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MODEL EXAM QUESTION AND ANSWER

How to answer short answer questions?

Time allocation is crucial when answering short answer questions in exams. Some short answer questions have multiple parts. It is important to take note of the number of marks allocated for each question (and sub-question) and structure your answer accordingly.

You need to get into the habit of not spending too much time making a long, detailed answer only to end up with less time for the more important questions which account for a large percentage of the overall grade. It is well worth defining the key terms and identifying any connections early on in order to save time. Very often, illustrating the relationships can be made easier by the aid of graphs/diagrams

Always **PLAN YOUR ANSWER** before writing. This is of upmost importance as it will help you clarify your thoughts and ensure that you avoid following exam strategies that students commonly resign themselves to:

i) 'the kitchen sink' i.e spilling all of your knowledge that is vaguely related to the topic onto the exam paper and hope for the best.
ii) 'the garden path' i.e going off on an irrelevant tangent

Question

Consider a small firm which is operating in a perfectly competitive market and is a price-taker in both the market where it buys its inputs and the market where it sells its product.

(a) Explain the difference between the Short Run and the Long Run in the analysis of this firm's costs of production. *(2 marks)*

(b) Explain why this firm's Short Run Average Cost Curve, depicting how per unit costs of production change as output is increased, is typically U-shaped. What is the significance of the output level at which Short Run Average Cost is minimized?
(5 marks)

(c) Explain the circumstances in which a profit-maximising firm would find it worthwhile to shut down operations in the short run.
(4 marks)

(d) What factors determine the shape of this firm's Long Run Average Cost Curve. *(4 marks)*

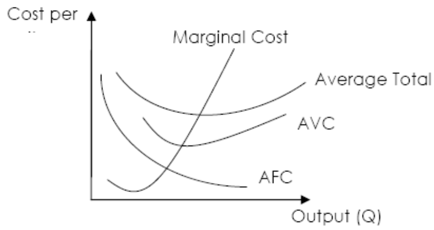
(e) Explain why in the long run this firm will be unable to make more than a normal profit. *(5 marks)*

Answer

Look at the marks allocated for each sub question- part (a) is only worth 2 marks- it is a simple compare and contrast question- define the key terms and tease out the differences

(a) When economists refer to the short run, they mean a period of time during which at least one of the firm's factors (costs) of production cannot be varied. By contrast, when economists speak of the long run, it refers to a time period of sufficient length that all the firms' factors of production are variable.

(b) The u-shape of the short-run AVC curve reflects the law of eventually diminishing returns. When the average productivity of the variable factor rises, AVC will fall. When average productivity of the variable factor falls, AVC will rise. AVC reaches its minimum and has its turning point at the level of output where average returns to the variable factor begin to diminish.



Answer the question. If you think a graph will clarify the concept better, then draw one by all means (but ensure it is drawn correctly!)

Since ATC at any level of output is the sum of AVC and AFC, the u-shape of ATC also reflects the law of diminishing returns. The AVC reaches a minimum at a level of output that is less than the level of output where ATC reaches a minimum, since AFC declines as output gets larger.

Note there are two parts to the question

When the level of output is at a level which AVC (ATC) is minimized, this signifies an output level in which VC (AC) is at its lowest, i.e. variable input is used most efficiently- i.e. where there is maximum marginal returns to the variable input.

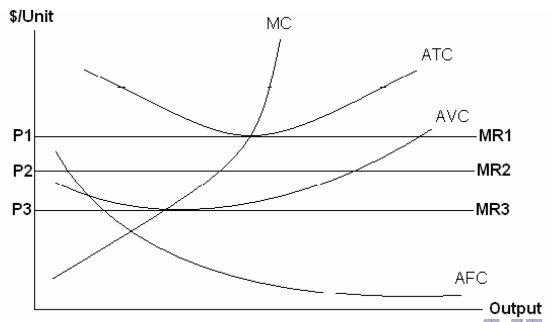
(c) Shutdown point is an exception to the price equals marginal cost profit maximising point rule.

Define key concepts- then offer an explanation

The firm should shut down in the short run when market price is so low that total revenue is less than variable cost, or price is less than AVC, when price equals marginal cost.

In this case, profit maximisation involves shutting down and producing nothing; the loss incurred is then equal to total fixed costs alone.

If the firm continues operation, the firm would incur total fixed costs PLUS variable costs for the production of the goods.



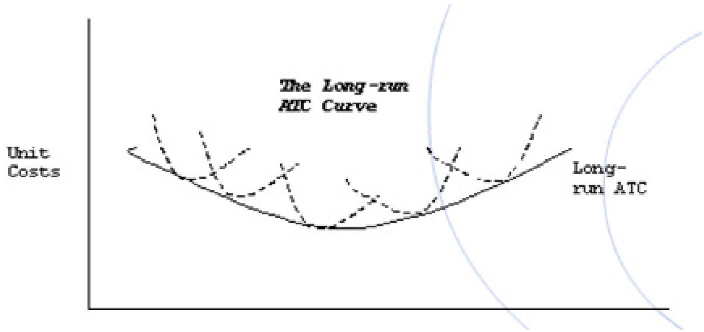
Diagrammatically, the firm should shut down at P3 or below. Note when If the price is at P2, where the MR curve intersects MC curve between the ATC and AVC curves, the firm is operating at a loss, but should not shut down because its revenues are still covering some of its fixed costs

It is worthwhile to include a diagram in this case because it helps to clarify the concept and demonstrate to examiner that you thoroughly understand the concept

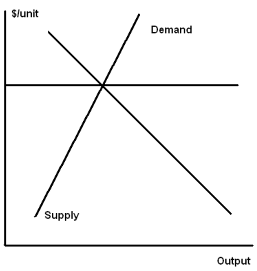
(d) In the long run the scale of production can be increased or reduced, because all factors of productions are variable. The long run average cost curve is affected by all factors of production, i.e. land, labour, capital and enterprise.

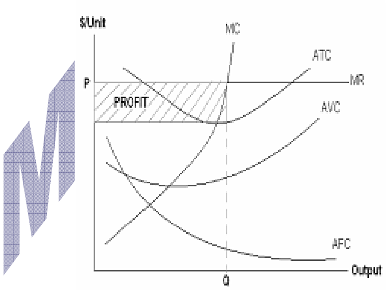
This allows the firm to move on to new average cost curves. For each size of firm there is an equivalent short run average cost curve. As the firm expands, it moves on to different short run average cost curves. If expanding the scale of output leads to a lower average cost for each level of output then the firm is said to be experiencing economies of scale.

The long run average total cost curve (LRAC) shown in the diagram below is the locus of points representing the minimum average total cost of producing any given rate of output, given current technology and resource prices.

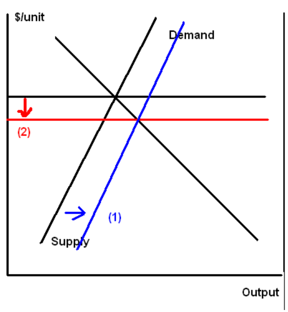


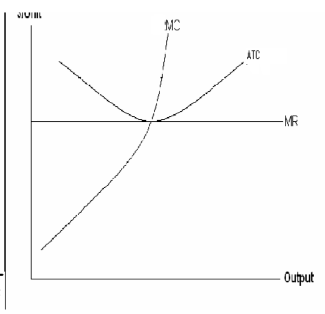
(e) The existence of positive economic profit means that producers in that market are earning more than their opportunity cost of production. Since price exceeds the opportunity cost of resources required to enter the markets, others will want to enter.





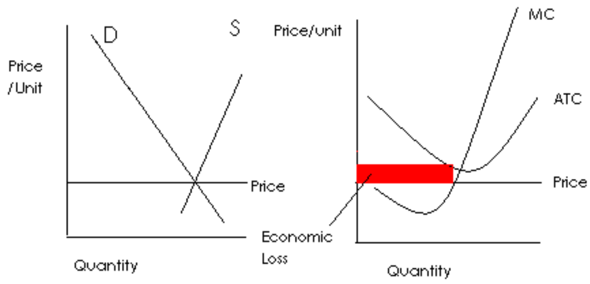
Economic profit lead to increase in supply as more suppliers want to reap the benefit of the economic profit.





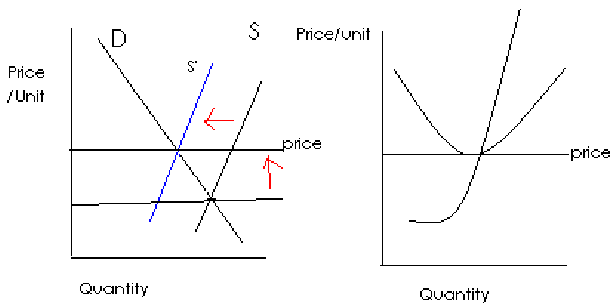
As supply increases (but demand stays the same), price decreases, so does economic profit. Future entry cease once price falls to the minimum value of ATC. At that point, economic profit is zero.

The existence of economic loss means that producers in that market are earning less than their opportunity cost of production. Since the opportunity cost of resources required to enter the markets exceeds the price of the goods, those in the market will exit for better alternatives.



Economic loss lead to decrease in supply as suppliers exit the market, and look for better investment opportunities with more profitable returns.

As supply decreases (but demand stays the same), price increases→ smaller losses. Future exits cease once price rises to the minimum value of ATC, at which point there will be no incentive for further exit.



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