

Answers to the microeconomic practice questions

Objective test questions

- | | | | |
|---|---|----|---|
| 1 | A | 6 | C |
| 2 | A | 7 | C |
| 3 | D | 8 | D |
| 4 | C | 9 | A |
| 5 | A | 10 | B |

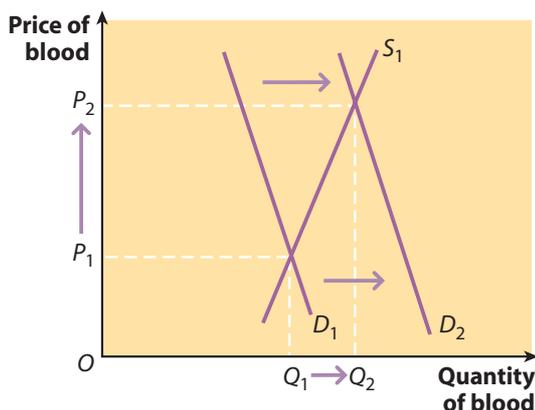
AS context question

Context 1

- 01** Welfare is happiness, satisfaction, utility and fulfilment of need.
- 02** Units of blood fell from approximately 54,000 to approximately 43,000. The absolute change was a fall of 11,000 units. The percentage fall ($11,000/54,000 \times 100$) was 20.3703703730%, which to one decimal place is 20.4%.
- 03** A first significant point of comparison is that blood stocks peaked at about 57,000 units early in the data period around 18 April 2014 and reached their low of about 39,800 units late in the data period around 4 August 2014.

A second significant point of comparison is that on a day-to-day basis, blood stocks were volatile throughout the data period. There was no period in which blood stocks were unchanged over a few days. An example of this volatility is that blood stocks, which as noted above stood at about 39,800 units around 4 August 2014, rose slightly, then fell, and then rose again to just under 43,000 units around 8 August.

04

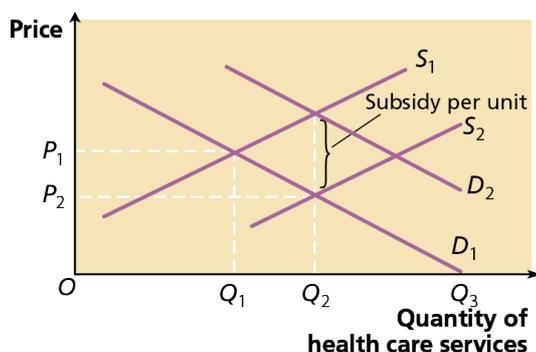


In the diagram, an unexpected increase in the demand for blood shifts the demand curve for blood rightward from D_1 to D_2 . Because we have drawn an inelastic supply curve, the resulting proportionate increase in price, from P_1 to P_2 , is significantly greater than the proportionate increase in the quantity of blood supplied, which rises from Q_1 to Q_2 . On a day-to-day basis, the supply curve might be completely inelastic (a vertical line), but it has been assumed here that, hearing of the blood shortage and rising blood prices, more people decide to sell their blood.

- 05** Merit goods can be defined in two ways: first, as a good which when consumed leads to benefits that other people enjoy; and second, as a good for which the long-term benefit of consumption exceeds the short-term benefit enjoyed by the person consuming the merit good. People are myopic and only consider the short-term costs and benefits. As a result, they choose to consume too little preventative health care such as regular dental checks and blood pressure tests. In the case of a merit good such as health care, the future private benefits are often substantial.

Most, though not necessarily all, health care services meet one or other, or possibly both, of these ways of defining a merit good. The provision of blood is in line with the first definition, but not really the second definition. When providing blood, positive externalities are generated which benefit the wider public, namely the people who need to receive blood transfusions. A possible long-term private benefit of giving blood is that donors can then confidently expect that if they, in their turn, need transfusions in future years, blood donated by other people will be readily available.

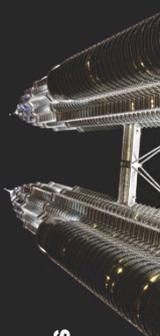
- 06** As we have indicated in our previous answer, many economists argue that health care is a merit good. One person's 'consumption' of health care may well have beneficial effects for others — particularly where infectious diseases are concerned. The positive consumption externalities generated when a person consumes a merit good are illustrated below.



In the diagram, the market supply curve of health care services is S_1 . The curve shows the quantity of beds that private hospitals (and NHS hospitals offering private health care) are prepared to supply at different possible prices. The market demand curve D_1 , which does not reflect the positive externalities enjoyed by society as a whole when health care services are consumed, shows how much private health care people are prepared to buy at the different possible prices. In this situation, the market price of health care services is P_1 , determined where the D_1 and S_1 curves intersect. At this price, Q_1 health care services are consumed.

However, the price would have to fall to P_2 to bring about the socially optimal level of consumption of health care services, namely Q_2 , which reflects the positive consumption externalities generated when people receive health care services. However, in a free market, private hospitals would refuse to reduce the price they charge for their services, as this would wipe out their profits. Free-market provision of health care, therefore, leads to under-consumption of health care services, and hence to their under-production. In a free market, too few scarce resources are allocated to the production and consumption of health care.

The market can still be used to provide health care, but with the prices adjusted by government subsidy. In the diagram, subsidies granted to private hospitals shift the market supply curve to S_2 , with the aim of bringing about Q_2 consumption.



There are further disadvantages of using markets to provide health care. First, there is the distributional argument. Rich people can afford expensive operations but poor people cannot. If health care is left to a free market, the poor will either go without care or consume health care services of inferior quality. Second, some health care economists argue that privately provided medicine incurs higher production costs than social provision outside the market, for example by the National Health Service. The cost of billing patients can be substantial, expensive equipment is often under-used during much of the day, and to make money for doctors, patients are encouraged to have operations they do not really need.

So what are the advantages and disadvantages of providing health care services outside the market? On the plus side, free provision by the state, as with the NHS, means that services are provided for the poor as well as for the wealthy. However, as the earlier graph shows, free provision can lead to over-provision and over-consumption. At zero price, people wish to consume Q_3 health care services, which is beyond the socially optimal level of consumption of Q_2 . Additionally, health care services are expensive to provide. Free provision outside the market means that taxpayers and sometimes charities have to pick up the bill. Resources are diverted into the NHS and out of other uses. And while surgical provision in the NHS is usually of a very high standard, shortages of nurses, the quality of hospital food and dilapidation of hospital wards means that other aspects of health care provision are often less good. Provision outside the market at zero price to the patient also leads to excess demand. Health care is rationed by queues rather than by price, and patients' health sometimes deteriorates while they wait for operations.

In conclusion, my own belief is that most health care services should not be provided by markets, though markets may have a role in providing services such as cosmetic surgery. Perhaps the best approach would be to go for insurance-based provision in which private hospitals provide surgical procedures through the market, but medical bills are paid by insurance companies. For people who can afford to pay health insurance premiums, health insurance should be made compulsory, with the state paying the insurance costs of the poor.