

AS/A Level Economics 9708

Unit 7: The Price System and Theory of the Firm

Recommended Prior Knowledge

Unit 2 builds on the material covered on the Price System in the Core curriculum. Parts of sections (n) and (p) on efficiency follow on from the previous Unit.

Context

This Unit applies some of the ideas covered in Unit 1 on economic efficiency, especially in sections (n) and (p), and takes further the ideas on the Price System covered in the Core curriculum. It is also crucial to the understanding of why governments might need to intervene in the Price System, the subject of Unit 3.

Outline

The material starts with price, marginal utility theory and budget lines and then goes on to look at short-run and long-run production functions, the distinction between a firm and an industry, the objectives of firms, the different market structures and an assessment of the conduct and performance of firms. It also looks at reasons for the survival of small firms and for the growth of firms. Finally, it looks at the demand for and the supply of labour and the determination of wages, including the role of trade unions and the government.

AO	Learning outcomes	Suggested Teaching activities	Learning resources
a	Candidates should understand the Law of Diminishing Marginal Utility and its relationship to the derivation of an individual demand schedule and curve	Students to think of examples where marginal satisfaction may decline as more units of a good are consumed, such as a hamburger, an ice cream or a bar of chocolate The first self-assessment task in Bamford (page 135) and the table and figures in Stanlake (page 65) are helpful in showing students the distinction between total and marginal utility This should lead on to a discussion of why economists need to try and measure the level of happiness or satisfaction that a person receives from the consumption of a good	Tutor2u: Consumer Choice and Utility Bamford, Chapter 9, pp 134-135 Anderton, Unit 69, p 452 Stanlake, Chapter 8, pp 65-67 Gillespie, p 6
	Candidates should have an understanding of the equi-marginal principle	Students need to understand the MU/P formula; the second self-assessment task in Bamford (page 135) is very useful	Bamford, Chapter 9, p 135 Stanlake, Chapter 8, p 67 Gillespie, p 6

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	Candidates should have an awareness of the limitations of marginal utility theory	Students need to consider how difficult it is to try and measure the level of happiness or satisfaction that a person receives from the consumption of a good; they should think of some possible examples	Hardwick, Chapter 4, pp 57-60
b	Candidates should have an understanding of budget lines and of the income and substitution effects of a price change	<p>Students need to be able to construct a budget line to show the possible combinations that can be purchased with a given sum of money; it should be remembered, however, that indifference curves have been removed from the syllabus</p> <p>The table and figures and the two self-assessment tasks in Bamford (page 136) are helpful in enabling students to understand the income and substitution effects of a price change</p> <p>The income and substitution effect is given a good treatment in Anderton (page 67) and table 10.2 and question 2 on the same page are useful; the treatment of this topic is also very good in Gillespie (page 5)</p>	<p>Bamford, Chapter 9, pp 135-136 Anderton, Unit 10, p 67 Stanlake, Chapter 8, pp 64-65 Gillespie, p 5</p>
c	Candidates should have an understanding of the short-run production function, including fixed and variable factors of production, total product, average product and marginal product	<p>Students need to be able to draw diagrams from data given which show changes in marginal and average product</p> <p>The data question in Anderton on holiday cottages (page 318) would help to reinforce understanding of the concepts of fixed and variable costs</p>	<p>Tutor2u: Short-run Production Bamford, Chapter 9, pp138-139 Anderton, Unit 46, pp 304-306</p>
	Candidates should also understand the Law of diminishing returns or Law of variable proportions	The data questions in Anderton (page 308) on diminishing returns in the fishing industry are useful and should help students to understand the concept	<p>Anderton, Unit 48, pp 315-318</p> <p>Tutor2u: Law of Diminishing Returns Stanlake, Chapter 37, pp 342-346 Gillespie, p 28</p>

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g	Candidates should understand the long-run production function and the concept of returns to scale	The information on diminishing returns in agriculture in Anderton (pp 317-318) is also helpful and should stimulate discussion and develop analytical skills	S-cool: The Law of Diminishing Marginal Returns
		Students need to understand, and be able to distinguish between, the concepts of increasing, constant and decreasing returns to scale; question 5 in Anderton (page 306) is useful in helping them to understand these terms	Bamford, Chapter 9, p139 (excluding isocosts and isoquants)
		Anderton also has a useful example of increasing returns at petrol stations (page 307) The data response questions in Stanlake (page 349) are also helpful	Anderton, Unit 46, pp 306-308 Stanlake, Chapter 37, pp 346-347 Gillespie, p 32
h	Candidates should understand how an economist's definition of costs would be different from that of an accountant	Question 1 in Anderton (page 309) and question 5 (a) and (b) (page 312) are good on the distinction between the two types of costs	Bized: Production Tutor2u: Measuring the Costs of Production S-cool: Costs and their Curves Anderton, Unit 47, pp 309-312
	They should be able to distinguish between marginal cost and average cost and, in the short-run cost function, between fixed costs and variable costs	Students should be able to draw these cost curves; there are useful examples in Bamford (pages 152-153) and Stanlake (pages 123-126)	Bamford, Chapter 9, pp 151-152 Stanlake, Chapter 13, pp 122-126
	They should also be able to explain the shape of the SRAC curve	Gillespie is particularly good on the concepts of marginal, average and total costs (pages 27-30)	Gillespie, pp 27-30
i	Candidates should understand the	Students need to be able to draw the appropriate diagrams; there are	Tutor2u: Long Run Costs of Production

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	<p>long-run cost function and be able to explain the shape of the LRAC curve</p> <p>They should also understand both internal and external economies of scale and recognise the relationship between economies of scale and decreasing costs</p>	<p>examples in Anderton (page 319), Stanlake (pages 127-129) and Gillespie (pages 31-32)</p> <p>They should try and find examples in newspapers of firms which are aiming to benefit from economies of scale, perhaps as a result of a merger, such as in the banking or airline industries; they should then report back to the group, identifying the types of economy of scale discovered</p> <p>There are some useful questions on Wal-Mart taking over Asda in Anderton (page 324)</p>	<p>Bized: Economies of Scale S-cool: Economies of Scale Tutor2u: Diseconomies of Scale</p> <p>Bamford, Chapter 9, pp 152-154 Anderton, Unit 49, pp 319-324 Stanlake, Chapter 13, pp 126-129 Gillespie, pp 31-32</p>
k	<p>Candidates should understand the relationship between elasticity and marginal, average and total revenue for a downward-sloping demand curve</p>	<p>Students need to understand that PED will vary along the length of a demand curve; there are diagrams showing this in Bamford (page 160) and Gillespie (page 8)</p>	<p>Tutor2u: Business Revenue and Turnover S-cool: Revenues and their Curves Bamford, Chapter 9, pp159-160 Anderton, Unit 47, p 311 Stanlake, Chapter 9 pp 78-79 Gillespie, p 8</p>
l	<p>Candidates should be able to distinguish between the concepts of a firm and an industry</p>	<p>Students need to consider the concept of the industrial concentration ratio; they should then research different industries, comparing the concentration ratios, and report back to the group There are some examples in Anderton (pages 336-337)</p>	<p>Bamford, Chapter 9, p 161 Anderton, Unit 51, pp 336-337 Stanlake, Chapter 45, p 427 Gillespie, p 44</p>
m	<p>Candidates should understand the traditional objective of a firm, profit</p>	<p>Each student should choose a firm and research it to find out what its declared objectives are; this could be done on the internet and through</p>	<p>Tutor2u: Profit Maximisation and Sales Revenue</p>

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	<p>maximisation, and should be able to distinguish between normal and abnormal profit</p>	<p>any literature produced by the firm, such as the annual report and students should try and focus on local firms in their own country The student could then give a presentation to the rest of the group</p>	<p>S-cool: Profit Tutor2u: Measuring Business Profits Tutor2u: Alternatives to Profit Maximisation Theories</p>
	<p>They also need to have an awareness of other possible objectives of a firm</p>	<p>The profit maximising condition is crucial and students need to be able to analyse this. There are some useful case studies on Rentokil (Stanlake, page 341) and Chefaid (Bamford, page 163). Anderton is very good on the goals of firms (pages 325-331), including behavioural theories, and there is some good material on the role of the shareholder and on stakeholder power</p>	<p>Bamford, Chapter 9, pp 161-163 Anderton, Unit 50, pp 325-331 Stanlake, Chapter 36, pp 336-341 Gillespie, p 46</p>
n	<p>Candidates should understand the structure of markets as explained by the number of buyers and sellers, the nature of the product and information and the degree of freedom of entry</p>	<p>The competition road map in Bamford (page165) is a very helpful starting point The students could then work in groups, each group concentrating on one particular market structure; within the group, each student should try and find out information about one or two firms to discover the characteristics of the market structure The groups would then report back to the whole class, leading to a discussion of the different types of market structure</p>	<p>S-cool: Market Structure I S-cool: Market Structure II Tutor2u: Gains from Competitive Markets and Industries Tutor2u: Long Run Equilibrium under Competition Tutor2u: Sources of Monopoly Power Tutor2u: Oligopolistic Markets Tutor2u: Economics of Contestable Markets Bamford, Chapter 9, pp 164-179</p>
	<p>Candidates should also understand the features of the different market structures: perfect competition, monopoly, monopolistic competition and oligopoly</p>	<p>There are some interesting case studies in the various textbooks, such as trains (Anderton, pages 355-356), football clubs (Anderton, page 356) and soft drinks (Stanlake, pages 425-426)</p>	<p>Anderton, Unit 51, pp 332-337 Anderton, Units 53-56, pp 343-366 Anderton, Unit 58, pp 372-376 Stanlake, Chapters 41-45, pp 384-439 Gillespie, pp 35-43</p>
o	<p>Candidates should have an understanding of the conduct of firms in terms of pricing policy and non-price</p>	<p>Students should look in newspapers and magazines for examples of different prices charged for goods and services and report their findings back to the rest of the group; this should lead to a useful discussion and</p>	<p>Tutor2u: Pricing Strategies and Company Objectives Tutor2u: Price Discrimination under</p>

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	<p>policy</p> <p>This should include price discrimination, price leadership models and mutual interdependence in the case of oligopolies</p>	<p>evaluation of different pricing policies</p> <p>They should try and find examples of price discrimination, such as in transport and telephone services. They should also look for examples in newspapers and magazines of other ways, apart from price, in which firms compete.</p> <p>Anderton is very good on price fixing and collusion (pages 420-425) and there is a useful section on OPEC with some data response questions which should help develop students' understanding of this topic.</p>	<p>Monopoly</p> <p>Bamford, Chapter 9, pp 164-179 Anderton, Unit 51, pp 332-337 Anderton, Units 53-56, pp 343-366 Anderton, Unit 65, pp 420-425 Stanlake, Chapters 41-45, pp 384-439 Gillespie, pp 35-43</p>
p	<p>Candidates should have an understanding of the performance of firms in terms of output, profits and efficiency</p> <p>They should be able to make comparisons between firms with regard to economic efficiency, barriers to entry, price competition, non-price competition and collusion.</p>	<p>Each student researches a firm on the internet and through published information, such as the annual report, to discover as much information as possible on its output, profits, efficiency, pricing and possible links with other firms; a lot of information can be obtained from newspapers and magazines.</p> <p>The student then reports back to the group on the information obtained.</p>	<p>Bamford, Chapter 9, pp 164-179 Anderton, Units 53-56, pp 343-376 Stanlake, Chapter 45, pp 427-439 Gillespie, p 44</p>
j	<p>Candidates should understand why small firms can survive.</p>	<p>Students should choose a small firm and try to find out why it has remained small and what advantages this might give it over a larger firm; they should then report back to the group. This should lead to a useful discussion on why small firms can survive.</p>	<p>Bized: Survival of the Small Firm Bamford, Chapter 9, pp 154-159 Anderton, Unit 38, p 255 Stanlake, Chapter 40, pp 371-382 Gillespie, p 45</p>

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	They should also have an understanding of the reasons for the growth of firms	They should also research a firm that has grown in order to try and discover the reasons for such growth and then give a presentation to the group on that firm; Anderton has the example of Ford and Kwik-Fit (pages 418-419).	Anderton, Unit 64, pp 413-419
d	Candidates should understand the meaning of, and the factors affecting, the demand for labour	Students should consider examples of derived demand so that they show that they have understood the concept. They should work in groups and consider the various factors that would influence the demand for labour, both generally and in particular occupations, and then report back to the whole class. There is an interesting example of the demand for workers in banking in Anderton (pages 466-467).	S-cool: The Demand for Labour Bamford, Chapter 9, pp 141-142 Anderton, Unit 21, pp 462-467 Stanlake, Chapter 17, pp 161-162 Gillespie, p 47
	They should also have an understanding of the derivation of an individual firm's demand for a factor using marginal revenue product	Students should try and think of examples where it might not be very easy to calculate the MRP of a worker.	
e	Candidates should understand the meaning of, and the factors affecting, the supply of labour.	Students should work in groups and consider the various factors that could affect the supply of labour; they should think of the different reasons why people work and report back to the whole class This should lead to an interesting discussion and evaluation of why people work, with a stress on both monetary and non-monetary factors	S-cool: The Supply of Labour Tutor2u: Supply Side Policies for the Labour Market Bized: The Labour Supply Curve Bamford, Chapter 9, pp 142-144 Anderton, Unit 72, pp 468-478 Stanlake, Chapter 17, pp 162-170 Gillespie, p 47
	They should also have an understanding of net advantages and the long-run supply of labour.		
f	Candidates should understand how wages are determined under free	Each student should choose an occupation and research the wages that operate in that industry; this should be followed by a presentation by	Tutor2u: Equilibrium Wages S-cool: The Equilibrium Wage

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	market forces (competitive product and factor markets).	each student and this should lead to a useful discussion and analysis of why there are such wide wage differentials in an economy.	Tutor2u: Trade Unions S-cool: Trade Unions Tutor2u: Economic Effects of the National Minimum Wage S-cool: The Minimum Wage Bized: The Minimum Wage Tutor2u: Wage Differences between Occupations Tutor2u: Economic Rent and Transfer Earnings Bamford, Chapter 9, pp 148-150 Anderton, Units 73-75, pp 479-505 Stanlake, Chapter 18, pp 170-178 Stanlake, Chapter 22, pp 206-216 Gillespie, pp 48-50
		An interesting topic for discussion would be the differences in male/female earnings in developed and developing countries and whether these had narrowed over time; this would reinforce skills of application.	
	They should also have an understanding of the role of trade unions and government in wage determination.	Students need to consider the role of trade unions in the presentation; there is a lot of useful information on trade unions in Anderton (pages 493-496).	
	Candidates should understand why wage differentials exist in an economy and they should have an awareness of the concepts of economic rent and transfer earnings	Consideration also needs to be given to an analysis of the role of government in wage determination; this would be a good opportunity to have a debate on the arguments for and against government intervention, such as through a national minimum wage	

