tutor2u™

A2 Economics Essential Glossary

The key terms you need to know for A2 Economics – from the Internet's leading resource for students and teachers of economics

http://www.tutor2u.net

Author: Geoff Riley (Eton College)

Abnormal profit

Abnormal profit is any profit in excess of normal profit - also known as supernormal profit

Anti competitive behaviour

Anti-competitive practices are business strategies designed deliberately to limit the degree of competition inside a market

Asymmetric information

Information relating to a transaction in a market where there is imbalance in the information available to either the buyer or the seller. Asymmetric information can distort the working of the market mechanism and lead to market failure

Barriers to entry

Barriers to entry are designed to block potential entrants from entering a market profitably

Behavioural economics

A branch of economics which focuses on understanding the nature of human decision making and which explores how decisions are taken when economic agents do not have access to full and free information and when their behaviour is not automatically assumed to be rational

Bilateral monopoly

A market in which a single seller faces a single buyer. The final determination of price and output is such a situation is uncertain - much depends on the relative bargaining strength between the two parties concerned

Break even

The break even output is the volume of goods or services that have to be sold in order for the business to make neither a loss nor a profit. The break even price is when price = average total cost

Break even output

The break-even output occurs when AR=ATC (at this output, normal profit only is made)

Business ethics

Business ethics is concerned with the social responsibility of management towards the firm's major stakeholders, the environment and society in general

Collective bargaining

Unions might seek to exercise their collective bargaining power with employers to achieve a mark-up on wages compared to those on offer to non-union members

Collusive oligopoly

When several large firms in an industry act to restrict price or output

Compensating wage differentials

Wage differentials in part act as a compensation for people who have to work unsocial hours or who are exposed to different degrees of risk at work, both in the short term and long run

Competition policy

Government policy which seeks to promote competition and efficiency in different markets and industries

Complex monopoly

A complex monopoly exists if at least one quarter (25%) of the market is in the hands of one or a group of suppliers who, deliberately or not, act in a way designed to reduce competitive pressures within a market

Concentration ratio

Measure the proportion of an industry's output or employment accounted for by, say, the three, five or seven largest firms

Constrained revenue maximisation

Shareholders of a business may introduce a constraint on the price and output decisions of managers – this is known as constrained sales revenue maximisation

Consumer surplus

Consumer surplus is the difference between the total amount that consumers are willing and able to pay for a good or service (indicated by the demand curve) and the total amount that they actually pay (the market price)

Contestable market

Baumol defined contestable markets as existing where "an entrant has access to all production techniques available to the incumbents, is not prohibited from wooing the incumbent's customers, and entry decisions can be reversed without cost."

Cost benefit analysis

Cost benefit analysis (COBA) is a technique for assessing the monetary social costs and benefits of a capital investment project over a given time period

Cost reducing innovation

Cost reducing innovations have the effect of causing an outward shift in market supply and they also provide the scope for businesses to enjoy higher profit margins with a given level of demand

Cross subsidy

A firm operates a cross subsidy when it uses profits from one line of business to finance losses in another line of business. There are many reasons for maintaining a cross subsidy, either to promote a product new to the market which is making losses, or as a form of predatory pricing designed to eliminate an existing competitor, the latter is illegal under UK and European competition law

Deadweight loss

A loss of social welfare deriving from a policy or action that has no corresponding gain. Deadweight losses of welfare are often associated with the economic costs of monopoly power in a market or the effects of negative and positive externalities that remain ignored by the free market mechanism

Dependency ratio

The ratio of dependent population (the young and the elderly) to the working age population

Deregulation of markets

Also known as market liberalisation, de-regulation involves the opening up of markets to competition by reducing some of the statutory barriers to entry that exist

Derived demand

The demand for all factors of production (inputs), including labour, is a derived demand i.e. the demand for factors of production depends on the demand for the products they produce

Diminishing returns

The law of diminishing returns states that as we add more units of a variable input (i.e. labour or raw materials) to fixed amounts of land and capital, the change in total output will at first rise and then fall. Diminishing returns to labour occurs when marginal product starts to fall

Diseconomies of scale

A business may expand in the long run may expand beyond the optimal size in the long run and experience diseconomies of scale. This leads to rising LRAC.

Disposable income

Disposable income equals gross income net of direct tax payments and state welfare benefits.

Divorce between ownership and control

The owners of a company normally elect a board of directors to control the business's resources for them. However, when the owner of a company sells shares, or takes out a loan to raise finance, they sacrifice some of their control

Dominant market position

A firm holds a dominant position if it can operate within the market without taking account of the reaction of its competitors or of intermediate or final consumers.

Duopoly

Any market that is dominated by two organisations

Duopsony

Two major buyers of a good or service in a market

Dynamic efficiency

Dynamic efficiency occurs over time. It focuses on changes in the consumer choice available in a market together with the quality/performance of goods and services that we buy

Economic efficiency

Economic efficiency is achieved when an output of goods and services is produced making the most efficient use of our scarce resources and when that output best meets the needs and wants and consumers and is priced at a price that fairly reflects the value of resources used up in production

Economies of scope

Economies of scope occur where it is cheaper to produce a range of products

Elasticity of labour demand

Elasticity of labour demand measures the responsiveness of demand for labour when there is a change in the ruling market wage rate

Elasticity of labour supply

The elasticity of labour supply to an occupation measures the extent to which labour supply responds to a change in the wage rate in a given time period

Emissions trading

Emission trading is another form of pollution control that uses the market mechanism to change relative prices and the incentives of producers and consumers.

Equal Pay Act

The Equal Pay Act introduced in 1970 sought to provide legal protection for female workers and encouraged employers to bring the pay for males and females into line.

Equilibrium wage

The equilibrium price of labour (market wage rate) in a given market is determined by the interaction of the supply and demand for labour

Excess capacity

The difference between the current output of a business and the total amount it could produce in the current time period. Often in a recession or slowdown, there is a rise in excess capacity (= to a fall in capacity utilisation) due to a fall in demand. The effect can be to increase the average fixed costs of production

Excess demand

When demand for a good or service exceeds the production capacity of a business in a given time period. When a firm cannot raise output in the short term the elasticity of supply will be zero (i.e. perfectly inelastic)

Explicit collusion

The aim collusion between firms is to maximise joint profits and act as if the market was a pure monopoly

External benefits

Positive externalities lead to social benefits exceeding private benefits

External costs

Negative spillover effects of production or consumption for which no compensation is paid. Externalities occur where the actions of firms and individuals have an effect on people other than themselves. With negative externalities, the social cost of production exceeds the private cost

External economies of scale

External economies of scale exist when the long-term expansion of an industry leads to the development of ancillary services which benefit all or the majority of suppliers in the industry.

First mover advantage

The idea that a business that creates a new product and which is first into the market can develop a competitive advantage in that market perhaps through learning by doing, because it has the advantage of being there first - making it more difficult and costly for new firms to come in

Fixed costs

Fixed costs relate to the fixed factors of production. Fixed costs are business expenses that do not vary directly with the level of output i.e. they are treated as exogenous or independent of production

Free rider problem

If a public good is supplied, it will be available to them just as it would be to anyone else because pure public goods are non-excludable. This is the essence of the "free rider problem": the incentive which consumers have to avoid contributing to financing public goods in proportion to their valuation of such good.

Game theory

A game occurs when there are two or more interacting decision-takers (players) and each decision or combination of decisions involves a particular outcome (pay-off.)

Gini coefficient

The gini coefficient is a measure of income or wealth inequality. It is the ratio between the area between a Lorenz curve and the 45 degree line and the area below the 45 degree line. If the Lorenz Curve was the 45 degree line - then the value of the Gini Coefficient would be zero, but as the level of inequality grows so does the Gini Coefficient. In the most extreme possible scenario the Gini Coefficient would be 1

Government failure

Even with good intentions governments seldom get their policy application correct. They can tax, control and regulate but the eventual outcome may be a deepening of the market failure or even worse a new failure may arise.

Horizontal integration

Horizontal integration occurs when two businesses in the same industry at the same stage of production become one

Imperfect competition

Covers market structures between perfect competition and pure monopoly, i.e. an industry with barriers to entry and differentiated products - examples include oligopoly and duopoly

Inequality

The extent to which income and wealth between the inhabitants of a country is dispersed

Innovation

The Oxford English Dictionary defines innovation as "making changes to something established". Invention, by contrast, is the act of "coming upon or finding: discovery"

Interdependence

Interdependence exists when the actions of one firm has an effect on its competitors in the market. Interdependence is a common feature of an oligopoly

Internal growth

Internal growth occurs when a business gets larger by increasing the scale of its own operations rather than relying on integration with other businesses

Kinked demand curve

The kinked demand curve model assumes that a business might face a dual demand curve for its product based on the likely reactions of other firms in the market to a change in its price or another variable

Labour demand

There is normally an inverse relationship between the demand for labour and the wage rate that a business needs to pay for each additional worker employed

Labour force

The labour force is defined as the number of people either in work or actively seeking paid employment and available to start work.

Labour market

This is made up of firms willing to employ workers and labour seeking employment. The demand for labour by firms is downward sloping with respect to wage (price of labour), while the supply of labour by households is upward sloping with respect to wage. The labour market is in equilibrium where the demand for labour equals the supply of labour.

Labour market discrimination

Discrimination is a cause of labour market failure and a source of inequity in the distribution of income and wealth and it is usually subject to government intervention e.g. through regulation and legislation.

Law of unintended consequences

The law of unintended consequences is that actions of consumer and producers — and especially of government—always have effects that are unanticipated or "unintended." Particularly when economic agents do not always act in the way that the economics textbooks would predict

Limit pricing

When a firm sets price just low enough to discourage possible new entrants

Marginal cost

Marginal cost is the change in total costs from increasing output by one extra unit

Marginal revenue

Marginal Revenue (MR) = The change in revenue from selling one extra unit of output

Marginal revenue product

Marginal Revenue Product (MRPL) measures the change in total revenue for a firm from selling the output produced by additional workers employed

Market failure

Market failure occurs when freely-functioning markets, fail to deliver an efficient allocation of resources. The result is a loss of economic and social welfare

Market failure under monopoly

The standard case against monopoly is that the monopoly price is higher than both marginal and average costs leading to a loss of allocative efficiency and a failure of the market mechanism

Means tested benefits

The process of means-testing looks at the levels of income and wealth of an individual or household to assess if they are entitled to something

Merit good

A merit good is a product that the government believes consumers undervalue and under-consume because of imperfect information

Minimum efficient scale

The minimum efficient scale (MES) is the scale of production where the internal economies of scale have been fully exploited. It corresponds to the lowest point on the long run average cost curve

Minimum wage

The National Minimum Wage was introduced in the UK with effect from 1st April 1999. It is a legally guaranteed wage rate for workers aged 18 years or older

Monopsony

As a firm grows in size it can purchase its factor inputs in bulk at negotiated discounted prices. This is particularly the case when a firm has monopsony (buying) power in the market

Monopsony employer

A monopsony producer has significant buying power in the labour market when seeking to employ extra workers. A monopsony employer may use their buying-power to drive down wage rates

Nash equilibrium

An idea important to game theory which describes any situation where all of the participants in a game are pursuing their best possible strategy given the strategies of all of the other participants

Natural monopoly

For a natural monopoly the long-run average cost curve falls continuously over a large range of output.

Negative externality

A negative externality occurs where a transaction imposes external costs on a third party (not the buyer or seller) who is not compensated by the market. The result is a loss of allocative efficiency and shown by a reduction in economic welfare

Non price competition

Non-price competition assumes increased importance in oligopolistic markets. Non-price competition involves advertising and marketing strategies to increase demand and develop brand loyalty among consumers.

Normal profit

Normal profit is the minimum level of profit required to keep the factors of production in their current use in the long run

Oligopoly

An oligopoly is a market dominated by a few producers, each of which has control over the market. However, oligopoly is best defined by the conduct (or behaviour) of firms within a market rather than its market structure

Operating costs

Another term for variable costs

Original income

Original income comes from wages and salaries in work, self-employment income, investment incomes

Overheads

Another term for fixed costs

Participation rate

The percentage of the population of working age in the labour force.

Peak pricing

When a business raises its prices at a time when demand has reached a peak - higher prices might be justified on the grounds of the higher marginal costs of supply at peak times

Penetration pricing

A pricing policy used to enter a new market, usually by setting a very low price

Perfect price discrimination

With perfect price discrimination, the firm separates the whole market into each individual consumer and charges them the price they are willing and able to pay

Polluter pays principle

The principle that firms which cause pollution should bear the cost of eradicating it, ameliorating it, or compensating those who have been affected by it

Pollution permit

A marketable pollution permit gives a business the right to emit a given volume of waste or pollution into the environment

Poverty trap

A situation in which a rise in income results in the recipient being worse off once tax has been paid and benefits withdrawn. The poverty trap acts as a disincentive for people on low incomes to earn some extra income from working extra hours or taking another job

Predatory pricing

When a business deliberately reduces price in the short run so as to force competitors out of the industry. Predatory pricing is illegal under current UK and EU competition law

Price discrimination

Price discrimination occurs when a firm charges a different price to different groups of consumers for an identical good or service, for reasons not associated with costs

Price fixing

Price fixing represents an attempt by suppliers to control supply and fix price at a level close to the level we would expect from a monopoly

Price leadership

Price leadership occurs when one firm has a clear dominant position in the market and the firms with lower market shares follow the pricing changes prompted by the dominant firm

Privatisation

Privatisation means the transfer of assets from the public (government) sector to the private sector. In the UK the process has led to a sizeable reduction in the size of the public sector of the economy

Producer surplus

Producer surplus is the difference between what producers are willing and able to supply a good for and the price they actually receive. The level of producer surplus is shown by the area above the supply curve and below the market price

Product differentiation

Product differentiation occurs when a business seeks to distinguish what are essentially the same products from one another by real or illusory means. This means that the assumption of homogeneous products made under conditions of perfect competition no longer applies

Product line pricing

It is frequently observed that a producer may manufacture many related products. They may choose to charge one low price for the core product (accepting a lower mark-up or profit on cost) as a means of attracting customers to the components / accessories that have a much higher mark-up or profit margin.

Product markets

Product markets are where businesses and consumers meet to buy and sell the output of goods and services produced by an economy

Production function

A mathematical relationship between the output of a business in a given time period and the inputs (factors of production) used to produce that output. We normally make a distinction between short run and long run production although this is often blurred in many industries

Profit maximisation

Profit maximisation occurs when marginal cost = marginal revenue (MC=MR)

Profit per unit

Profit per unit (or the profit margin) = AR - ATC

Profit related pay

Where part of the earnings of people working for a business are linked directly to the profits made by that business. Profit related pay is often used as an incentive to raise productivity

Regulatory capture

This is when the industries under the control of a regulatory body (i.e. a government agency) appear to operate in favour of the vested interest of producers rather than consumers

Rent seeking behaviour

Behaviour by producers in a market that improves the welfare of one but at the expense of another

Returns to scale

In the long run, all factors of production are variable. How output responds to a change in factor inputs is called returns to scale

Revenue

Revenue (or turnover) is the income generated from the sale of output in goods markets

Revenue maximisation

Revenue maximization is when MR = zero (i.e. when price elasticity of demand = 1)

Satisficing behaviour

Maximising behaviour may be replaced by satisficing which in essence involves the owners setting minimum acceptable levels of achievement in terms of revenue and profit.

Second degree price discrimination

This type of price discrimination involves businesses selling off packages of a product deemed to be surplus capacity at lower prices than the previously published/advertised price

Sex Discrimination Act

The Sex Discrimination Act of 1975 outlawed unequal opportunities for employment and promotion in the workplace because of gender and it set up the Equal Opportunities Commission

Short run

The short run is defined as a period of time where at least one factor of production is assumed to be in fixed supply

Shut down price

In the short run the firm will continue to produce as long as total revenue covers total variable costs or put another way, so long as price per unit > or equal to average variable cost (AR = AVC).

Social benefit

Social benefits refer to the total benefit to society from a good i.e. the benefit to individuals and any beneficial unintended spill-over effects on third parties

Spare capacity

When a firm or economy is able to produce more with existing resources

Static efficiency

Static efficiency occurs at a point in time and focuses on how much output can be produced now from a given stock of resources, and whether producers are charging a price to consumers that reflects fairly the cost of the factors used to produce a product.

Strategic entry deterrence

Strategic entry deterrence involves any move by existing firms to reinforce their position against other firms or potential rivals

Sub-normal profit

Sub-normal profit - is any profit less than normal profit (where price < average total cost)

Sunk costs

Sunk costs cannot be recovered if a business decides to leave an industry

Tacit collusion

Tacit collusion occurs where firms undertake actions that are likely to minimise a competitive response, e.g. avoiding price cutting or not attacking each other's market

Total cost

Total cost = total fixed cost + total variable cost

Total revenue

Total revenue (TR) refers to the amount of money received by a firm from selling a given level of output and is found by multiplying price (P) by output i.e. number of units sold

Trade unions

Trade unions are organisations of workers that seek through collective bargaining with employers to protect and improve the real incomes of their members, provide job security, protect workers against unfair dismissal and provide a range of other work-related services including support for people claiming compensation for injuries sustained in a job.

Two part pricing tariffs

A fixed fee is charged (often with the justification of it contributing to the fixed costs of supply) and then a supplementary "variable" charge based on the number of units consumed

Variable cost

Variable costs are business costs that vary directly with output since more variable inputs are required to increase output

Vertical integration

Vertical Integration involves acquiring a business in the same industry but at different stages of the supply chain

Work leisure trade off

The choice labour makes between working more hours and taking more leisure when the rate of income tax changes.

X inefficiency

The lack of real competition may give a monopolist less of an incentive to invest in new ideas or consider consumer welfare