

## **PRICE THEORY.**

This is the study of prices in relation to goods and services.

**Price** is the exchange value of a commodity expressed in monetary terms.

In a lay man's language, it's the amount of money that has to be paid for a specific quantity of a given commodity.

## **ROLE/USES/IMPORTANCE OF PRICE IN AN ECONOMY.**

1. It measures the value of goods and services. This is because the value of a commodity is reflected by the price attached to it.
2. It guides producers on what to produce. Producers produce more of those commodities with a high price and less of the commodities with a low price in order to maximize profits.
3. It provides an automatic adjustment of demand and supply. This helps to overcome a problem of excess demand or excess supply.
4. It determines income distribution in an economy. This is because with use of prices, income goes to those who own resources and the income received by an individual depends on the resources he owns and their prices.
5. It helps consumers to make consumption plans. This is because for utility maximization, consumers buy more of those commodities with low prices.
6. It determines how to produce. Producers make choice of the production techniques depending on the prices of factors of production.
7. It guide producers on where to allocate their production enterprises. These usually prefer establishing enterprises in prices where prices are high.

## **DETERMINANTS OF PRICE IN THE ECONOMY.**

- ◆ Costs of production.
- ◆ Demand for a commodity.
- ◆ Supply of the commodity.
- ◆ Government policy on price.
- ◆ Expected future demand.
- ◆ Goal of the producer.
- ◆ Elasticity of demand for the commodity.
- ◆ Quality of the commodity.

## **TYPES OF PRICES.**

**Market price.** It's the price prevailing in the market at a given period of time.

**Equilibrium price.** It's the price at which quantity demanded is equal to quantity supplied.

**Normal price.** It's a price that regulates demand and supply so that they are equal in the long-run i.e. It's the long-run equilibrium price.

**Reserve price.** It's the lowest price a producer is willing to accept in exchange for his commodity.

### **DETERMINANTS OF A RESERVE PRICE**

#### **Future expected demand.**

When the seller expects the demand for the commodity to be high in the future, the reserve price is high as one is not scared of selling at a lower price. Expectation of a lower demand in the future implies a low reserve price.

#### **Durability of the commodity.**

Durable commodities have a high reserve price since they can be stored when the price is low and sold in the future at a high price while perishable commodities have a low reserve price since they have to be sold immediately.

#### **Future costs of transport and storage.**

When such costs are high, the reserve price is low as people try to avoid such costs but when such costs are low, the reserve price is high as it's profitable to sell at a later date or to transport goods to other places where price is high.

#### **The length of time it will take before supply of new commodities.**

The longer the time period, the higher the reserve price as supply remains low but when the time period is short, the reserve price is low due to fear of increased supply in the near future.

**Liquidity preference.** A high liquidity preference implies a low reserve price since the demand for commodities is low but when the liquidity preference is low, the reserve price is high since demand for goods is high.

#### **Future costs of production.**

When producers expect the costs of production to be high in the future, they set a high reserve price so that they are able to cover such costs but when they expect the production costs to be low, they set a low reserve price since they can easily cover the production costs.

### **THE MARKET.**

A market is an arrangement within which buyers and sellers negotiate the exchange of goods.

It can also be defined as an institution or a medium that brings together buyers and sellers.

### **FEATURES OF A MARKET.**

There should be a commodity to be exchanged.

There should be buyers.

There should be sellers.

There should be an established medium of exchange.

### **TYPES OF MARKETS.**

1. **Perfect market.** It's a market where there are many buyers and many sellers of homogeneous products and no single buyer or seller can influence the price of the commodity.
2. **Imperfect market.** It's a market where there's limited competition and a buyer or a seller can influence the price of the commodity. It includes, monopolistic competition, oligopoly etc.
3. **Free market.** It's a market where there's no government intervention in price and output determination. In this market, price is determined by the free market forces of demand and supply.
4. **Controlled market.** It's a market where there's government intervention over price and output determination.
5. **Commodity market.** It's a market where goods are exchanged.
6. **Factor market.** It's a market where factors of production are exchanged. It includes, the labour market, the capital market.

### **PRICE DETERMINATION IN THE MARKET.**

Price in the market can be determined in any of the following ways;

#### **Haggling/Bargaining.**

This is where the seller and the buyer discuss the price of the commodity until they agree on the price. The seller keeps on reducing the amount he is willing to accept and the buyer keeps on adding to the amount he is willing to pay until they come to a compromise.

#### **Auctioning/Bidding.**

This is where there's a single seller and many prospective buyers. Buyers compete amongst themselves and the one who pays the highest price takes the commodity.

#### **Forces of demand and supply.**

This applies to a free enterprise economy where there's no government intervention in price determination. In this case, when demand exceeds supply, price increases and when supply exceeds demand, price reduces.

#### **Fixing by treaty/Agreement/Collusion.**

When prices are fixed by treaties, buyers and sellers come together and agree on the price and fix it with a written agreement.

In case of collusion, sellers of a similar commodity come together and fix the price at which they will sell their commodities. This is usually done to reduce competition among the sellers.

### **Government price legislation.**

This is where the government determines the price of the commodity through price control in form of maximum and minimum price legislation.

### **Resale price maintenance.**

This is where a producer determines the price at which the commodity is to be sold to the final consumer, e.g newspapers, airtime etc.

### **Advantages of resale price maintenance;**

1. It reduces the exploitation of the consumers by the retailers.
2. It increases the volume of sales and the profit level
3. It maintains price stability.
4. It makes it easy for the consumers to make their consumption plans.
5. It reduces competition between small scale retailers and large scale retailers.

### **Price leadership.**

This is where a dominant firm or a low cost firm determines the price and other firms in the industry follow.

### **Offers at fixed prices.**

This is where the seller determines the price of the commodity and the consumer has no influence over the price. It's mostly done by monopolists who unless interfered by the government, have the ability to determine their prices even when they do not favour the public.

### **DETERMINANTS OF MARKET PRICE.**

- Demand for the commodity. When the demand for the commodity is high, price is also high since many people are interested in buying the commodity but when the demand is low, price is low as sellers try to increase the volume of sales.
- Supply of the commodity. When supply of the commodity is high, sellers set a low price so as to attract buyers but when the supply is low, they set a high price since the commodity is scarce.
- Aim of the producer. When the producer aims at profit maximization, he restricts output and sets a high price but when he aims at sales maximization, he increases output and sells at a relatively low price so as to attract more customers.

- **Costs of production.** High production costs force producers to set high prices so that they cover the production costs and also make profits while low production costs lead to low prices since producers can easily make profits.
- **Level of taxation.** High taxes force producers to sell commodities at high prices so that they pay the taxes and also make profits while low taxes lead to low prices since they enable producers to make profits even when they sell at low prices.
- **Elasticity of demand for the commodity.** Producers set high prices for commodities with inelastic demand since consumers buy almost the same amount at any price but when demand for the commodity is elastic, a low price is set to attract more consumers.

## **DEMAND.**

This is the desire backed by ability and willingness to pay a certain amount of money for a given quantity of a commodity at a particular period of time.

Effective demand is actual buying of a commodity. *goods and services at a given time*

Quantity demanded is the amount of goods that consumers are able and willing to buy at various prices.

**Individual demand.** This refers to the quantity of a given commodity that a given consumer is able and willing to buy at a given price at a given time.

**Market demand.** This is the total quantity of a given commodity that all consumers of a given commodity are able and willing to buy at a particular price during a given period of time i.e it's the sum-total of all individual demands.

## **INTER-RELATED DEMAND.**

It refers to demand for a commodity which is affected by demand or price of another commodity. It includes;

### **Joint/Complementary demand.**

This is the demand for commodities that are used together e.g a pen and a book, a car and fuel, a gun and bullets etc. With such commodities, an increase in price of one leads to a reduction in the quantity demanded of the other. Examples include;

- Demand for cars and fuel.
- Demand for guns and bullets.
- Demand for a toothbrush and tooth paste etc.

**Composite demand.**

This is the demand for a commodity that has several uses, e.g electricity, steel, water, timber, paper etc. The total demand for such commodities is composed of its demand for the different uses.

**Competitive demand.**

It's the demand for commodities which serve a similar purpose e.g, coffee and tea, beans and peas, beef and chicken, omo and nomi etc.

**Derived demand.**

It's the demand for commodities which are not used for satisfaction of human needs but they are demanded because they help in the production of other goods e.g cotton is demanded for production of clothes, a tractor is demanded to produce agricultural products.

It should be noted that all factors of production have a derived demand.

**Independent demand.**

It's the demand for a commodity which isn't affected by the demand for another commodity.

**DEMAND SCHEDULE.**

It's a table showing various quantities demanded of a given commodity at various prices.

DIAGRAM

The demand schedule can be drawn for an individual showing quantity demanded by this individual at various prices or for the whole market showing total demand for a given commodity at various prices.

A market demand schedule is derived by adding together the demand schedules for all consumers in the market.

Assuming that we have three consumers in the market, we can derive the market demand schedule as below.

DIAGRAM

## THE DEMAND CURVE.

It's a curve/graph which shows various quantities demanded of a given commodity at various prices.

The demand curve is drawn for an individual or for the whole market. A market demand curve is derived by undertaking a horizontal summation of the individual demand curves.

The tables and graph above shows that people demand more of the commodity when its price is low and they demand less of it when the price is high.

## REASONS WHY PEOPLE DEMAND GOODS.

1. **Functional demand.** This is where people demand goods because of their ability to satisfy human needs e.g one buys a drink when he is thirsty.
2. **Exclusivity effect.** This is where one buys a commodity to be unique i.e to look different from others.
3. **Conspicuous consumption/Snob effect.** This is where an individual buys a commodity which is very expensive to show off his economic status/economic power.
4. **Speculative effect.** Expectation of a future price increase stimulates demand for a commodity as some people buy more today so as to avoid buying at a higher price in the future.
5. **Inclusivity/Bandwagon effect.** This is where an individual buys a commodity because others are buying it i.e he wants to be like others.
6. **Impulse buying.** This is where an individual buys a commodity on a sudden desire i.e, one buys a commodity because he has seen it.

## DETERMINANTS OF/FACTORS AFFECTING/INFLUENCING DEMAND.

### ✓ Price of the commodity.

When the price of the commodity is high, some people especially the poor buy less of the commodity because of their low purchasing power but when the price is low, the purchasing power is high and demand is high.

### ✓ Prices of substitutes.

High prices of substitutes leads to high demand for a given commodity as some consumers of the substitute shift to the commodity but low prices of substitutes lead to a low demand for a commodity as some consumers shift to the substitute.

✓ **Price of a complementary good.**

A high price of a complementary good leads to a low demand for a commodity as less of the complement is bought but when the price of the complementary good is low, demand for a commodity is high as people buy more of its complement.

✓ **Income level of the people.**

A high income level leads to a high purchasing power thus high demand for the commodity while a low income level leads to a low demand for the commodity because of the low purchasing power.

✓ **Tastes and preferences.**

Favourable tastes for a commodity leads to its high demand as many people are interested in it while unfavourable tastes for a commodity leads to low demand since less people are less interested in the commodity.

✓ **Size of the population.**

A big population ensures a large market for a commodity as many people buy the commodity while a small size of the population implies low demand because it provides a small market as a few people are buying the commodity.

✓ **Government policy of taxation and subsidization.**

High taxation discourages production and reduces people's disposable income thus low demand while low taxes imply a high disposable income thus a high demand.

✓ **Future price expectation.**

Expectation of a future price increase leads to a high demand for a commodity as people buy more to avoid buying at a higher price in the future but when people expect prices to reduce in the future, they buy less of the commodity as they wait to buy more in the future.

✓ **Seasonal factor.**

Some commodities such as umbrellas, seasonal greeting cards are demanded seasonally. When the season is on, many people are interested in them and their demand is high but when they are off season, people aren't interested in them and their demand is low.

✓ **Level of advertisement.**

When the commodity is highly advertised, people are made aware of its existence and others are persuaded to buy it thus a high demand but when the level of advertisement is low, people are ignorant of the existence of the commodity and its demand is low.

✓ **Income distribution.** When income is evenly distributed, demand is high because even the poor have some money to spend on consumption. Wide income inequality implies low demand since the poor almost have nothing to spend.

**Qn. Explain the causes of low demand.**

**Explain the factors that lead to high demand.**

## **UTILITY.**

It refers to satisfaction that's derived from consumption. Any good that satisfies an economic need possesses utility. Utility is measured in units called 'UTILS'. It includes;

### **Total utility.**

This refers to the total satisfaction that is derived from consumption of certain units of a commodity.

### **MARGINAL UTILITY.**

It's the additional satisfaction that is derived from consumption of an additional/extra unit of a commodity. Marginal utility reduces as one consumes more units of a commodity.

$$M.U = \frac{\text{Change in total utility}}{\text{Change in units consumed.}}$$

Change in units consumed.

## **DISUTILITY.**

It refers to a negative satisfaction or satisfaction lost as more units of a commodity are consumed.

## **RELATIONSHIP BETWEEN TOTAL UTILITY AND MARGINAL UTILITY.**

DIAGRAM

From the table and the curve, the following should be noted;

When total utility is increasing, marginal utility is reducing but above zero (0)

When total utility is at maximum, marginal utility is zero (0)

When total utility is declining, marginal utility is negative.

The point where total utility is at maximum is called a bliss point or point of satiety.

### THE LAW OF DIMINISHING MARGINAL UTILITY.

It states that as one consumes more units of a commodity, satisfaction derived from the additional units goes on declining. This implies that the first units of a commodity consumed give an individual more satisfaction than the additional units.

#### Assumptions of the law of diminishing marginal utility.

- ✓ It assumes that the consumer aims at utility maximization.
- ✓ The consumer has a fixed level of income.
- ✓ The commodity prices are fixed and constant.
- ✓ The consumer's tastes and preferences are constant.
- ✓ It assumes that the commodity has a uniform size.
- ✓ It assumes continuity in consumption i.e the units are consumed one after the other.
- ✓ It assumes the consumer is not addicted to the commodity.

#### CONSUMER'S SURPLUS

This refers to the difference between what the consumer is willing to pay for a commodity and what he actually pays.

OR

It's the extra satisfaction that a consumer enjoys without paying for it because the market price is below what he is willing to pay.

#### PRODUCER'S SURPLUS.

It's the excess earnings a producer receives above the minimum amount of money he was willing to accept in exchange for his commodities.

OR

It's the difference between what a producer actually gets from the sale of his commodities and what he was willing to accept.

Application of the Law of diminishing utility

### Consumer's surplus.

Price the consumer is willing to pay (shs)	Units
15000	1
12000	2
10000	3
7000	4
5000	5

Using 10000 as the market price, calculate the consumer's surplus when three units of a commodity are bought.

CS = Anticipated expenditure - Actual expenditure.

$$\begin{aligned} &= 15000 + 12000 + 10000 - (10000 \times 3) \\ &= 37000 - 30000 \\ &= 7000 \text{shs.} \end{aligned}$$

OR

$$15000 - 10000 = 5000$$

$$12000 - 10000 = 2000$$

$$10000 - 10000 = 00$$

7000 shs.

### Producer's surplus.

Price a producer is willing to accept	Units
5000	1

	2
7000	3
10000	4
12000	5
15000	

Using 10000 as the market price, calculate the producer's surplus.

Producer's surplus = Actual revenue - Anticipated revenue

$$(1000 \times 3) - (5000 + 7000 + 10000)$$

$$= 30000 - 22000 = 8000 \text{ shs.}$$

OR

$$1000 - 5000 = 5000$$

$$1000 - 7000 = 3000$$

$$1000 - 10000 = 00$$

$$= 8000 \text{ shs.}$$

### THE SLOPE OF THE DEMAND CURVE.

A normal demand curve slopes downwards from left to right following the law of demand which states that *Ceteris Paribus*, (Keeping other factors constant), the higher the price, the lower the quantity demanded and the lower the price, the higher the quantity demanded.

This negative slope of the demand curve reflects an inverse relationship between price and quantity demanded i.e. the higher the price, the lower the quantity demanded and the lower the price, the higher the quantity demanded. This slope is due to the following factors;

#### ❖ The law of diminishing marginal utility.

According to this law, when one consumes more units of a commodity, satisfaction derived from the additional units goes on declining. This implies that consumers only buy more units of the commodity when the price reduces proving that demand is low at a high price.

#### ❖ Income effect of a price change.

When the price of a commodity reduces assuming that the income of the consumer remain constant, real income increases such that with the same amount of money, one consumes more units of the commodity but when the price of the commodity increases, real income reduces and one buys less commodities with the same amount of money.

#### ❖ Substitution effect of a price change.

When the price of the commodity reduces assuming that the price of a substitute remains constant, consumers buy more of this commodity and less of the substitute but when the price of the commodity increases, consumers buy less of the commodity and more of the substitute whose price has remained constant.

#### ◆ Total price effect.

This is a combination of the income effect and the substitution effect of a price change. When the price of the commodity reduces, more consumers buy it and others increase their consumption but when its price increases, the number of consumers reduces and others consume less of it thus a reduction in its demand.

#### ◆ Presence of low income earners.

These people can only buy more of the commodity at a low price but as its price increases, they buy less of it since they have a tight-budget. Therefore when such people exist in society, less is bought at a high price and more is bought at a low price.

#### ◆ Different uses of a commodity.

With commodities that have several uses, when the price increases, people use them for only very important purposes and this results into a reduction in demand. However, when the price reduces, people use them even for luxurious purposes thus an increase in their demand.

#### ABNORMAL/REGRESSIVE DEMAND CURVES.

These are demand curves which do not obey/violate the law of demand and they arise under the following circumstances;

#### ◆ Articles of ostentation/Luxurious goods.

These are goods which are consumed to show off one's status in society. Some people believe that their economic status can only be noticed when they consume very expensive commodities and as a result they buy more of a commodity at a high price and less of it at a low price.

DIAGRAM

When the consumers expect the price of the commodity to increase in the future, they buy more of the commodity even when its price is high to avoid buying at a higher price in the future but when they expect the price to reduce in the future, they buy less at low prices as they wait to buy at a lower price in the future.

#### ❖ Necessities.

These are commodities which man can hardly do without e.g salt, soap etc. With such commodities, quantity demanded remains constant even when there's a change in their price.

#### ❖ Ignorance effect.

Due to ignorance of the market conditions, one may associate high prices with good quality and as a result, he demands more of the commodity at a high price and less of the commodity at a low price.

#### ❖ Depression effect.

A depression is a period of low economic activities, high levels of unemployment, limited money supply etc. During this period, income levels are so low that although prices of commodities are low, quantity demanded is also low.

#### ❖ Giffen goods.

These are low quality goods consumed by the poor and they take a big percentage of their income. When their prices increase, more is bought but when their prices reduce, less is bought as consumers become capable of buying better commodities.

The demand curve for a giffen good is abnormal at relatively low prices.

DIAGRAM

### INCOME DEMAND CURVES (ENGEL CURVE)

These are the demand curves which show a relationship between the income of the consumer and the quantity demanded of a commodity.

- The demand curve of a normal good has a positive slope which implies that as the income of a consumer increases, demand for a commodity also increases.
- The demand curve for an inferior good has a negative slope which implies that as the income of a consumer increases, demand for a commodity also decreases.

- ✓ For necessities, the demand curve is flat which means that as the income of the consumer increases, quantity demanded increases slightly and then becomes constant.

### CHANGE IN DEMAND.

It refers to either an increase or a decrease in the amount demanded of a commodity brought about by a change in other determinants of demand when price is constant.

DIAGRAM

**A change in demand can be brought about by;**

- ✦ **Change in the consumer's income.**

An increase in the consumer's income increases the purchasing power thus an increase in demand while a decrease in the consumer's income reduces the purchasing power thus a reduction in demand.

- ✦ **Change in the level of advertisement.**

An increase in the level of advertisement makes more consumers aware of the existence of a commodity thus an increase in its demand while a decrease in the level of advertisement reduces the number of people who are aware of the commodity thus a reduction in the demand for the commodity.

- ✦ **Change in the size of the population.**

An increase in the size of the population increases the number of consumers thus an increase in demand while a decrease in the size of the population reduces the number of consumers thus a decrease in demand.

- ✦ **Change in income distribution.**

A more even income distribution increases the demand for a commodity since even the poor have something to spend while wider income inequality reduces demand since the poor almost have nothing to spend.

❖ **Change in the prices of substitutes.**

An increase in the prices of substitutes increases the demand for the commodity as some consumers of the substitutes shift to the commodity while a decrease in the prices of substitutes reduces the demand for a commodity as some of the consumers shift to the substitutes.

❖ **Change in the price of a complementary good.**

An increase in the price of a complementary good reduces the demand for the commodity as less of the complement is bought while a decrease in the price of the complementary good increases the demand for the commodity since more of the complement is bought.

❖ **Change in the government policy of taxation.**

An increase in the level of taxation reduces the disposable income thus a reduction in demand while a reduction in the level of taxation increases the consumers' disposable income thus an increase in demand.

❖ **Seasonal changes.**

When the season becomes favourable, more of a commodity is bought as many people need the commodity but when the season becomes unfavourable, demand for the commodity reduces as less people need the commodity.

❖ **Expectation of a future price change.**

When consumers expect the price of the commodity to increase in the future, they buy more of the commodity so as to avoid buying at a high price in the future but when they expect the price to reduce in the future, they buy less as they want to buy at a lower price in the future.

**INCREASE IN DEMAND.**

This is where more is demanded of a given commodity at a constant price. It is caused by favourable changes in the determinants of demand.

DIAGRAM

**FACTORS THAT LEAD TO AN INCREASE IN DEMAND**

- ✓ An increase in demand is caused by;

- ✓ Increase in the income level of the consumer.
- ✓ Increase in the size of the population.
- ✓ Increase in the prices of substitutes.
- ✓ Decrease in the price of a complementary good.
- ✓ Increase in the level of advertisement.
- ✓ favourable seasonal change.
- ✓ Reduced income inequality.
- ✓ Tastes and preferences becoming favourable.

### DECREASE IN DEMAND.

This is where less of a given commodity is demanded at a constant price. It is caused by unfavourable changes in the determinants of demand.

It is caused by;

- ✓ Reduced incomes of the consumers.
- ✓ Increase in the price of a complementary good.
- ✓ Reduction in prices of substitutes.
- ✓ Income inequality becoming wider.
- ✓ Tastes and preferences becoming unfavourable.
- ✓ Reduced population size.
- ✓ Season becoming unfavourable.
- ✓ Expectation of a future price reduction.
- ✓ Reduction in the level of advertisement.

### CHANGE IN QUANTITY DEMANDED.

It's an increase or decrease in the amount demanded of a given commodity brought by a change in the price of the commodity when other determinants of demand are constant. It's illustrated by a movement along the same demand curve either upwards or downwards.

An upward movement implies a reduction in quantity demanded while a down ward movement implies an increase in the quantity demanded.

DIAGRAM

When the price increases from  $P_0$  to  $P_1$ , quantity demanded reduces to  $Q_1$  but when the price reduces to  $P_2$ , quantity demanded increases to  $Q_2$ .

An increase in quantity demanded is a situation where more is demanded of a given commodity due to a reduction in its price when other determinants of demand are constant.

A decrease in quantity demanded is where less is demanded of a given commodity due to an increase in its price when other determinants of demand are constant.

## SUPPLY

It refers to the quantity of a given commodity that suppliers are able and willing to bring to the market at various prices during a given period of time.

### DETERMINANTS OF SUPPLY.

#### ❖ Price of the commodity.

When the price is high, producers bring more commodities to the market since it's more profitable to supply at a high price. A low price leads to low supply since it brings about low profits.

#### ❖ Prices of commodities produced using similar resources.

When price of one increases, supply of the other reduces as producers shift some of the resources to the production of one whose price has increased and when price of one reduces, supply of the other increases as producers shift resources from the one whose price has reduced.

#### ❖ Price of a commodity with joint supply.

For such commodities, an increase in price of one leads to an increase in the supply of the other since one can't be produced without production of the other and a reduction in the price of one leads to a reduction in the supply of the other since reduction in production of one leads to a reduction in the production of the other.

#### ❖ Availability of factors of production.

When factors of production are available in plenty, supply is high since producers can produce large volumes of output but when they are scarce, producers fail to get the necessary inputs.

#### ❖ Costs of production.

High production costs reduce the profit level, discourage production and low production costs imply a high profit level which encourages production.

#### → Ease of entry of new firms into the industry.

Easy entry of new firms into the industry leads to high supply as producers are free to join production and increase output while restricted entry implies low supply as potential producers aren't free to join production.

#### → Climatic conditions.

For agricultural commodities, favourable climatic conditions promote crop production which leads to high supply while unfavourable climatic conditions limit crop production leading to low supply.

#### → Aim of the firm.

Firms which aim at profit maximization limit output so that they sell at high prices and maximize profits while firms that aim at sales maximization produce more output so that they sell more and increase revenue.

#### → Government production policy.

Imposition of high taxes on producers increases the costs of production, reduces the profit level leading to low supply while low taxes reduce the production costs which increases the profit level leading to high supply.

#### → Gestation period.

For commodities with a long gestation period, supply is low especially in the short-run leading to low supply while for commodities that have a short gestation period, production can be increased in the short-run, leading to high supply.

#### → Market demand.

High demand for a commodity leads to high supply as more is produced to cater for the high demand while low demand leads to low supply as producers produce less to avoid losses.

#### → Number of producers.

A big number of producers leads to high supply as each adds to the total output in the market while a small number of producers leads to low supply as a few people put output on the market.

#### → Price expectation.

Expectation of an increase in prices in the future leads to low supply as producers wait to supply more in the future while expectation of a low price in the future leads to high supply as producers supply more to avoid supplying at low prices in the future.

#### → Level of technology.

Use of advanced technology in production increases the pace of production, leads to production of large volume of output thus high supply while use of poor technology reduces the pace of production leading to production of low output thus low supply.

❖ **Level of infrastructural development.**

Well developed infrastructure reduces the costs of production and also makes it easy to transport goods to the market thus high supply while underdeveloped infrastructure increases the cost of production, delays transportation of goods to the market thus limiting supply.

❖ **Political situation.**

Political security ensures safety of lives and property leading to increased production and high supply while insecurity scares investors as they fear for their lives and property thus limiting production and supply.

❖ **Efficiency of factors of production.**

Efficient factors of production produce at a high speed leading to high output and high supply while inefficient factors of production produce at a low speed which leads to production of low output thus low supply.

**THE SUPPLY SCHEDULE.**

It's a table which shows various quantities of a given commodity that are brought to the market at various prices.

OR

It's the numerical representative of the quantities of a given commodity that are brought to the market at various prices.

**THE SUPPLY CURVE.**

It's a curve which shows various quantities of a given commodity that are brought to the market at various prices.

A normal supply curve slopes upwards from left to right and this positive slope reflects the law of supply which states that *Ceteris Paribus*, the higher the price, the higher the quantity supplied and the lower the price, the lower the quantity supplied.

DIAGRAM

**ABNORMAL / REGRESSIVE SUPPLY CURVES.**

These are supply curves which do not obey the law of supply. They exist under the following circumstances;

### 1. Backward bending labour supply curve.

This is caused by the following;

#### ✓ Existence of target workers.

These are willing to increase the number of hours worked before achieving their targets. However, after achieving their targets, they reduce the number of hours worked as the wage level increases.

#### ✓ Reference for leisure.

To some people, as their income level increases, they realize that they need more leisure time and as a result, they reduce the number of hours worked as their wage level increases.

#### ✓ Fear of progressive taxation.

Some people reduce the number of hours worked as their wage level increases because they fear to be taxed at a higher rate.

#### ✓ Poor relationship between the employer and the employee.

This forces the employee to reduce the number of hours worked in order to reduce their interaction with the employer.

### 2. Seasonal / Fixed supply.

For some commodities that are supplied seasonally, a change in the price may not affect quantity supplied since supply of these commodities is fixed in the short-run, e.g supply of agricultural commodities.

3. Land has a regressive supply curve since its supply is perfectly inelastic.

4. A regressive curve may also occur when firms are operating at their optimum capacity.

5. It also occurs when production is according to a quota system.

## CHANGE IN SUPPLY.

It's a situation where more or less of a given commodity is brought to the market at a constant price due to changes in other determinants of supply.

It's illustrated by an inward or outward shift of the supply curve. An outward shift implies an increase in supply while an inward shift implies a decrease in supply.

### **A change in supply is caused by;**

- ✓ Change in the level of technology.
- ✓ Change in the costs of factors of production.
- ✓ Change in the price of a jointly supplied commodity
- ✓ Change in natural/climatic conditions.
- ✓ Change in the level of infrastructural development.
- ✓ Change in the supply of factors of production
- ✓ Etc.

### **INCREASE IN SUPPLY.**

It's a situation where more of a given commodity is brought to the market at a constant price. It's due to favourable changes in the determinants of supply.

#### **Increase in supply is brought about by;**

- ✓ Increase in the price of jointly supplied commodities.
- ✓ Decrease in the costs of production.
- ✓ Increase in the supply of factors of production.
- ✓ Improvement in the level of infrastructural development.  
- better political situation.
- ✓ Better natural conditions/ Natural conditions becoming favourable.
- ✓ Decrease in the price of a competitively supplied commodity etc.

### **DECREASE IN SUPPLY.**

This is where less of a given commodity is brought to the market at a constant price. It's brought about by unfavourable changes in the determinants of supply.

#### **Decrease in supply is brought about by;**

- ✓ Increase in the costs of production.
- ✓ Decline in the price of a jointly supplied commodity.
- ✓ Natural factors becoming unfavourable.
- ✓ Breakdown of infrastructure.
- ✓ Decrease in the supply of factors of production.
- ✓ Expectation of a future price increase.
- ✓ Change from advanced technology to poor technology.
- ✓ Government policy on production becoming unfavourable.

## CHANGE IN QUANTITY SUPPLIED.

It refers to an increase or decrease in the amount of a given commodity brought to the market due to a change in the price of the commodity when other determinants of demand are constant.

It's illustrated by either an extension or a contraction of supply.

DIAGRAM

An increase in quantity supplied is where more of a given commodity is brought to the market due to an increase in its price when other determinants of supply are constant.

A decrease in quantity supplied is where less of a given commodity is brought to the market due to a decrease in its price when other determinants of supply are constant.

## JOINT SUPPLY.

This refers to the supply of two or more commodities from the same source/same production process. An increase in price of one leads to an increase in the quantity supplied of the other e.g, meat and hides/skins, wool and mutton.

## COMPETITIVE SUPPLY.

It's the supply of two or more commodities that use the same resources for their production. An increase in price of one leads to a decrease in supply of the other, e.g crop and animal production from a piece of land, meat and milk from a cow.

## ELASTICITY.

This refers to the degree of responsiveness of dependent variables to independent variables. Dependent variables are quantity demanded and quantity supplied while independent variables are the determinants of demand and the determinants of supply.

Elasticity of demand is the degree of responsiveness of quantity demanded of a commodity to a change in its determinants. These determinants include;

- ✓ Price of the commodity.
- ✓ Income of the consumer.
- ✓ Prices of other commodities.
- ✓ The different concepts of elasticity of demand therefore include;

- ✓ Price elasticity of demand.
- ✓ Income elasticity of demand.
- ✓ Cross elasticity of demand.

### PRICE ELASTICITY OF DEMAND.

This refers to the degree of responsiveness of quantity demanded of a commodity to a change in its own price.

$$\text{Price elasticity of demand} = \frac{\text{Proportionate change in quantity demanded}}{\text{Proportionate change in price.}}$$

-OR-

$$\frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price.}}$$

$$= \frac{\text{Change in quantity demanded} \times \text{Original price.}}{\text{Change in price} \times \text{Original quantity demanded.}}$$

Example;

Price	Quantity
600	80
1200	40

Calculate the price elasticity of demand.

$$\text{P.E.D} = \frac{\text{Change in quantity demanded} \times \text{original price}}{\text{Change in price} \times \text{original quantity demanded.}}$$

$$= \frac{40-80 \times 600}{1200-600 \times 80}$$

$$= \frac{-40 \times 600}{600 \times 80} = -1/2 = -0.5.$$

Elasticity has no units.

### CATEGORIES OF PRICE ELASTICITY OF DEMAND.

### ELASTIC DEMAND.

This is where a change in the price of the commodity brings about a more than proportionate change/a bigger percentage change in quantity demanded. In this case, price elasticity of demand is greater than 1.

DIAGRAM

### INELASTIC DEMAND.

This is where a change in the price of the commodity brings about a less than proportionate change/ a smaller percentage change in quantity demanded. In this case, the price elasticity of demand is less than 1.

DIAGRAM

### UNIT/UNITARY ELASTICITY OF DEMAND.

This is where a change in the price of the commodity brings about a proportionate change/ a similar percentage change in quantity demanded. In this case, the price elasticity of demand is 1.

DIAGRAM

### PERFECTLY INELASTIC DEMAND.

This is where quantity demanded does not respond to the change in the price of the commodity. i.e zero price elasticity of demand.

DIAGRAM

## PERFECTLY ELASTIC DEMAND.

This is where the consumers are willing to buy all that they need at the prevailing price and nothing at all even at a slightly higher price. I.e infinite elasticity.

DIAGRAM

## DETERMINANTS OF PRICE ELASTICITY OF DEMAND.

- ❖ **Availability of substitutes.**
- ❖ Commodities with close substitutes have elastic demand because as their prices increase, some of the consumers shift to the substitutes. Commodities without close substitutes have inelastic demand since the consumers have no alternative for them.
- ❖ **Degree of necessity.**

Commodities with a high degree of necessity have inelastic demand because consumers hardly do without them while luxurious goods have elastic demand since the consumers can easily do without them.

- ❖ **Proportion of the consumers' income spent on the commodity.**

When consumers spend a high proportion of their income on a commodity, its demand is elastic because an increase in its price has a big negative effect on their budget. For commodities that take a small proportion of the consumers' income, demand is inelastic because a change in the price has a small impact on the consumers' income.

- ❖ **Level of income of the consumers.**

Rich people have inelastic demand since a change in the price doesn't seriously affect their budget. The poor have elastic demand because a change in the price of the commodity has a big impact on their budget.

- ❖ **The number of uses a commodity can serve.**

Commodities that have several uses have elastic demand because when their prices increase, they use them only for very important purposes and when their prices reduce, they use them for many purposes.

luxurious purposes. Commodities with less uses have inelastic demand because consumers may not have alternatives to leave out when their price increase.

#### ◆ Time period.

Demand is inelastic in the short run and elastic in the long run. This is because in the short run, there's hardly any substitute and people have not yet learnt to live without the commodity. In the long run, people develop substitutes and others learn to live without the commodity.

#### ◆ Habit.

Commodities consumed out of habit have inelastic demand because people get addicted to them and find it difficult to live without them. Commodities that aren't consumed out of habit have elastic demand since consumers can easily do without them.

#### ◆ Complementarity of commodities.

Commodities which are used together have inelastic demand because as long as one is used, the other one has to be used even when its price has increased. Commodities that are independently used have elastic demand since they don't complement any commodity.

#### ◆ Durability/Perishability of the commodity.

Highly durable commodities have inelastic demand because even if their prices reduce, those who have already bought don't buy more. Perishable commodities have inelastic demand because they are not easily stored and people hardly buy more because of a reduction in their prices since they are not easy to store for future use.

#### ◆ Possibility of postponement of consumption.

Commodities whose consumption can be postponed have elastic demand because as their prices increase, consumers buy less as they wait to buy more at lower prices. Commodities whose consumption can't be postponed have inelastic demand because consumers need them immediately.

#### ◆ Convenience of acquiring a commodity.

When consumers find it convenient to get a commodity from a certain place, its demand is inelastic as they are not willing to look for it from somewhere else even when its price increases but if it's not convenient, demand is elastic since consumers can acquire it from anywhere when its price increases.

#### ◆ Level of advertisement.

A high level of advertisement persuades people to buy a given commodity even when its price increases thus making demand inelastic while a low level of advertisement leads to elastic demand as people easily reduce the demand for a commodity when its price increases.

### CAUSES OF INELASTIC DEMAND.

- ✓ Lack of substitutes.
- ✓ High degree of complementarity of commodities.
- ✓ High proportion of the consumer's income spent on the commodity.
- ✓ High degree of necessity.
- ✓ High income of the consumer.
- ✓ Commodity being addictive.
- ✓ High degree of durability of the commodity.
- ✓ Limited uses of the commodity.
- ✓ Short-run period.
- ✓ Inability to postpone the consumption of the commodity.
- ✓ High level of advertisement.
- ✓ The commodity being convenient to access.

**Note; Inelastic demand means low price elasticity of demand.**

**Elastic demand means high price elasticity of demand.**

**Qn; Explain the causes of elastic demand.**

### **RELEVANCE/IMPORTANCE/PRACTICAL APPLICATION OF PRICE ELASTICITY OF DEMAND.**

- ✓ It helps a producer to determine the price of his commodity. For commodities whose demand is inelastic, a high price is charged in order to get more profits but when demand is elastic, a low price is charged in order to increase the volume of sales.
- ✓ It helps a monopolist who sells by price discrimination. In the market where demand is inelastic, a high price is set since this has little effect on the quantity demanded. In the market where demand is elastic, a low price is set since a high price scares away many consumers and greatly reduces the demand for a commodity.
- ✓ It helps producers in wage determination. A high wage is given to skilled labour whose demand is inelastic since they are indispensable while a low wage is given to unskilled labour whose demand is elastic since it's easy to substitute such labour with machines.
- ✓ It helps a producer to determine the level of advertisement. Commodities whose demand is elastic are advertised highly so as to convince consumers to buy more. When demand for a commodity is inelastic, the level of advertisement is low since quantity demanded of the commodity is almost fixed.
- ✓ It helps to determine the tax incidence. When demand for a commodity is inelastic, the bigger burden of the commodity goes to the consumer since he can hardly reduce the amount demanded but when demand is elastic, the bigger burden goes to the producer due to fear of scaring away many consumers when he increases prices highly.
- ✓ It's used by the government to determine the taxes imposed on commodities. When the government wants to raise more revenue from taxation, it imposes high taxes on commodities with inelastic demand.

- commodities with inelastic demand as this has little effect on the amount demanded. Low taxes are imposed on commodities with elastic demand so as to maintain the volume of sales.
- ✓ It's used by the government when carrying out devaluation. Devaluation is carried out to increase the volume of exports and reduce the volume of imports. It should be noted however, that devaluation is only successful when the demand for exports and imports is price elastic.
  - ✓ It helps the government when establishing public enterprises. Government sets up enterprises producing commodities with inelastic demand so as to protect consumers from producers' exploitation.
  - ✓ It's used by the government when carrying out international trade policies such as protectionism. Industries producing commodities with elastic demand are protected for the benefit of the consumers.
  - ✓ Government uses it when subsidizing local enterprises. Government subsidizes industries producing commodities with elastic demand so that they can reduce their prices and increase the volume of sales.
  - ✓ It's used in determination of price control. A maximum price is set for commodities with inelastic demand to protect consumers and a minimum price is set for commodities with elastic demand to protect producers.
  - ✓ It helps a consumer to plan expenditure as the price of the commodity changes. When the demand for a commodity is inelastic, the consumer spends more when its price increases but when the demand for a commodity is elastic, the consumer spends less when its price

### INCOME ELASTICITY OF DEMAND.

It's the degree of responsiveness of quantity demanded of a commodity to a change in the income of the consumer.

$$Y.E.D = \frac{\text{Change in quantity demanded}}{\text{Change in income}} \times \frac{\text{original income}}{\text{original quantity demanded}}$$

Change in income

original quantity demanded.

#### Example 1.

Income	Quantity
10,000	100
15,000	150

$$Y.E.D = \frac{150 - 100}{15000 - 10000} \times \frac{10000}{100}$$

$$= \frac{50}{5000} \times 10000$$

$$= 50 \times 10000$$

$$= 1.$$

5,000      100

**Nature of the commodity is a Normal good.**

This is because the Y.E.D is positive.

**Sample 2**

Income	Quantity.
10,000	200
15,000	180

$$\begin{aligned} \text{Y.E.D} &= \frac{180-200}{15,000-10,000} \times \frac{10,000}{200} \\ &= \frac{-20}{5000} \times \frac{10,000}{200} \end{aligned}$$

$$\text{Y.E.D} = -1/5 = -0.2.$$

**Nature of the commodity is inferior good.**

This is because the Y.E.D is negative.

**Note;**

- ✓ Income elasticity of demand is positive for normal goods i.e. An increase in the income of the consumer leads to an increase in the quantity demanded.
- ✓ It is negative for inferior goods i.e. An increase in the income of the consumer leads to a decrease in the quantity demanded.
- ✓ It's zero for necessities i.e, quantity demanded does not respond to a change in income.

**Importance of income elasticity of demand.**

It guides the government on its taxation policy.

It helps the producer to predict the demand for the commodity when the income of the consumers change.

It's used to determine the nature of the commodity.

**CROSS ELASTICITY OF DEMAND.**

It's the degree of responsiveness of quantity demanded of a given commodity(x) to a change in price of another commodity (y).

$$C.E.D = \frac{\text{Change in quantity demanded (X)} \times \text{Original price (Y)}}{\text{Change in price (Y)} \times \text{Original quantity demanded (X)}}$$

Example 1.

Price (Y)	Quantity (X)
600	40
1200	60

$$C.E.D = \frac{60-40}{600} \times \frac{600}{40} = \frac{1}{2} = 0.5$$

**Nature of commodities.**

Commodities are substitutes. This is because the cross elasticity of demand is positive.

Example 2.

Price (A)	Quantity (B)
10,000	2,000
15,000	1,800

$$C.E.D = \frac{1,800 - 2,000}{15,000 - 10,000} \times \frac{10,000}{2,000} = \frac{-200}{5000} \times \frac{10,000}{2000} = -1/5 = -0.2$$

**Nature of the commodities.: Complementary goods.**

Note.

- ✓ Cross elasticity of demand is negative for complementary goods i.e. an increase in the price of one commodity leads to a reduction in the quantity demanded of another.
- ✓ It's positive for substitutes i.e. an increase in the price of one good leads to an increase in the quantity demanded of another.
- ✓ It's zero for commodities that are not related i.e. an increase in price of one has no effect on the quantity demanded of the other.

**Importance of cross elasticity of demand.**

- ✓ It helps to determine the nature of the commodity.
- ✓ It enables consumers to make their consumption plans as prices of related commodities change,

- ✓ It helps producers to determine the future demand of their commodities as prices of commodities change.

### ELASTICITY OF SUPPLY.

It's the degree of responsiveness of quantity supplied to a change in the determinants of supply. It should be noted however that with elasticity of supply, we consider only price elasticity of supply.

#### PRICE ELASTICITY OF SUPPLY.

It's the degree of responsiveness of quantity supplied to the change in the price of the commodity.

$$P.E.S = \frac{\text{Percentage change in quantity supplied}}{\text{Percentage change in price.}}$$

OR

$$\frac{\text{Change in quantity supplied}}{\text{Change in price}} \times \frac{\text{original price}}{\text{original quantity supplied.}}$$

Example;

When the price of a given commodity increased from shs 10,000 to shs 12,000, quantity supplied increased from 500kgs to 700 kgs. Calculate the price elasticity of supply.

$$\frac{\text{Change in quantity supplied}}{\text{Change in price}} \times \frac{\text{original price}}{\text{original quantity supplied.}}$$

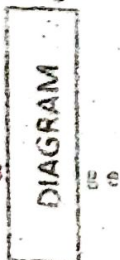
$$= \frac{700 - 500}{12,000 - 10,000} \times \frac{10,000}{500}$$

$$= \frac{200}{2000} \times \frac{10,000}{500} = \frac{20}{10} = 2.$$

### CATEGORIES OF PRICE ELASTICITY OF SUPPLY.

#### ELASTIC SUPPLY.

This is where a change in the price of the commodity brings about a more than proportionate change in the quantity supplied. In this case, the price elasticity of supply is greater than one.



1/10

### **INELASTIC SUPPLY.**

This is where a change in the price of the commodity brings about a less than proportionate change in the quantity supplied. i.e price elasticity of supply is less than one.

DIAGRAM

### **UNIT/UNITARY ELASTICITY OF SUPPLY.**

This is where a change in the price of the commodity brings about a proportionate change in the quantity supplied. i.e price elasticity of supply is one

DIAGRAM

### **PERFECTLY INELASTIC SUPPLY.**

This is where a change in the price has no effect on the quantity supplied i.e quantity demanded doesn't respond to the change in price i.e zero price elasticity of supply.

DIAGRAM

### **PERFECTLY ELASTIC SUPPLY.**

This is where the producers are willing to bring to the market all they can at the prevailing price and nothing at all even at a slightly lower price i.e infinite elasticity.

DIAGRAM

## DETERMINANTS OF PRICE ELASTICITY OF SUPPLY.

- ❖ **Costs of production.** When the cost of production are low, supply is elastic since producers are able to buy factor inputs and increase supply as prices increase but when they are high, supply is inelastic since it's less profitable to increase supply even when prices have increased.
- ❖ **Availability of factors of production.** When factors of production are available in plenty, supply is elastic since producers can easily access them and increase supply when prices increase but when they are scarce, supply is inelastic since it's difficult to access factors of production so as to supply more at a higher price.
- ❖ **Gestation period.** A long gestation period makes supply inelastic since it makes supply fixed in the short run while a short gestation period leads to elastic supply since output can be increased in a short time period in case price increases.
- ❖ **Degree of entry of new firms into the industry.** When there's free entry of new firms into the industry, supply is elastic because as price increases, more firms join production and increase supply. Restricted entry leads to inelastic supply as firms are not allowed to join production even when prices increase.
- ❖ **Nature of the product.** Perishable goods have inelastic supply since they can't be stored during periods of excess supply. Durable goods have elastic supply because they can be stored when prices are low and brought to the market when prices increase.
- ❖ **Production method.** Use of advanced technology enables firms to increase output in a short time period thus making supply elastic while use of poor technology makes it difficult to increase output in a short time period thus making supply inelastic.
- ❖ **Time period.** Supply is inelastic in the short run since it takes producers time to increase output. It is elastic in the long run as producers have enough time to increase output as prices increase.
- ❖ **Government policy on production and importation of commodities.** When government imposes high taxes or limits importation of commodities, supply is inelastic since output can hardly be increased. A favourable government policy leads to elastic supply because output can easily be increased either through increased production or importation when prices increase.
- ❖ **Transport facilities.** A well developed transport system enables easy movement of commodities from the firms to the market thus making supply elastic while poor transport facilities make supply inelastic since this makes it difficult to transport goods to marketing centers as their prices increase.
- ❖ **Political situation.** Political security enables producers to concentrate on production and increase output as prices increase thus making supply elastic while insecurity leads to inelastic supply since it distabilises the production process and limits output.
- ❖ **Existence of excess capacity.** When firms are producing at excess capacity, supply is elastic because it's easy to increase output by utilizing more of the available resources. Production at optimum capacity leads to inelastic supply because output can't be increased without increasing investment.

## IMPORTANCE OF PRICE ELASTICITY OF SUPPLY.

It's used in pricing of factors of production.

Government uses it in its taxation policy.

Used in the subsidization policy.

Used in pricing of jointly supplied commodities.

Important in making production decisions e.g. what to produce.

It's used in exchange rate determination.

Used in determination of the tax incidence.

Used in determination of the benefits in international trade.

## PRICE MECHANISM AND RESOURCE ALLOCATION.

Resource allocation refers to the utilization of resources in order to produce goods and services.

Price mechanism is an economic organization where price acts as a guiding factor in the utilization of resources and this price is determined by the free market forces of demand and supply.

Under price mechanism, producers base their production decisions on the prices ruling in the market and consumers base their consumption decisions on the prices ruling in the market without government intervention.

According to Adam Smith, the system is an invisible hand in the market which directs resource allocation in an automatic way.

## ASSUMPTIONS OF PRICE MECHANISM.

Consumers are rational beings whose aim is utility maximization. As a result, they buy from the cheapest source available.

- ✓ It assumes there's perfect knowledge of the market conditions;
- ✓ There's no government intervention in price and output determination.
- ✓ The aim of the producer is profit maximization.
- ✓ It assumes that factors of production are perfectly mobile.
- ✓ It assumes that some firms are more efficient than the others and the efficient firms force the inefficient ones out of the industry.

Price mechanism operates either in a free market economy or in the private sector of a mixed economy. If the above assumptions exist, price mechanism allocates resources by answering the various economic questions of what to produce, how to produce, where to produce, when to produce and for whom to produce.

When price mechanism is used in the allocation of resources, producers produce more of those commodities that enable them to maximize profits.

### ROLE OF PRICE MECHANISM.

- ❖ It promotes efficiency in production. This is because of the need to maximize profits which forces producers to reduce the production costs in order to increase their profit level.
- ❖ It encourages competition in production which results into improvement in the quality of the goods produced.
- ❖ It guides income distribution. In a free enterprise economy, income goes to those who own resources and the prices of those factor services determine how much an individual earns.
- ❖ It encourages inventions and innovations. This is because producers make an effort to come up with new production methods and new types of goods in order to increase the volume of output and their market share.
- ❖ It promotes consumer sovereignty. In this case, consumers influence the nature of the goods to be produced by paying high prices for such goods.
- ❖ It determines the type of technology to be used. Producers employ production methods that can enable them to maximize profits.
- ❖ It acts as an indicator in the market on what to produce. Resource owners direct their resources to the production of commodities with high prices and this reduces resource wastage since it's the highly priced commodities that are produced.
- ❖ It determines the allocation of production units, i.e. where to produce. Producers usually establish their enterprises in areas where the market demand and prices are high so that they are able to maximize profits.
- ❖ It determines when to produce. Profit maximizing firms produce commodities when prices are high.
- ❖ It provides a variety of commodities to the consumers thus widening their choice.
- ❖ It provides an automatic adjustment of demand and supply. This helps to avoid excess demand and excess supply.

### ADVANTAGES OF PRICE MECHANISM.

- ❖ It increases employment opportunities. This is because of the profit motive that encourages producers to increase the level of investment.
- ❖ Encourages arbitrage. This is because sellers transfer commodities from where prices are low to where they are high in order to make profits.
- ❖ It promotes competition which leads to production of better quality commodities.
- ❖ It promotes incentive to work hard which results into increased production.
- ❖ It reduces the costs of administration since there's limited government control over economic activities.
- ❖ It provides a wide variety of goods and services which broadens the consumer's choice.

- ❖ It promotes consumer sovereignty which reduces resource wastage since production is according to demand.
- ❖ Leads to efficient allocation of resources. This is because of the need to maximize profits which forces producers to reduce the production costs.
- ❖ It encourages research, inventions and innovations because of the need to maximize profits.

### **DISADVANTAGES OF PRICE MECHANISM.**

- ❖ Misallocation of resources. More resources are directed towards the production of luxurious goods which are consumed by the rich who are capable of paying a high price. This leaves the poor with less commodities to consume.
- ❖ It increases income inequality. This is because income goes to those who own resources and as a result, they are able to become richer as those without resources remain poor.
- ❖ It increases the unemployment problem. Some people become unemployed when the inefficient firms are forced out of production and also due to use of capital intensive technology in order to maximize profits.
- ❖ It can't be relied upon in the allocation of public goods and services such as roads, defence, etc. This is because they are not profitable yet they are important to society.
- ❖ Divergence between private and public interests. Price mechanism results into social costs such as over exploitation of resources, pollution of the environment by the high profit making firms. In this case, individuals benefit at the expense of the public.
- ❖ It leads to economic instabilities such as price fluctuation, instability in the exchange rate etc. This is because market forces are not always in equilibrium.
- ❖ It encourages the emergence of monopoly as inefficient firms are forced out of production.
- ❖ It leads to exploitation of consumers. Since producers aim at profit maximization, they sometimes sell their commodities at very high prices.
- ❖ Consumers are misguided into consumption of goods which do not suit their tastes due to the persuasive advertisement carried out.
- ❖ It doesn't respond to rapid structural changes in the economy which require immediate attention in order to deal with difficult situations in the economy.
- ❖ Qn. Why may the government interfere in price mechanism?

### **LIMITATIONS OF PRICE MECHANISM.**

- ❖ Ignorance of the market conditions. Due to the ignorance of the consumers, prices which are determined by price mechanism may not reflect consumers' needs since in some cases consumers are misguided into buying commodities of high prices thinking that they are of a better quality.
- ❖ The existence of monopoly hinders the operation of price mechanism. This is because there's restricted entry of firms into the industry which enables producers to produce poor quality commodities and even charge high prices due to absence of competition.
- ❖ Government intervention in price and output determination makes it difficult for prices in the market to be determined by the forces of demand and supply.
- ❖ Immobility of factors of production. This makes it difficult for producers to shift from production of commodities whose prices are low to production of commodities with high prices.
- ❖ Irrationality of consumers. Some consumers buy commodities from particular places at high prices and ignore commodities in other areas at lower prices because to them where they buy their commodities determines their status.
- ❖ Limited capital. In some cases, prices increase but due to limited capital, producers fail to increase the prices of such commodities.
- ❖ Limited skilled labour. Some producers fail to increase output due to inefficiency which results from shortage of skilled labour.
- ❖ Limited entrepreneurship. This limits the ability of the producers to increase their production scale when demand increases as they may fear the complications of running big enterprises.
- ❖ Poor infrastructure. This increases the costs of production, limits investment and also makes it difficult to transport commodities from where they are cheap to where they are expensive.

### **HOW TO REDUCE THE DEFECTS OF PRICE MECHANISM.**

- ✓ Formation of consumer associations to educate the consumers on the quality and prices of commodities in the market in order to reduce their ignorance.
- ✓ Government should tax the rich highly and subsidize the poor or direct funds to activities which benefit the poor in order to reduce income inequality.
- ✓ Anti-monopoly legislation. This involves nationalization, liberalization etc. This should be adopted in order to control monopoly power.
- ✓ Unemployment can be reduced by establishing more industries, subsidizing weak firms and encouraging producers to use intermediate technology in production.
- ✓ Government should establish enterprise that produce cheap commodities and also provide public goods and services which are ignored by the private sector since they are not profitable.
- ✓ Government should control the prices of essential goods so as to reduce the exploitation of the consumers by the producers.

- ✓ Social costs can be minimized by taxing the private sector highly, issuing costly licenses to those who use the country's natural resources and supervising the use of the country's resources so as to avoid their quick depletion.
- ✓ There's a need for government to carry out planning so as to cater for the structural changes in the economy and also direct economic growth in the country.
- ✓ Provision of credit facilities to potential investors. This enables them to expand their production scale and increase the volume of output when demand increases.
- ✓ Development of infrastructure. This increases production when need arises and also enables producers to transport commodities from where they are cheap to where they are expensive.
- ✓ Training manpower. This increases the skills of workers and enables them to increase their efficiency in production.

### PRICE FLUCTUATION.

It's the continuous increase and reduction in prices of commodities. Prices of agricultural commodities usually fluctuate and this is because of the following reasons.

- ✦ **Divergence between planned and actual output.** For agricultural commodities, it's not easy to produce the actual amount of output that you planned for. When the actual output exceeds the planned output, price reduces but when the actual output is less than the planned output, price increases.
- ✦ **Long gestation period.** Most agricultural commodities have a long gestation period which leads to low supply in the short run thus increasing prices. When supply increases in the long run, prices reduce.
- ✦ **Price inelastic demand.** Most agricultural commodities whose demand is price inelastic. This implies that when there's excess output, price reduces by a big percentage and when there's scarcity, prices increase highly because of the excess demand.
- ✦ **Perishability.** Most agricultural commodities are perishable which makes it difficult to store them for a long time. As a result, prices are low during the harvesting period because of excess supply and they increase when the harvesting period ends because of shortage.
- ✦ **Bulkiness.** Most agricultural products are bulky and this makes it difficult to transport them from areas where they are plenty and cheap to where they are scarce and expensive. As a result, when there's excess supply, prices reduce and when there's scarcity, prices increase since it's difficult to increase supply.
- ✦ **Poor planning.** Agriculturalists are many and they plan independent of each other. This makes it difficult to predict future supply and in case of high prices in the current season, more is produced which results into excess supply and reduced prices. The low prices discourage producers and they produce less in the next season which results into shortage and higher prices.
- ✦ **Limited bargaining power in international trade.** The position of LDC'S in international trade is weak and as a result, prices of their products are determined by the major buyers.

- These pay a high price in periods of shortage and they pay a low price when there's excess supply.
- ✓ **Agriculture is affected by natural factors** such as climate, pests and diseases. When the natural factors are favourable for the growth of crops, output is high and prices reduce but when they are unfavourable, output is low leading to higher prices.
- ✓ **Poor surplus disposal.** LDC'S are faced with poor road network, poor storage facilities which makes it difficult for farmers to dispose off their surplus output. As a result, when they produce more than what is needed in the market, prices reduce and when they produce less, prices increase.
- ✓ **Agricultural commodities have a low income elasticity of demand.** This implies that even when the income of the consumers changes, demand remains almost the same. Therefore, when there's 'excess supply, prices reduce and when there's shortage, prices increase.
- ✓ **Development of synthetic fibres.** Due to technological development, some countries have come up with artificial raw materials which has reduced the demand for agricultural raw materials. As a result, when there, excess supply, prices reduce and when there's shortage, prices increase.
- ✓ **Changes in the costs of production.** When the costs of production increase, some farmers withdraw from production, leading to a reduction in output and higher prices but when the production costs reduce, more producers join production, leading to an increase in output and lower prices.

### **EFFECTS OF PRICE FLUCTUATION.**

- ✓ It leads to fluctuation on the incomes of the producers. When the prices increase, their incomes increase and when the prices reduce, farmers' incomes reduce thus making it difficult for them to make their budgets.
- ✓ It frustrates agriculturalists and discourages them from carrying out commercial production due to fear of making losses. This reduces the volume of output that is produced.
- ✓ It increases the problem of unemployment in the agricultural sector. This is because some producers are forced to lay off some of the workers in order to reduce the production costs and avoid losses.
- ✓ It brings about unstable government revenue. When prices reduce, revenue reduces and when prices increase, revenue increases and this sometimes forces the government to revise its budget.
- ✓ It's associated with unstable terms of trade. When prices increase, terms to trade improve but when prices reduce, terms of trade worsen implying that a country has to give in more of its exports in order to get a given quantity of imports.
- ✓ It leads to unstable foreign exchange earnings. When prices increase, foreign exchange earnings increase and when they reduce, foreign exchange reduces, making it difficult for the country to import all that it needs.

- ✓ Results into fluctuating balance of payments. When prices increase, balance of payments improve but when they reduce B.O.P worsens forcing countries to borrow in order to fill their deficits.
- ✓ It makes government planning which is based on anticipated foreign exchange earnings difficult. This is because the government is not certain of how much it's to get from its agricultural exports.
- ✓ It increases income inequality between agriculturalists whose commodity prices are usually unstable and low and industrialists whose commodity prices are usually stable and high.
- ✓ It increases rural urban migration and its associated negative effects. This is because people move from rural areas after losing hope in agriculture with a hope of getting higher incomes in urban areas.

### MEASURES TO REDUCE PRICE FLUCTUATION.

- Improvement of the transport system. This makes it easy for commodities to be transported from where they are plenty and cheap to where they are scarce and expensive in order to stabilize supply and prices.
- Adopting a price control policy by the government. This involves fixing a maximum price when the price is very high or a minimum price when the price is very low.
- Improvement of storage facilities. This enables producers to store commodities during periods of excess supply and low prices so that they are brought to the market during periods of scarcity and high prices.
- Diversification of the agricultural sector. This reduces the problem of over production since a wide variety of commodities is produced which reduces the possibility of over flooding the foreign market with similar commodities.
- Signing of international commodity agreements with the buyers of the commodities. This stabilizes prices since buyers and sellers have to agree on the price at which the commodity is to be sold.
- Use of a quota system. This involves controlling the volume of output that is put on the market in order to regulate the supply in the market and stabilize prices.
- Promotion of use of advanced technology such as irrigation. This ensures constant supply throughout the year and also enables producers to control pests and diseases so as to stabilize supply and prices.
- Establishment of primary processing industries so as to process these commodities, add value to them and also make it easy to store them when prices are low and bring them to the market when prices are high.
- Diversification and expansion of markets possibly through economic integration. This increases demand for those commodities and also increases the bargaining power of the producers.
- Promotion of co-operative societies. These provide the necessary information to the farmers which enables them to regulate supply and stabilize prices.

- Operation of buffer stocks. This is where the government, through the marketing boards buys the excess output on the market, stores them and brings them to the market during periods of scarcity in order to stabilize supply and prices.
- Use of a stabilization fund. This is where the marketing boards fix the prices at which commodities are bought from the producers. If the prices on the market exceed the set prices, marketing boards make profits and keep part which is used as a stabilization fund when prices on the market are below the set prices.

### PRICE CONTROL/ PRICE LEGISLATION.

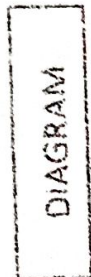
Price control refers to a situation where the government sets either a maximum price to protect consumers or a minimum price to protect producers.

Maximum price legislation is where the government sets the price of the commodity below the equilibrium price and it becomes illegal to sell or buy above that price.

A maximum price is the price set by the government below the equilibrium price and it's illegal to sell or buy above that price.

Minimum price legislation is where the government sets the price of the commodity above the equilibrium price and it becomes illegal to sell or buy below that price.

A minimum price is the price set by the government below the equilibrium price and it's illegal to sell or buy below that price.



### MERITS OF A MAXIMUM PRICE.

- ✓ Protects consumers from being exploited by the producers.
- ✓ Controls monopoly power.
- ✓ Avails commodities to all income groups.
- ✓ Reduces income inequality.
- ✓ Controls inflation.
- ✓ Stimulates investment by increasing aggregate demand.
- ✓ Controls the production of undesirable commodities,
- ✓ Promotes exportation of commodities.

### Demerits of maximum price legislation.

- ✓ Discourages the growth of entrepreneurship since it reduces the profit level

- ✓ Leads to shortages since it discourages production.
- ✓ Leads to trade malpractices such as hoarding, black marketing etc.
- ✓ Leads to underutilization of resources.
- ✓ Leads to high government expenditure due to high administrative costs.
- ✓ Leads to unemployment due to reduced investment.

#### **Advantages of a minimum price.**

- ✓ Protects producers from being exploited by the consumers.
- ✓ Increases the volume of output since it encourages production.
- ✓ It stabilizes the income of the producers since it minimizes price fluctuation.
- ✓ Controls the consumption of undesirable commodities.
- ✓ Helps to offset an economic recession or depression by increasing prices of commodities.

#### **REASONS FOR PRICE CONTROL.**

- To protect the consumers from producer's exploitation. Such producers, if not controlled may charge very high prices in an effort to maximize profits.
- To control monopoly power by limiting the price at which monopolists can sell their commodities.
- To control inflation in the country. This is because the price won't be allowed to increase beyond a certain level.
- To avail income to all income groups. This enables the poor to access necessities at affordable prices.
- To reduce income inequality especially between the industrialists who sell their commodities at high and stable prices and agriculturalists whose commodity prices are usually unstable and usually low.
- To stabilize the incomes of the producers so as to enable them budget their income properly.
- To protect producers from being exploited by consumers who may want to pay them low prices for their commodities.
- To increase the volume of output produced so as to avoid the problem of scarcity in the market.
- To discourage the consumption of undesirable commodities. This is done by setting a high price which scares away some of the consumers.
- To increase the rate at which the industrial sector grows. This is because a high price encourages investment in the sector.
- To enable the economy offset an economic depression or recession. This is done by increasing the prices of commodities so as to encourage producers to increase the level of investment.

**Explain the advantages of price control.**

## DISADVANTAGES OF PRICE CONTROL,

- ✓ It leads to shortage of commodities. This is because producers reduce the volume of output brought to the market due to reduced prices in order to avoid losses.
- ✓ It encourages trade malpractices such as hoarding of commodities, smuggling and development of black markets as producers try to maintain their profits.
- ✓ It's expensive for the government to enforce a price control policy as some people may be willing to sell or to buy at a price that violates the one set by the government.
- ✓ It leads to excess production. This occurs when a minimum price is set since it encourages producers to increase the volume of output thus leading to overproduction and storage problems.
- ✓ It reduces the level of consumption especially among the poor who can't afford to buy much at a high price.
- ✓ It leads to inefficient allocation of resources since it interferes with price mechanism.
- ✓ It discourages private entrepreneurs from increasing the level of investment since it reduces the profit level of enterprises thus reducing the rate of economic growth.
- ✓ It increases the problem of unemployment. This is because it discourages investment in the economy and also reduces the demand for commodities.
- ✓ It results into underutilization of resources as producers are discouraged from increasing the volume of output.
- ✓ It leads to an increase in the costs of production due to increased factor prices which scares away potential investors.

Note.

Price support refers to a situation where the government buys the surplus output on the market which arises from fixing a minimum price with the aim of maintaining the minimum price.