

Consumers in the Market Economy

4

Multiple Choice

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|---------------|---------|---------|
| 1. (A) | 6. (C) | 11. (B) |
| 2. (C) | 7. (A) | 12. (B) |
| 3. (D) | 8. (B) | 13. (C) |
| 4. (B) or (D) | 9. (A) | 14. (B) |
| 5. (C) | 10. (A) | 15. (C) |

Short Answers

Question 1

- (a). $Y = C + S$
- (b). $MPC = 0.75$. As income increases by 200, savings increase by 50. Therefore the MPS is $50/200 = 0.25$. As $MPS + MPC = 1$, the MPC is therefore 0.75.
- (c). An individual's marginal propensity to save generally increases as an individual's income increases. As incomes rise, people do not need to spend as much of their income on necessities. An individual can afford to save a higher proportion of each extra dollar of income without reducing their previous consumption levels as their income increases.
- (d). As an economy's level of income increases, its average propensity to consume is likely to fall. That is because consumers on lower incomes spend proportionately more of their disposal income on necessities than those on high incomes. Although consumption is also likely to rise as income increases, consumption typically rises slower than incomes, and thus the proportion of an economy's income spent on consumption, i.e. its APC , will fall.
- (e). (e) An individual's income and saving tend to change over the course of a lifetime a lot, while their level of consumption is more constant. The 'life-cycle theory of consumption' states that when individuals are young, they have relatively low levels of income due to inadequate skills, education and experience and this means that most of their income is derived through borrowing, and is spent. An individual's average propensity to consume during their youth is therefore likely to be high. As individuals enter the workforce and especially towards middle age, their incomes rise and typically a smaller proportion of income is consumed as they begin saving and accumulating assets for retirement. Their APC will tend to fall during this period. As individuals enter retirement, they no longer earn income from labour and are likely to consume out of past savings and wealth. During retirement, an individual's APC is likely to rise as a greater proportion of their savings is spent on consumption.

Question 2

- (a). Income refers to monetary benefits that flow to individuals and households for their contribution of factors of production to the production process. Income may also refer to benefits received from the government.
- (b). Labour is the factor of production providing wages - the majority of household income.
- (c). If the unemployment rate were to fall, the proportion of household income received from social welfare payments will fall, whilst the proportion of income received from wages will increase. This is because less people will become eligible for government transfer payments when they re-enter the workforce, and they will earn wages
- (d). Social welfare payments provide a safety net source of income for individuals who would otherwise not receive enough income due to their inability to contribute to the production process. Social welfare payments provide a more equitable distribution of income in a market economy by redistributing income to lower income earners. The payments can also boost overall levels of consumption and economic growth in an economy because lower income earners tend to have higher a propensity to consume.
- (e). The average propensity to consumer refers to the proportion of an individual's *total* income that is spent on consumption. The marginal propensity to consume refers to the proportion of *each extra dollar* of income that goes to consumption.
- (f). As wages increase, it is likely that individuals will tend to save a higher proportion of their income as higher income individuals spend proportionately less of their disposable income on necessities than lower income individuals. Although consumption is also likely to rise as income increases, the rise in consumption will be slower than the rise in incomes. Thus as wages increase, the economy's average propensity to save is likely to rise.

Question 3

- (a). Individual demand refers to the choice of an individual over what goods and services and how much will be consumed using their disposable income.
- (b). Substitute goods are those that consumers may choose to buy in the place of another good, such as butter and margarine. Complimentary goods are those that are used or consumed in conjunction with another good, such as a computer and computer software.
- (c). The price of a good or service will influence consumer choice. Unless the good is a necessity for daily life (where demand will not change greatly even if prices change), it is likely that as the price for a particular good or service increases, consumers would reduce their demand. The price of substitute goods will also influence consumer choice, as consumers will weigh up the price of alternative goods or services which they may choose to buy in the place of another good or service. Consumer tastes and preferences will also influence their consumption choices, and these may change significantly over time through innovation and technological progress.
- (d). In a market economy, consumer sovereignty reflects the freedom of choice that consumers have when deciding what goods and services to consume. This will ultimately determine what is produced by businesses. Consumers send signals to producers through their demand for particular goods or services. Business practices however, may reduce consumer sovereignty. Advertising and direct marketing can exert powerful influences over the spending patterns of consumers and distort their freedom of choice. Misleading and deceptive conduct by firms and other anti-competitive behaviour by business may also reduce the ability for consumers to make informed choices.

Skills revision

(left-hand graph)

$$\text{MPC} = 0.4$$

$$\text{MPS} = 0.6$$

$$\text{APC (at point A)} = 0.53$$

$$\text{APS (at point B)} = 0.5$$

(right-hand graph)

$$\text{MPC} = 0.4$$

$$\text{MPS} = 0.6$$

$$\text{APC (at point A)} = 0.5$$

$$\text{APS (at point B)} = 0.46$$