

June 2004 Past Paper

Question 1

(a) (i) What is meant by absolute poverty?

Absolute poverty is a situation where the standard of living is below what is defined to be adequate. Those who cannot afford the basic necessities like food, clothing and shelter are said to live in absolute poverty.

(ii) Explain why the established method of defining poverty as 'below 60% of average family income' is a measure of relative poverty.

It measures the level of income earned in comparison to another group over a given time so measures the poverty of one group to another, the relative poverty.

(iii) State and explain one policy measure which the government could use to reduce poverty.

The national minimum wage rate reduces poverty by creating a decent wage enabling people to achieve and improve their standard of living. This reduces the inequality gap between the rich and poor.

(Alternatively consider better training/schooling opportunities, more jobs through creation of the flexible labour market or subsidised child care costs to single parents here.)

(b) Using table 1:

(i) Compare earnings in London and the North East;

Average earnings in London are higher than they are in the North East. In London there is a large gap between the average wage in the highest average wage area and the lowest average earnings sector. In the North East the gap between Administrative Area with High Average Earnings and Administrative Area with Low Average Earnings is lower.

The Administrative Area with Lowest Average Earnings figure for London is lower than the lowest average figure for the North East.

(ii) Comment on the extent to which the data is useful in measuring the distribution of income

Some conclusions can be drawn between different regions and within the same regions, but there are some limitations. The data is based on earnings, not income, so does not include overtime or bonuses.

The cost of living also differs between areas as the variation in average house prices in table 1 suggests. The average values may also be distorted by individuals with very high or very low earnings so may not represent the data well.

(c) There is difficulty in filling job vacancies in Kensington and Chelsea, but there are many people unemployed in Redcar and Cleveland.

Discuss policies which the government may use to improve labour mobility.

(Two or three well explained points should gain 4 marks and 2 marks are gained for evaluating the effectiveness of the policies.)

To improve geographical immobility of labour the government couple implement housing subsidies in areas where house prices are high. This will make it easier for workers to move from Redcar and Cleveland to Kensington and Chelsea.

Occupational immobility can be improved by training to increase skills in jobs required in Chelsea and Cleveland.

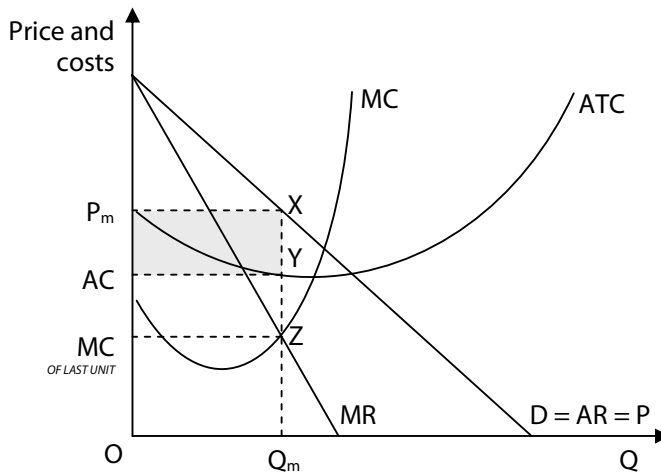
Improving the lack of information may also help as workers aware of vacancies in Kensington may consider moving if they were aware of the jobs available to them.

However, these policies may not be effective as workers have social ties and are not guaranteed a job. The uncertainty of the unknown and disruption to family life will mean the immobility of labour is likely to continue and the associated disparity in wage rates in to the long run.

Question 2

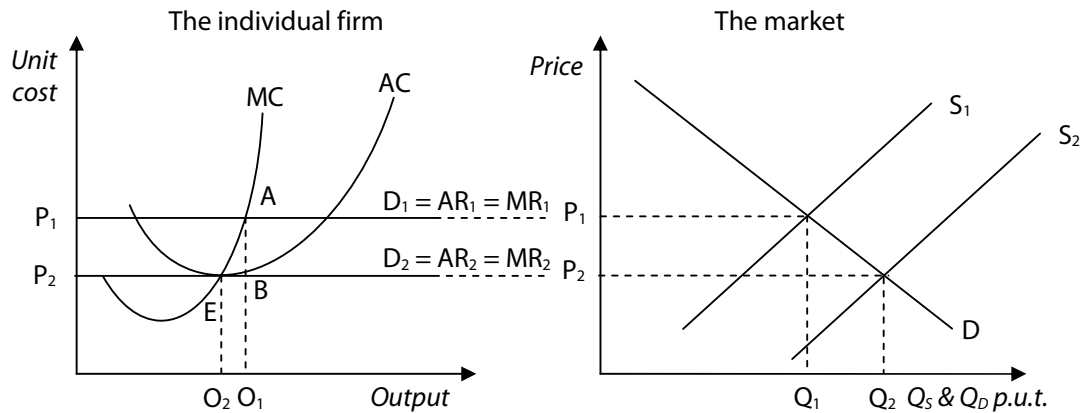
(a) Explain the difference in the way that prices are determined in perfect competition and in monopoly. [10]

Assuming that firms are aiming to maximise their profits then under a monopoly firms will charge a price where $MC = MR$, as at this output they maximise output.



The above diagram shows the monopolists cost structure, which is the cost structure of the industry as the pure monopolist is the industry. The monopolist charges a price much higher than their costs of production so makes large supernormal profits as the price is determined by the monopolist, not market forces.

Under perfect competition the market forces determine the price. In the short run this will result in some small supernormal profits of P_1ABP_2 , which attract new entrants into the industry, causing supply to shift from S_1 to S_2 .



Therefore in the long run the price will be set at the lowest point on the ATC curve, bringing about productive efficiency.

(b) In a leisure industry of your choice, discuss the way in which its market structure affect the ability of firms to set prices and make profits. [15]

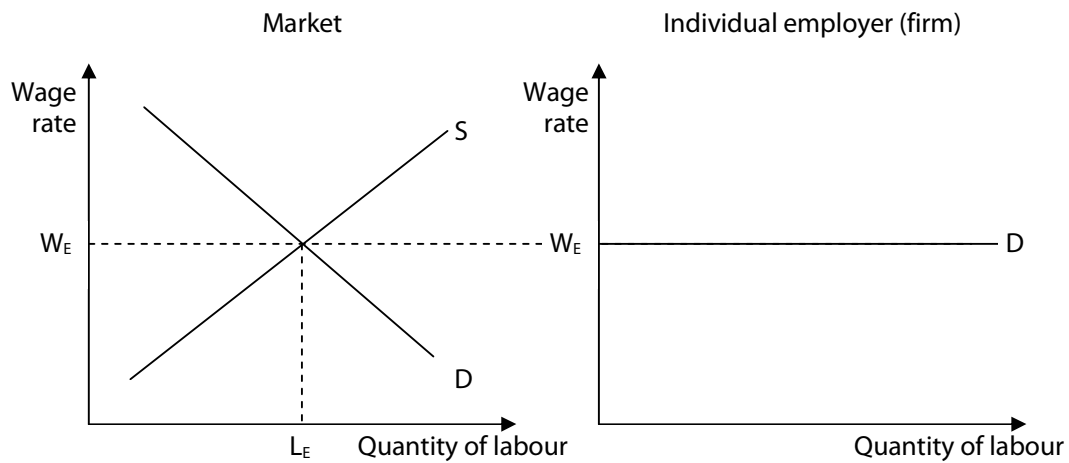
- The market for airlines has many characteristics of an oligopoly and some from monopolistic competition.
- Characteristics from oligopoly:
 - i. A small number of large firms, high concentration ratio
 - ii. Lots of non-price competition
 - iii. Supernormal profits made in the long run
 - iv. Brand leadership is important
 - v. Interdependence between firms (so kinked demand curve theory suggests price stability, and price leadership exists to set the price for stability).
- If the firm were an oligopoly it would not have control over the prices it set by kinked demand curve theory and would have to follow the price leader, though this firm is likely to choose a price that allows all firms to make supernormal profits.
- Characteristics from monopolistic competition:
 - i. Barriers to entry have been decreased since regulations on European skies were removed.
 - ii. Small firms can use hired aircraft and become profitable more quickly working at a low cost in the market.
 - iii. This makes the market more contestable and improved efficiency in the larger firms as there is the threat of smaller firms implementing a hit and run policy.
 - iv. Good knowledge.
- If the firm were a monopolistically competitive firm in the long run new entrants would decrease demand for an individual's firm's products and would charge a lower price for the same product, making a lower profit. Whilst the price is not taken directly from the market new entrants reduce the firm's power to set their price, leaving them in the very long run with only one output at which the firm does not make a loss.
- Conclusion: As the market structure for airlines takes its characteristics from monopolistic competition and oligopoly most firms in the market do not have much power to set prices in the long run. This can be seen to be true in the airline market as the effect of the new low-cost entrants to the market impacts the pricing of larger firms.

Question 3

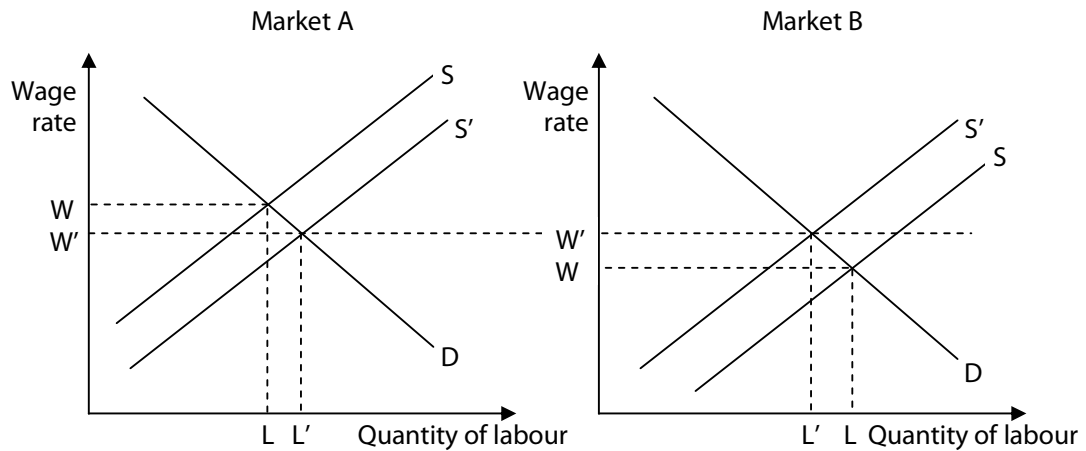
(a) Explain why, in a perfectly competitive labour market, the total net advantages of all occupations would be equalised in the long run. [10]

The net advantages of any occupation are the monetary and non-monetary advantages and disadvantages of any occupation, including wage rate, job satisfaction, flexibility of hours and danger involved in the job.

The characteristics of a perfectly competitive labour market are perfect geographical and occupational immobility, perfect knowledge by employers and employees and homogeneous workers with the same skills and qualifications. There are no trade unions so there is no control over the supply of labour and a large number of small firms employ workers as wage takers, at a wage level of W_E taken from the market.



All workers receive the same wage rate in the long run as if two occupations have different net advantages then due to perfect knowledge, workers will move to the market with higher net advantages so remove the disparity.



Showing only the monetary rewards, workers move from market B to market A causing a shift in supply from S to S' in each market. This causes the monetary rewards in each market to be an equal wage of W' .

Therefore generally we can say if there are two occupations with different net advantages then labour will move occupation to one with a higher net advantage, so remove net advantage inequalities in the long run.

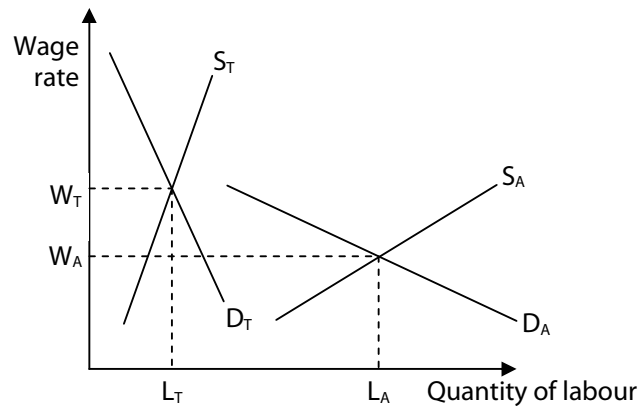
(b) Discuss why the net advantages of teachers are persistently greater than those of shop assistants. [15]

Teachers have higher net advantages for many reasons. The pecuniary differences are due to differences in supply and demand for labour in these occupations.

The MRP, the demand curve for labour, is given by $MPP \times P$. Teachers will have a greater and more inelastic demand because the MPP, the productivity of teachers, is higher than the productivity of shop assistants and the price of the product produced by teachers is higher than that produced by shop assistants, although it is very hard to measure the productivity of this service output accurately.

The supply of teachers is more inelastic than the supply of shop assistants due to the need for qualifications, specialist skills, length of training and the PGCE qualification making the market for teachers closed.

There are no specialist skills required for being shop assistants. There are strong trade unions for teachers, which are not very strong for assistants.



So diagrammatically the monetary advantages of teachers are higher than the monetary advantages for shop assistants by a level $W_A W_T$.

For teachers there are high non-monetary advantages because they have high job satisfaction and feel they are giving a service to the community. Teachers also have longer holidays than shop assistants, though teachers have the disadvantage of persistently dealing with unruly students, which makes the job more stressful. Teachers also have a greater degree of responsibility than shop assistants.

Overall the non-monetary advantages of the teachers are greater than the non-monetary advantages of the shop assistants.

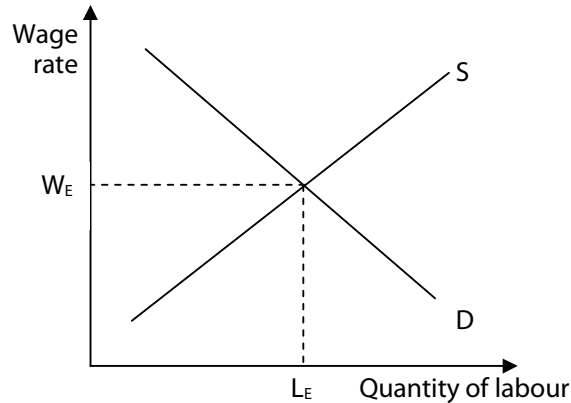
The disparity between the two occupations is caused by the immobility of labour. Teachers can easily become shop assistants but shop assistants cannot easily become teachers because of the reasons mentioned earlier. A high proportion of teachers' earnings are therefore economic rent, whereas much of shop assistants' wages are transfer earnings.

So from the points argued above the net advantages of working in teaching are higher than the net advantages of being a shop assistant.

Question 4

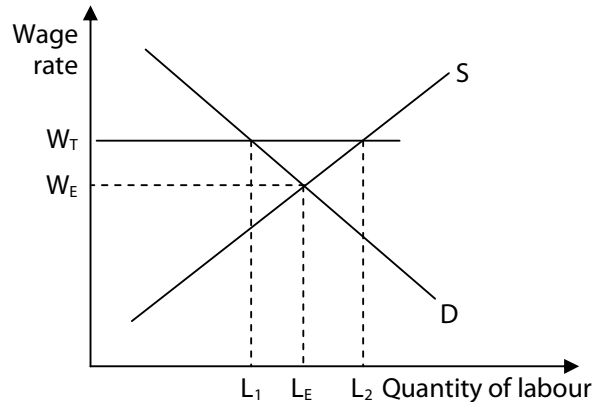
(a) Explain how the activities of a trade union may cause labour market failure. [10]

A trade union is an organisation of workers which aims to increase the wage rate of workers, the employment level and the working conditions for members.



In a perfectly competitive labour market the employment level and wage rate are determined by the interaction of the supply of labour and the demand for labour. This can be shown diagrammatically, that an equilibrium wage rate of W_e and a workforce of size L_e would be the equilibrium in the labour market for any type of labour.

An effective trade union, one with a large proportion of the workforce of the relevant industry as members, has strong bargaining power so can push for either a higher wage or an increase in the size of the workforce.



Negotiating a higher wage rate of W_T means that the firms will employ L_1 workers creating a level of unemployment L_1L_2 as L_1L_E workers are made redundant and L_EL_2 workers are now willing and able to work at the wage rate.

The size of this effect depends on the price elasticities of supply and demand. If the price elasticity of demand or supply is inelastic the unemployment caused will be

proportionally small, but if the price elasticity of demand or supply is elastic the unemployment caused will be proportionally large.

The existence of a trade union causes a market failure because the artificially high wage rate means the labour market is not efficient and resources are being wasted in the form of unemployment.

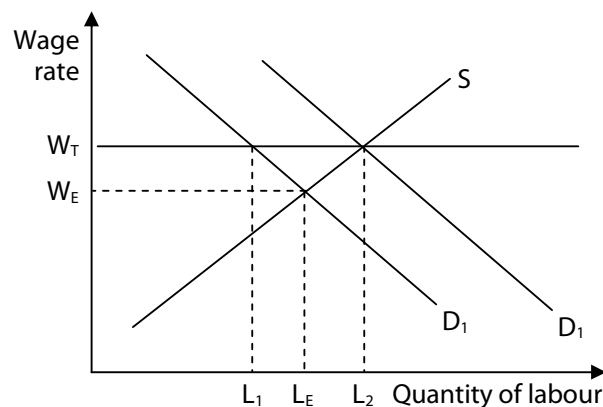
(b) Discuss the view that, in order to improve the competitiveness of the UK economy by reducing its unit labour cost, the government should attempt to reduce further the effective power of trade unions. [15]

The effectiveness of a trade union is determined by the proportion of the relevant workforce that are members. A strong trade union will have a high proportion of the workforce as members so the union can hold strong bargaining power at negotiations by threatening strikes.

Trade unions aim to unite workers and restrict supply. This is the opposite of the policy the government is currently implementing. The Labour government has aimed to transform the UK labour market into a flexible labour market. Characteristics of this market include short term contracts, flexible working hours and minimising geographical and occupational. This leads to wage flexibility as workers move freely between occupations and in or out of the labour market and allows wages to fulfil their role as a signal attracting more workers to an industry and improving allocative efficiency.

In the last 30 years the power of trade unions has been reduced by the government implementing legislation such as the abolition of closed shop agreements and the requirement of secret ballots before industrial action. This has helped to improve labour market flexibility.

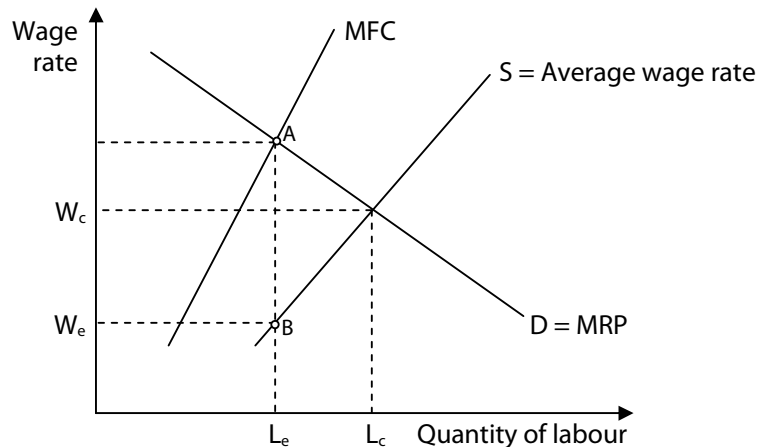
Flexibility helps reduce unemployment and wage differentials between workers, which is one of the aims of government policy. The government might then see the complete abolition of trade unions as useful in improving the competitiveness of the UK economy as the free market leads to lower unit labour costs.



However, some economists may argue that the negotiation of a higher wage rate, W_E by a trade union may improve the motivation of workers and so improve their output. This will cause the MPP, the Marginal Physical Product to increase. The demand for labour is the MRP curve, which is calculated by $MPP \times P$, so increasing MPP will increase the demand for labour from D_1 to D_2 meaning the negotiation of the higher wage rate by trade unions has resulted in a greater level of employment, L_2 at a wage rate W_T . As each worker is more productive this will

lower unit costs so help the UK economy to become more competitive internationally.

Also, under a bilateral monopoly the presence of a trade union can reduce the exploitation possible by the monopsonist. Without a trade union the monopsonist will employ at a profit-maximising level of employment, a quantity where $D = MFC$ at a wage rate W_e , lower than the equilibrium wage rate in a perfectly competitive labour market, W_c , and a smaller workforce L_e than L_c in a perfectly competitive labour market.



The presence of a trade union negotiating a higher wage rate, say W_c , can reduce exploitation by the monopsonist by increasing both the wage rate and employment level. This will cause the wage bill to increase but the workers will be more motivated so be more productive and lower unit wage costs.

There are alternative measures the government could undertake to improve the unit labour cost per worker and so improve the competitiveness of the UK economy. This could be achieved through the introduction of new technologies improving productivity of workers, so reducing unit costs and improving competitiveness. Increased spending on education and training improves workers skills and qualifications so can increase productivity and reduce unit costs and so also help to improve UK efficiency.

In conclusion, for political reasons the government will not completely abolish trade unions and trade unions can in theory help to reduce unit labour costs however this is not consistent with other policies of the government. Currently the government is aiming to improve labour market flexibility through investment in education and training, to create the features mentioned earlier. Reducing the effective power of trade unions further is consistent with this approach.