**
For each of the following, what can be the potential opportunity cost?

- Studying for your exam
- Spending 2 hrs playing computer games instead of doing exercise
- Going to a university instead of staying at home
- You decide to spend $80 on some great shoes and do not pay your electric bill.

(b) Differentiate between positive and normative economics and identify each of the following statement as positive or normative. **(4)**

- There is an inverse relationship between wealth and demand for inferior goods.
- Wealth tax should be implemented to reduce the disproportionate distribution of wealth.
- Adopting protectionist policies results in shrinkage of the total global gross domestic product.
- An increase in tax rate ultimately decreases total tax revenue.
- Tariffs should be increased on imports from countries with poor human rights record.
- Developing countries should adopt democracy as a system only when they population is educated and emancipated.

Q2: (a) Consider the following diagram and explain it in few points by stating the respective law. **(4)**

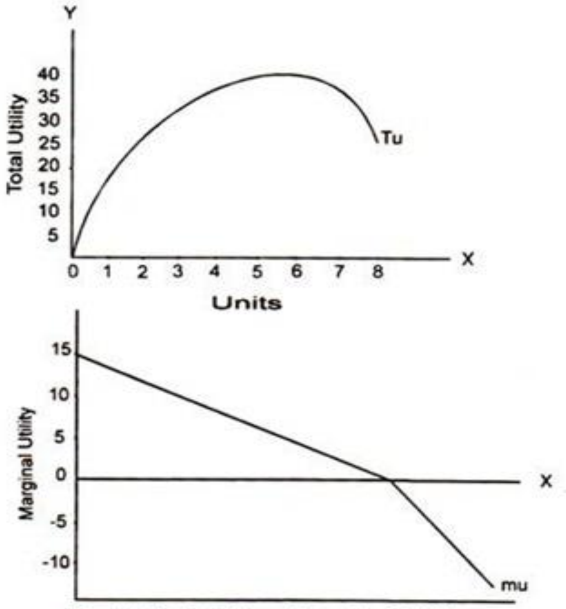


Fig.3. Diminishing Marginal Utility

(b) What the concept of ***diminishing marginal rate of substitution*** is all about? **(3)**
(c) Give any **2** characteristics of IC. **(3)**

Q3: (a) Differentiate between **(6)**

- Cardinal and ordinal approach
- Marginal utility and total utility
- Cost and benefit

(b) What does the budget line show? In what cases it shift forward or backward?
(4)

Question # 1 (Part A)

Discuss briefly the concept of *opportunity cost* in Economics.
For each of the following, what can be the potential opportunity cost?

- Studying for your exam
- Spending 2 hrs playing computer games instead of doing exercise
- Going to a university instead of staying at home
- You decide to spend $80 on some great shoes and do not pay your electric bill.

Answer

Opportunity cost

When economists refer to the "opportunity cost" of a resource, they mean the value of the next-highest-valued alternative use of that resource. If, for example, you spend time and money going to a movie, you cannot spend that time at home reading a book, and you cannot spend the money on something else. If your next-best alternative to seeing the movie is reading the book, then the opportunity cost of seeing the movie is the money spent plus the pleasure you forgo by not reading the book.

The word "opportunity" in "opportunity cost" is actually redundant. The cost of using something is already the value of the highest-valued alternative use. But as contract lawyers and airplane pilots know, redundancy can be a virtue. In this case, its virtue is to remind us that the cost of using a resource arises from the value of what it could be used for instead.

For each of the following, what can be the potential opportunity cost.

Studying for your exam

The opportunity for studying for exam is the leisure time that we forego while we study. The opportunity cost arises because individual face choices. We have to sacrifice some activity to do the other. The next best activity that we sacrifice is the opportunity cost of whatever we do.

Spending 2 hrs playing computer games instead of doing exercise

The opportunity cost of playing the computer game is the other productive that we can do within that 2 hours. We could have exercise or have done some other job. Thus, the opportunity cost of the playing computer game is to exercise or to work.

Going to a university instead of staying at home

Staying at home during the time we could have to attend university to acquire skill to get a high paying job. Thus the opportunity cost here of staying at home that we forego in order to attain skills by going university.

You decide to spend $80 on some great shoes and do not pay your electric bill.

The opportunity cost is having the electricity turned off, having to pay an activation fee and late charges. You might also have food in the fridge that gets ruined and that would add to the total cost.

Question # 1 (Part B)

Differentiate between positive and normative economics and identify each of the following statement as positive or normative.

- There is an inverse relationship between wealth and demand for inferior goods.
- Wealth tax should be implemented to reduce the disproportionate distribution of wealth.
- Adopting protectionist policies results in shrinkage of the total global gross domestic product.
- An increase in tax rate ultimately decreases total tax revenue.
- Tariffs should be increased on imports from countries with poor human rights record.
- Developing countries should adopt democracy as a system only when they population is educated and emancipated.

Answer

Difference between positive and normative economics.

Positive economics and normative economics are two standard branches of modern economics.

- Positive economics describes and explains various economic phenomena, while
- Normative economics focuses on the value of economic fairness or what the economy should be.
- Normative economics focuses on the value of economic fairness, or what the economy "should be" or "ought to be."
- While positive economics is based on fact and cannot be approved or disapproved, normative economics is based on value judgments.

Positive Economics

Positive economics is a stream of economics that focuses on the description, quantification, and explanation of economic developments, expectations, and associated phenomena. It relies on objective data analysis, relevant facts, and associated figures. It attempts to establish any cause-and-effect relationships or behavioural associations which can help ascertain and test the development of economics theories.

Normative Economics

Normative economics focuses on the ideological, opinion-oriented, prescriptive, value judgments, and "what should be" statements aimed toward economic development, investment projects, and scenarios. Its goal is to summarize people's desirability (or the lack thereof) to various economic developments, situations, and programs by asking or quoting what should happen or what ought to be.

Identification of the following statement as positive or normative.

Positive Economics

- There is an inverse relationship between wealth and demand for inferior goods.
- Adopting protectionist policies results in shrinkage of the total global gross domestic product.
- An increase in tax rate ultimately decreases total tax revenue.

Normative Economics

- Wealth tax should be implemented to reduce the disproportionate distribution of wealth.
- Tariffs should be increased on imports from countries with poor human rights record.
- Developing countries should adopt democracy as a system only when they population is educated and emancipated.

Question # 2 (Part A)

Consider the following diagram and explain it in few points by stating the respective law.

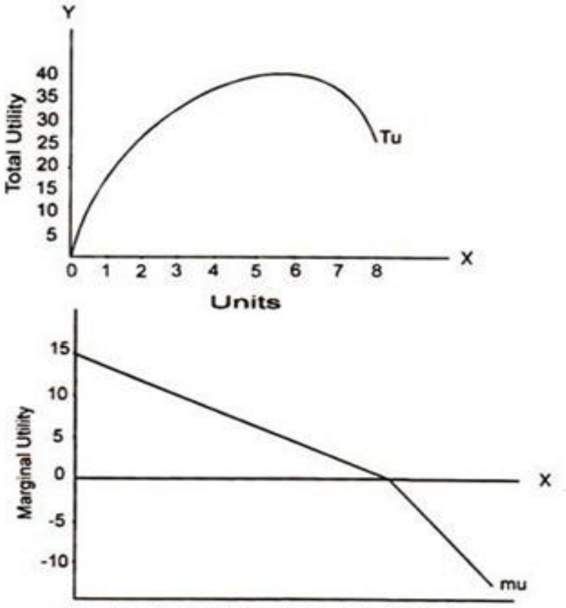


Fig.3. Diminishing Marginal Utility

Answer

TU increases with an increase in consumption of a commodity as long as MU is positive. In this phase, TU increases but a diminishing rate as MU from each successive unit tends to diminish.
When TU reaches its maximum, MU becomes zero. TU stops rising at this stage. This point is known as point of satiety.
When consumption is increased beyond the point of satiety, TU starts falling as MU becomes negative.

Question # 2 (Part B)

What the concept of *diminishing marginal rate of substitution* is all about?

Answer

Usually, marginal substitution is diminishing, meaning a consumer chooses the substitute in place of another good rather than simultaneously consuming more.
The law of diminishing marginal rates of substitution states that MRS *decreases* as one moves down a standard convex-shaped curve, which is the indifference curve.

- The marginal rate of substitution (MRS) is the amount of a good that a consumer is willing to consume in relation to another good, as long as the comparable good is equally satisfying.
- Marginal rates of substitution are graphed along an indifference curve which is usually downward sloping and convex.
- The MRS is the slope of the indifference curve at any given point along the curve.

- When the law of diminishing marginal rates of substitution is in effect, the marginal rate of substitution forms a downward, negative sloping, convex curve showing more consumption of one good in place of another.

Calculating the MRS Formula

The marginal rate of substitution (MRS) formula is:
|MRSxy| = dy/dx = Mux/MUy

Where
x, y = two different goods
dy/dx = derivative of y with respect to x
MU = marginal utility of good x, y

Question # 2 (Part C)

Give any 2 characteristics of IC.

Answer

Characteristics of Indifference Curve

1. Indifference curve slopes downward from left to right.
2. Indifference curve are convex to the origin.
3. Higher indifference curves represent higher level of satisfaction.
4. Indifference curve never intersect each other.
5. Indifference curve does not touch the Y axis or X axis.

Question # 3 (Part A)

Differentiate between

- Cardinal and ordinal approach
- Marginal utility and total utility
- Cost and benefit

Answer

- **Cardinal Approach**

1. Cardinal utility is the utility wherein the satisfaction derived by the consumers from the consumption of good or service can be measured numerically. Ordinal utility states that the satisfaction which a consumer derives from the consumption of product or service cannot be measured numerically.
2. Cardinal utility measures the utility objectively, whereas there is a subjective measurement of ordinal utility.
3. Cardinal utility is less realistic, as quantitative measurement of utility is not possible. On the other end, the ordinal utility is more realistic as it relies on qualitative measurement.
4. Cardinal utility is based on marginal utility analysis. As against this, the concept of ordinal utility is based on indifference curve analysis.
5. The cardinal utility is measured in terms of utils, i.e. units of utility. On the contrary, the ordinal utility is measured in terms of ranking of preferences of a commodity when compared to each other.

These two above mentioned demand analysis approaches are not in competition with each other, but during the analysis of consumer behaviour, they represent two levels of sophistication. Both cardinal and ordinal utility are vital to assess and analyse consumer demand for a good or service, irrespective of the purpose.

- **Marginal utility and total utility**

Total utility is the total satisfaction received from consuming a given total quantity of a good or service, while marginal utility is the satisfaction gained from consuming an additional quantity of that item. Sometimes, economists like to subdivide utility into individual units that they call utils

- **Cost and benefit**

In contrast, cost-effectiveness analysis compares two outcomes based on relative costs to see which of the two provides the best opportunities for success. The easy way to remember the difference is a benefit is a desired financial reward while effectiveness is the potential success of the program.

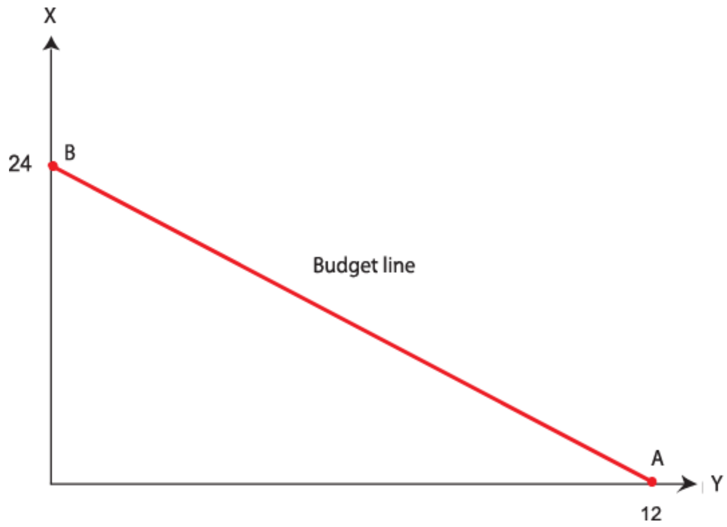
Question # 3 (Part B)

What does the budget line show? In what cases it shift forward or backward

Answer

Budget line show

Budget line is a graphical representation of all possible combinations of two goods which can be purchased with given income and prices, such that the cost of each of these combinations is equal to the money income of the consumer.

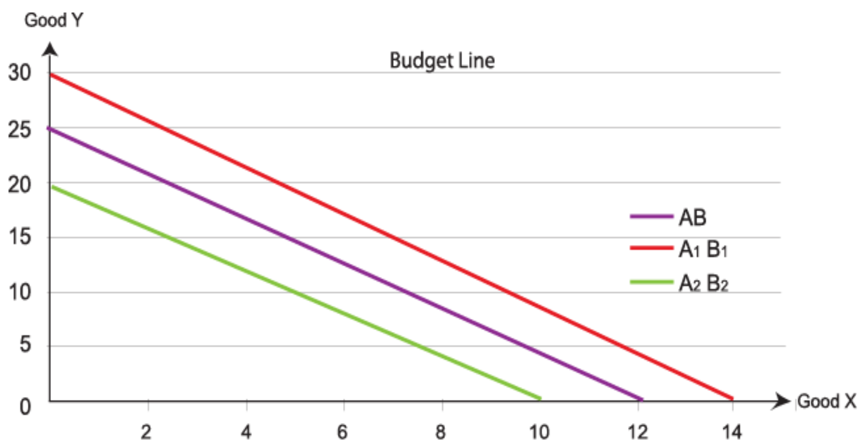


Shift in the budget line

The budget line will shift when there is,

A change in the prices of one or both products with nominal income (budget) remaining the same.

A change in the level of nominal income with the relative prices of the two products remaining the same.



- An increase in consumer's income will lead to a shift of the budget line to the right, A1B1.
- A decrease in consumer's income will shift the budget line to the left as represented by A2B2