

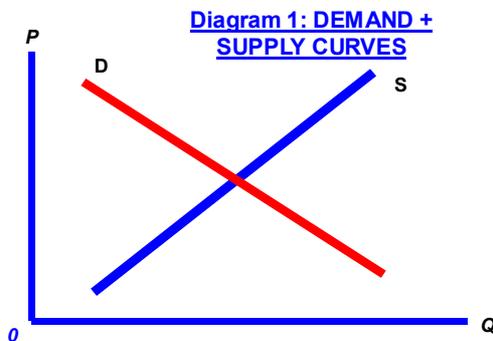
**Big Question:**  
What makes the market system work effectively?

**Webnote 108**  
**Syllabus: Item 17**

**SYLLABUS REFERENCE 1.1**

**RESOURCE ALLOCATION IN A MARKET ECONOMY: HOW ALLOCATION IS DETERMINED BY PROFIT AND LOSS OF THE FIRM**

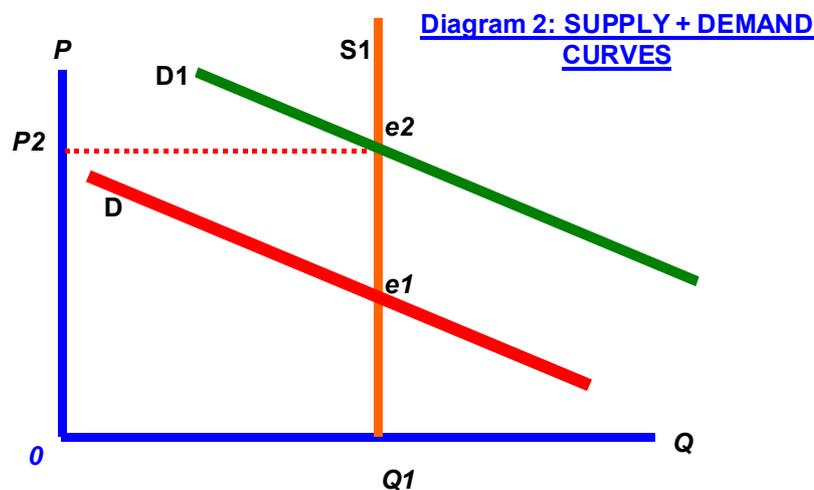
1.) What is meant by resource allocation? See box A.



**A**

Allocation of resources by the market occurs along the Q axis. A shift or movement in demand (or supply) will result in MORE OR LESS factors of production used by the firm. One key factor here is the incidence of profit or loss for the firm. More resources (factors of production) are likely to enter the industry when profit levels increase.

2.) As an example consider a situation where the supply of a good is fixed in the short run. A useful example would be the supply of fresh fish to Düsseldorf for one particular day. In short run-entry of new firms + spare capacity can only occur after some time interval. The supply of fish is therefore fixed at  $Q_1$ , illustrated in diagram 2. Equilibrium will initially result at  $e_2$  with a price of  $p_2$  and quantity of  $Q_1$ .



**Notes:**

May 2015 HP1

1a Explain how changes in price work to reallocate resources in a market. (10 marks)

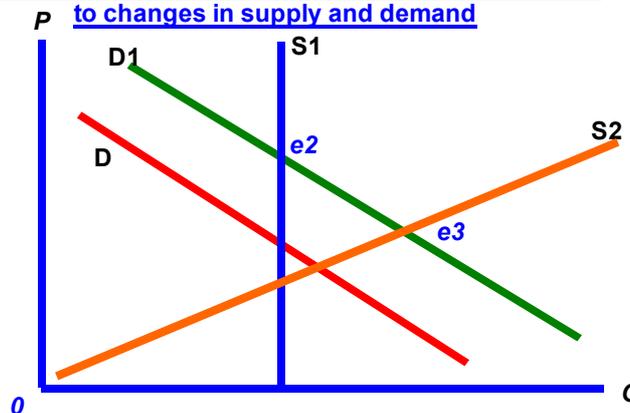
1b Discuss the view that the overuse of common access resources is best addressed by government. (15 marks)

3.) Entrepreneurs / firms will respond to the higher prices and the likelihood of higher profits as a result of the shift in consumer demand. This is an example of an improved profit situation for the firm. Production costs do not increase as supply is fixed. Firms respond by putting their prices up.<sup>1</sup>

4) After some time e3 will occur (see diagram 3) due to increased output in the industry caused by increases in the number of firms and /or new capacity by existing firms. More factors of production have entered the industry. If the equilibrium in this example moves from e2 to e3 the opposite can also occur and firms will leave the industry and factors of production will have to find alternative uses or become unemployed. Firms cannot endure loss making in the long run. Profits must occur. Allocation of resources follows.

Read:  
Blink pp 126-127

**DIAGRAM 3: Economic resource allocation responding to changes in supply and demand**



**Note:**

Consumer surplus is sometimes referred to as “consumer sovereignty”. It’s exactly the same concept.

Producer surplus is sometimes referred to as “producer sovereignty”. It’s exactly the same concept.

**Task 1: Draw the area of producer surplus as a result of the change in demand when D shifts to D1. This will test your understanding of webnote 106**

**Task 2: Why does S1 shifts to S2?**

**Tip:** “\_\_\_\_\_ follow\_\_\_\_\_”

<sup>1</sup> Such a situation arises often Düsseldorf when a large Messe/fair takes place. Hotels all over the city are fully booked and prices increase by as much as 100 % during the days of the Messe. Once the Messe ends the hotel process revert to the lower rates.