Concordia University
Department of Economics

ECON 201 – INTRODUCTION TO MICROECONOMICS
Winter 2010

COMMON FINAL EXAMINATION AND ANSWERS VERSION 1

STUDENT NAME: _____

STUDENT NUMBER: _____

Please read all instructions carefully.

1. This is a three-hour exam (180 minutes). The questions are worth 150 marks altogether. It is a good strategy to spend one minute per mark for your answers (150 minutes) and spend the remaining time (30 minutes) to review your answers.

2. The exam consists of four parts.
   (i) Part I: 25 multiple-choice questions (25 marks);
   (ii) Part II: Choose 5 out of 7 "true-false" questions (25 marks);
   (iii) Part III: Choose 4 out of 5 long questions (80 marks), and
   (iv) Part IV: Choose 2 out of 3 "current events" questions (20 marks).

3. Write your answers for the multiple-choice questions on the computer scan-sheet with a **pencil**. For Parts II to IV, write all your answers on this exam. Do not use additional booklets.

4. You are allowed to use a non-programmable calculator and a dictionary. You may use either pen or pencil to provide your answers for Parts II to IV.

Grades:

Part I: _____

Part II: _____

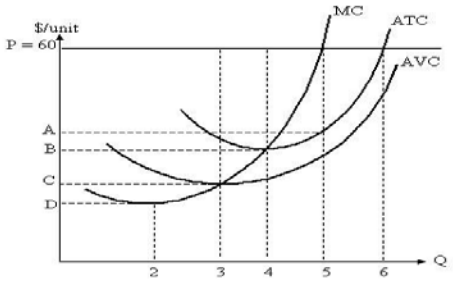
Part III: _____

Part IV: _____

Total: _____

Part I: Multiple Choice Questions. Write your answers on the computer sheet in PENCIL (Total=25 marks).

1. If the price faced by a perfectly competitive firm is equal to $60, then the maximum profit this firm will earn is...



a. $(60 - D)x2
b. $(60 - C)x3
c. $(60 - B)x4
d. $(60 - B)x5
e. $(60 - A)x5

2. Consider a perfectly competitive firm in the following position: the firm produces 4000 units, the market price is $1, fixed costs are equal to $5000, variable costs equal $900, and marginal cost equals $1.10. In order to maximize profit in the short-run the firm should

a. reduce output
b. increase output
c. shut down
d. increase the market price
e. not change output

3. Suppose the per-unit tax on cars is raised. If the demand for cars is unit elastic and the supply curve is upward sloping then this will cause tax revenue to ___. [Hint : Tax revenue = Spending by consumers minus firm revenue. Use elasticity to figure out what happens to consumer spending. Use diagram to figure out what happens to firm revenue].

a. rise
b. fall
c. stay constant
d. rise if the supply elasticity is greater than one and fall if the supply elasticity is less than one
e. rise if the supply elasticity is less than one and fall if the supply elasticity is greater than one

4. Data on the prices, quantities sold, and average incomes of buyers of Jolt Cola and Coke, over several years, are shown below.

Year	Price of Jolt	Price of Coke	Average Income of Buyers	Quantity of Jolt Sold
2000	$1.00 / can	$1.00 / can	$25,000	15,000 cases
2001	$1.00 / can	$1.40 / can	$25,000	25,000 cases
2002	$1.00 / can	$1.40 / can	$35,000	15,000 cases
2003	$1.40 / can	$1.40 / can	$35,000	5,000 cases

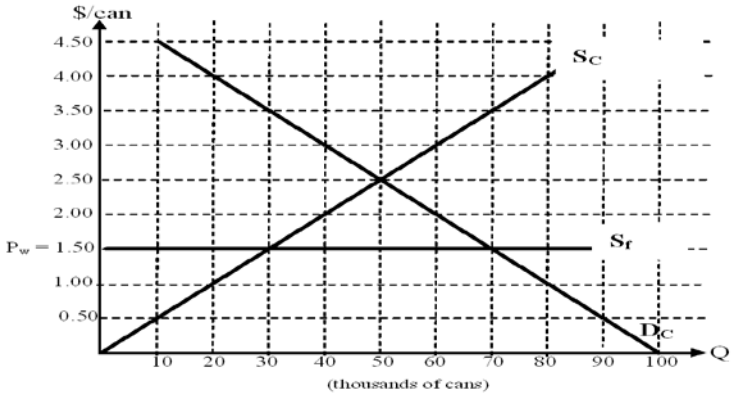
The income elasticity of Jolt is:

a. 1.5
b. 0.67
c. -0.67
d. -1.5
e. not determinable, given that all the variables are changing.

5. The demand equation for widgets is $P = 200 - 5Q_D$. The absolute value of the price elasticity of demand between quantity demanded of 23 and 27 is

a. 0
b. 0.16
c. 0.2
d. 0.6
e. 1.0

6. The market for canned tuna is shown below. The foreign supply curve S_f is drawn as perfectly elastic at the world price of $1.50 per can. The Canadian domestic demand and supply curves are denoted as D_C and S_C respectively



A tariff of $0.50 per can is imposed on imported cans of tuna. Government tariff revenue from this tariff is _____, and the deadweight loss caused by the tariff is _____.

a. $10,000, $5,000
b. $20,000, $2,500
c. $25,000, $5,000
d. $15,000, $2,500

7. Which of the following leads to the buyers paying all of a tax?

a. Demand is perfectly price elastic
b. Demand is perfectly price inelastic.
c. Price elasticity of demand equals 1
d. Price elasticity of supply equals 1
e. Supply is perfectly price inelastic.

8. An effective minimum wage imposed on a competitive labour market will

a. raise the incomes of all workers and raise employment
b. raise the incomes of all workers and not change employment
c. have no effect on worker income or employment
d. raise the incomes of workers who keep their jobs and lower employment.
e. lower the income of all workers and raise employment.

9. Using a supply and demand diagram of your own, if a per unit tax is imposed, the more elastic the supply curve, the:

a. more likely the deadweight loss is to be affected.
b. larger the deadweight loss.
c. larger the deadweight loss to producers.
d. smaller the deadweight loss to consumers.

10. Dave is risk-averse while Scott is risk-neutral. Both are confronted with the following gamble: win $5,000 with the probability of 65% or lose $9,000 with a probability of 35%. One can predict that:

a. both will accept the gamble.
b. only Scott will accept the gamble.
c. only Dave will accept the gamble.
d. Scott will accept and Dave may accept.

11. The process of buying a variety of assets is called:
    a. risk aversion.
    b. risk seeking.
    c. profit maximization.
    d. diversification.

12. The Figure below shows the apartment rental market in Bigtown. If the Bigtown Housing Authority imposes a rent ceiling *above* $750 per month, the ceiling will

    a. Help all tenants (i.e. renters)
    b. Help all landlords
    c. Have no effect
    d. Help some tenants (i.e. ones that can find apartments) and hurt other tenants (i.e. ones who can no longer find apartments)
    e. Help some landlords (i.e. ones that can find tenants) and hurt other landlords (i.e. ones that can no longer find tenants)

13. When economists describe a good as being 'under-priced', they mean that:
    a. output should be increased because the marginal social benefit in consumption exceeds the marginal social cost of production.
    b. too much of the good is being produced since there is a negative externality associated with the good.
    c. resources are properly allocated since society wants more of the good at a lower price.
    d. there is an under-allocation of resources in the production of the good.

14. A movement along any given demand curve for a particular good reflects a changing quantity demanded of the good and a change in:
    a. the number of buyers in the market for the good.
    b. the income level of consumers.
    c. the prices of related goods.
    d. the price of the good itself.

15. Assuming that peanut butter and jam are complementary goods, an increase in the price of peanut butter will cause:
    a. a decrease in the demand for peanut butter.
    b. a decrease in the demand for jam.
    c. an increase in the demand for jam.
    d. no change in the demand for jam but a decrease in the quantity demanded of peanut butter.

16. A quota results in:
    a. a reduction in demand.
    b. a redefinition of the supply curve.
    c. a shift in the demand curve.
    d. none of the above.

17. You wait in line to buy a ticket for a show and are fortunate to buy the last ticket for $65. The lady behind you offers to buy the ticket for $100 but you refuse. We can conclude that the value you place on the show is:
   a. less than $65.
   b. $65.
   c. $100.
   d. at least $100.

18. Suppose that a firm's total cost of producing an output of 400 units a day is currently $2,000. If technology and the price of inputs remain unchanged, what level of output would be produced if total costs incurred are $4,000 and increasing returns to scale exist?
   a. More than 400 but less than 800 units.
   b. 5 units.
   c. 800 units.
   d. More than 800 units.

19. What does MES (minimum efficient scale) refer to?
   a. The marginal efficient size of a firm.
   b. The biggest-size plant that is capable of achieving economies of scale.
   c. The biggest-size plant that is capable of achieving diseconomies of scale.
   d. The smallest-size plant capable of achieving the lowest long-run average cost of production.

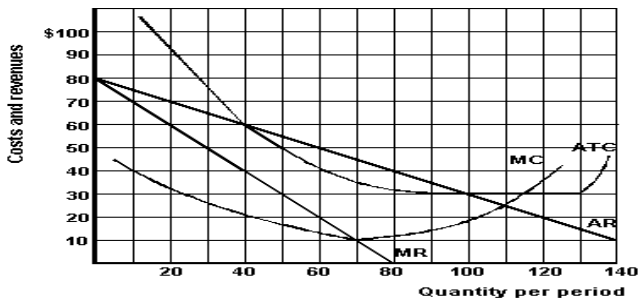
20. When the pure monopolist and the pure competitor are compared, the monopolist does not use society's scarce resources as efficiently since:
   a. the monopolist charges a price for its output that is too high.
   b. the monopolist does not equate MC and MR when determining its optimal output level.
   c. the monopolist is able to practice price discrimination, and this harms society.
   d. the monopolist does not produce enough of the good.

21. If firms are allowed to fully cooperate, then they establish a market price and quantity by equating:
   a. the industry demand and industry average total cost.
   b. industry marginal revenue and industry average total cost.
   c. industry marginal cost and industry average variable cost.
   d. industry marginal revenue and industry marginal cost.

22. In monopolistic competition the long-run tangency equilibrium is between:
   a. demand and average cost.
   b. marginal cost and marginal revenue.
   c. price and average cost.
   d. marginal cost and average cost.

23. Which one of the following would suggest the existence of a barrier to entry into a market?
   a. Monopoly profits.
   b. Economies of scale.
   c. Patents on products.
   d. All of the above.

Use the following diagram to answer the next question:



24. Where demand is the average revenue curve AR, if the monopolist is regulated and forced to charge the socially optimum price and produce the *efficient* level of output, what will be its price and output?
    a. $10 and 70.
    b. $25 and 110.
    c. $30 and 100.
    d. $45 and 70.

25. The law of comparative advantage states that countries _____ in producing and exporting the goods that they produce at a lower _____ cost than other countries.
    a. diversify, absolute
    b. specialize, relative
    c. diversify, relative
    d. specialize, absolute

Part II: Answer FIVE of the following seven questions in the allotted space. If more than five questions are answered, only the first five will be marked. State whether each statement is true or false and explain. Use graphs to support your answers when applicable. No marks will be awarded to simply stating "true" or "false" without explanation (Total=25 marks).

1. Part of the opportunity cost of you attending college is the income that you give up by going to class rather than working.
   Ans: True → the opportunity cost of a good is the quantity of other goods that must be sacrificed to get an increment in the first good.

2. An increase in the price of milk, other things constant, will cause the supply curve for ice cream to shift upward and to the left.
   Ans: True → the price of milk is part of the cost of producing ice cream → when the production cost increases, a firm might increase the price of ice cream / reduce the quantity produced → supply curve shift upward and to the left.

3. Complementary goods have positive cross-price elasticities.
   Ans: False → complementary goods: if the price of one good decreases, the demand for a second good would be increasing → negative cross-price elasticities

4. Marginal utility is the additional utility derived from consuming one more dollar's worth of a product.
Ans: False → marginal unility is the addition to total utility created when one more unit of a good or service is consumed.

5. Risk spreading involves dividing a single large risk among several insurers.
Ans: True → Risk spreading works by reducing the stake of each participant → for example, if a large risk is divided between two insurers, the risk in utility terms to each insurer would be less than half of the total risk.

6. In a perfectly competitive market, no firm can charge more than the market price, and each firm takes this price as given.
Ans: True → in a perfectly competitive market, there are many suppliers facing many buyers → no one participant can have an impact on the market price → each firm is a price taker.

7. Economic theories, like physics or chemistry, can be tested in a laboratory environment.
Ans: False → variables in social sciences are changing simultaneously → we cannot fix some of them and observe how the others changes → unlike physics or chemistry, economic theories cannot be tested in a laboratory environment.

Part III: Answer FOUR of the following five questions. If more than four questions are answered, only the first four will be marked (Total=80 marks).

Question 1. International trade and comparative advantage (20 marks)
The following are hypothetical production possibilities tables for Canada and the United States.

Canada's Production Possibilities Table
(Millions of bushels)

	A	B	C	D
Peaches	0	5	10	15
Apples	30	20	10	0

The United States' Production Possibilities Table
(Millions of bushels)

	A	B	C	D
Peaches	0	10	20	30
Apples	15	10	5	0

For each line required, plot any two or more points on the line.
(i) Plot Canada's production possibilities curve by plotting at least 2 points on the curve. (2 marks)
Canada's Production Possibilities Curve
An example of two points you could have plotted to define this line are (0,15) and (30,0)

(ii) Plot the United States' production possibilities curve by plotting at least 2 points on the curve on the graph above. (2 marks)
The United States' Production Possibilities Curve
An example of two points you could have plotted to define this line are (0,30) and (15,0)
(iii) What is each country's cost ratio of producing Peaches and Apples? (4 marks)
Canada
The correct ratio is : 2 apples = 1 peach.
In Canada, 2 apples must be given up to get 1 peach. This means that in Canada the domestic cost ratio for the two goods is 2 apples for 1 peach.

The United States
The correct ratio is : 1 apple = 2 peaches.
In the United States, 1 apple must be given up to get 2 peaches. This means that in the U.S. the domestic cost ratio for the two goods is 1 apple for 2 peaches.

(iv) Which nation should specialize in which product? (3 marks)
The United States should specialize in peaches because the U.S. has the lowest domestic opportunity cost of peaches. Canada should specialize in apples.

(v) Plot the United States' trading possibilities curve (by plotting at least 2 points on the curve) if the actual terms of the trade are 1 apple for 1 peach. (3 marks)
US's Trading Possibilities Curve
An example of two points you could have plotted to define this line are (30,0) and (0,30)

(vi) Plot the Canada' trading possibilities curve (by plotting at least 2 points on the curve) if the actual terms of the trade are 1 apple for 1 peach. (3 marks)
Canada's Trading Possibilities Curve
An example of two points you could have plotted to define this line are (30,0) and (0,30).

(vii) Suppose that the optimum product mixes before specialization and trade were B in the United States and C in Canada. What are the gains from specialization and trade? (3 marks)

The correct answer is : 10 peaches and 10 apples.
Before specialization, the United States produced 10 peaches and 10 apples, and Canada produced 10 peaches and 10 apples for a total of 20 peaches and 20 apples.
After specialization, the United States will specialize in peaches, producing 30 peaches and Canada will specialize in apples, producing 30 apples, for a total of 30 peaches and 30 apples.
The gain in production is the difference between the pre-specialization production and the after-specialization production, which is 10 peaches and 10 apples.

Question 2. Consumer and Producer Surpluses, and Government Intervention (20 marks)

The demand function for amalgamated widgets is

$$Q = 100 - 2P,$$

and the supply function is

$$Q = 2P.$$

(i) Find the equilibrium price and quantity; graph your solution, labeling the intercepts. (4 marks)

P = 25 and Q = 50

(ii) Find consumer surplus, producer surplus and the total social welfare. (4 points)

CS =(50-25)*50/2=625

PS =25*50/2=625

TW = 1250

Suppose the government now decides to provide a subsidy of $5 per unit to the suppliers of widgets.

(iii) Find the new equilibrium quantity, the price paid by consumers, the payment per unit received by producers (including the subsidy and what consumers pay). (4 marks)

Q = 55

Price paid by consumers = 22.5

Payment per unit received by producers = 27.5

(iv) Given such a subsidy policy, find the new consumer surplus, producer surplus, the cost to the government and the deadweight loss. (4 marks)

CS = (50-22.5)*55/2=756.25

PS = 27.5*55/2=756.25

Costs to the government = 275

DWL = change in consumer surplus + change in produce surplus + change in government funds= 131.25+131.25-275=12.5

(v) How would your answers to (iv) change if the subsidy is now not giving to suppliers but buyers? (4 marks)

No change at all. This is seen through a diagram where demand shifts to the right by $5 - in a parallel fashion. The new intersection point will be at the equilibrium price of $27.5. This results in consumers actually paying (27.5-5)=$22.5 and producers receiving $27.5, the fact that yields the same CS and PS computed in part (iv).

Question 3: Budget Constraint (20 marks)

I have cappuccino and muffins every morning at the Starbuck's on Guy.

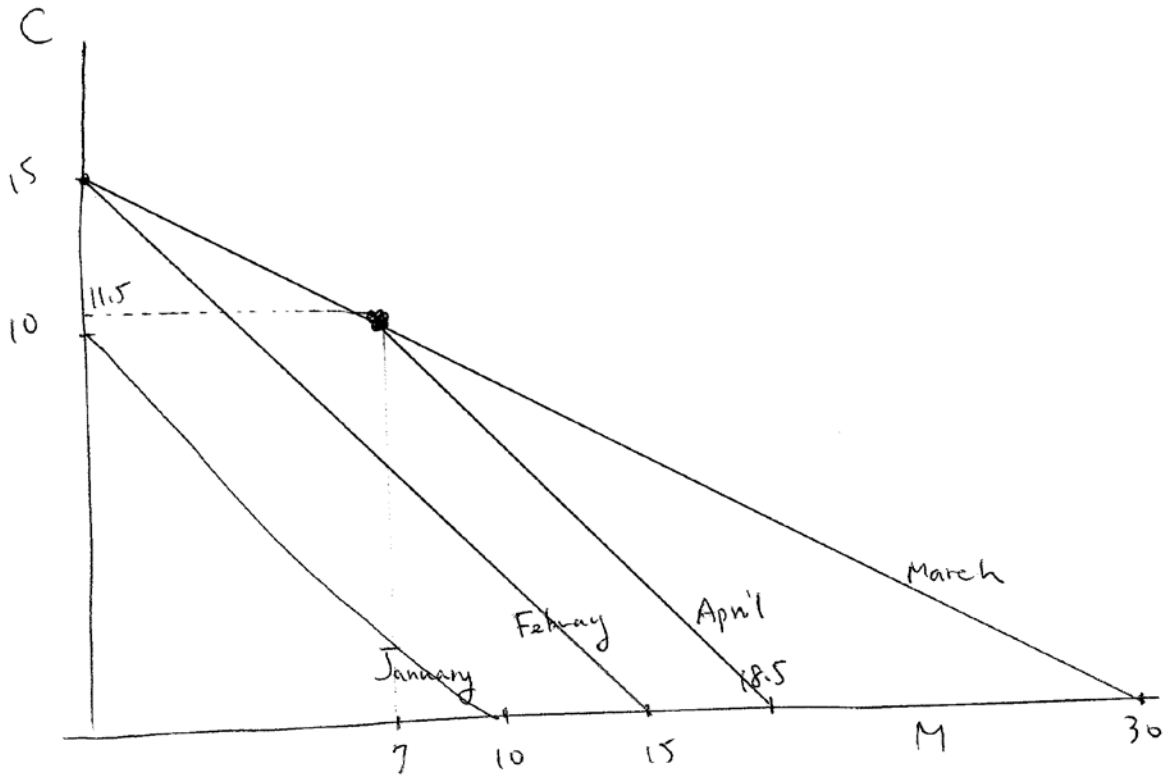
(i) In January, I decided I could afford to spend $20/week on cappuccino and muffins; cappuccino was $2 and muffins were $2. (5 marks)

(ii) In February, I decided I could afford to spend $30/week; prices remained the same. (5 marks)

(iii) In March, I discovered that the Java U across the street from Starbuck's sells equally good muffins for $1. So, I started buying cappuccino at Starbuck's and muffins at Java U's. [Everything else remained the same as in February.] (5 marks)

(iv) In April, Starbuck's manager got a little huffy (annoyed) about my bringing in muffins from Java U's across the street (and sitting in Starbuck's to drink and eat and read the paper). After much argument, we came to a compromise: I can bring in 7 muffins per week from Java U's – but after that I have to buy all my muffins at Starbuck's. [Everything else remained the same as in February.] (5 marks)

On **ONE DIAGRAM**, show my budget set in January, February, March, and April.



Question 4: Perfect Competition (20 marks)

Gasoline is sold through local gas stations under perfectly competitive conditions. All gas station owners face the same long-run average cost curve given by

$$LRAC = 0.1q - 1 + \frac{1000}{q}$$

and the same long-run marginal cost curve given by

$$MC = 0.2q - 1$$

where q is the number of gallons sold per day.

(i) Assuming the market is in the long-run equilibrium, how much gas will each individual owner sell per day? What are the long-run average cost and marginal cost at this output level? (7 marks)

LRAC=MC

➔ q = 100, LRAC = MC = 19

(ii) The market demand for gasoline is given by

$$Q = 2{,}500{,}000 - 500P$$

where Q is the number of gallons demanded per day and P is the price per gallon. Given your answer to part a, what will be the price of gasoline in the long-run equilibrium? How much gasoline will be demanded and how many gas stations will there be? (7 marks)

P = LRAC=MC=19, Q =2,500,000-500*19= 2490500, N =Q/q=2,490,500/100=24905

(iii) Suppose that because of the development of hybrid cars, the market demand for gasoline shifts inward to

$$Q = 2{,}000{,}000 - 1{,}000P$$

In long-run equilibrium, what will be the price of gasoline, how much total gasoline will be demanded, and how many gas stations will there be? (6 marks)

LRAC is unchanged=19
➔ P=LRAC=MC=19, Q = 2,000,000-1,000*19=1981000, N=Q/q =1,981,000/100= 19810

Question 5. Price Discrimination (20 marks)

Suppose McGraw-Hill (a textbook monopoly on its own textbooks) can produce any level of output it wishes at a constant marginal (and average) cost of $5 per book. Assume that the monopoly sells its books in Canada and Thailand. The inverse demand in Canada can be written as

$$P_C = 55 - Q_C .$$

MR associated with this demand function is:

$$MR_C = 55 - 2Q_C$$

The demand in Thailand is given by

$$P_T = 35 - \frac{Q_T}{2}$$

MR associated with the Thai demand function is:

$$MR_T = 35 - Q_T$$

(i) Suppose McGraw-Hill can maintain the separation between the two markets. (For example, post offices in both countries charge around $100 to ship one book by airmail in addition to taxation.) What level of output should be produced in each market and what price will prevail in each market? What are McGraw-Hill's total profits in this situation? (7 marks)

The existence of shipping costs means that markets can be segregated → company can apply price discrimination:

Canada: Q = 25, P = 30, and Profits = TR-TC=P*Q-MC*Q=30*25-5*25=625

Thailand: Q = 30, P = 20, and Profits = TR-TC= P*Q-MC*Q=20*30-5*30=450

Total profits = 1075

(ii) Assume there are no shipping costs between the two countries, so that the markets can no longer be segmented. What would be the quantity demanded if the price is 40? And how about the quantity demanded when the price is 20.? (7 marks)

If P=40, then quantity demanded in Canada is 55-40=15. Quantity demanded in Thailand is 2(35-40)<0, so that it is zero. Total quantity demanded at P=40 is 15+0=15.

If P=20, then quantity demanded in Canada is 55-20=35. Quantity demanded in Thailand is 2(35-20)=30. Total quantity demanded at P=20 is 35+30=65.

(iii) How would your answer to (ii) change if it costs buyers $5 instead of "0" per book to air-mail books from Thailand to Canada or from Canada to Thailand? (6 marks)

From part "i" we can deduce that when shipping costs exist, the price charged in Canada is $30 and the price charged in Thailand is $20 → Hence, Canadians can buy their books from Thailand at $20 and ship them into Canada and by doing so incur $5 in shipping. The shipped book would cost them $25 as opposed to $30 when buying locally. To prevent this, McGraw-Hill needs to set the price competitively

Part IV: Choose TWO out of the following three questions. If more than two questions are answered, only the first two will be marked (Total = 20 marks).

1. Consider the following news clip:

> **Implementing the Firearms Act**
>
> ***Last Updated: Wednesday, November 4, 2009 | 6:52 PM ET***
>
> **CBC News**
>
> Harper's government introduces a bill in the Senate to abolish the long-gun registry, but not relax controls on machine guns.
>
> The bill marks a change in strategy for the Harper government, which had been backing the controversial Bill C-301. That bill, introduced in the House of Commons by Conservative MP Garry Breitkreuz, proposed ending the registration of rifles and shotguns, as well as softening controls on machine guns, by allowing people to transport fully automatic and semi-automatic assault guns to public shooting ranges.
>
> The bill, which was ultimately killed, was strongly opposed by the Canadian Association of Chiefs of Police, as well as majority of Canadians.

Generally, homeowners prefer to live in an unarmed society, but would buy a gun if they know criminals are armed. And criminals prefer to buy a gun as a tool in their trade – it enhances their productivity and hence maximizes their "profit". Suppose the table below outlines the outcomes for homeowners and criminals, where the outcomes for each group are ranked as 1, 2, 3, 4, where the most preferred outcome is 1 and the least preferred is 4. The first number is for homeowners, the second for criminals.

	CRIMINALS		
HOMEOWNERS		NO GUNS	GUNS
	NO GUNS	1, 2	4, 1
	GUNS	2, 4	3, 3

(i) Do homeowners have a dominant strategy? Do criminals have a dominant strategy? What is the Nash equilibrium outcome of the game? (2 marks)

The homeowners do not have a dominant strategy, criminals do – to buy guns. Knowing the dominant strategy of criminals, homeowners will buy guns and the Nash equilibrium is at (3, 3).

(ii) Is there a mutually preferred outcome to the Nash equilibrium? (1 marks)

Yes, both will prefer (1,2) to the Nash equilibrium.

(iii) How does this situation resemble a Prisoner's Dilemma? (1 marks)

It resembles Prisoner's Dilemma, because both players can get a better outcome – (1,2), but are instead stuck at (3,3) as an equilibrium.

(iv) If criminals pre-commit not to have guns, can the mutually preferred outcome be achieved? Will the pre-commitment be credible? (2 marks)

If criminals pre-commit not to buy guns, then the best response of homeowners is to not buy guns as well, and the mutually beneficial outcome (1,2) is achieved. This pre-commitment is not credible though, as criminals would prefer to buy guns once homeowners do not have guns and thus move to an outcome (4, 1). Knowing this, homeowners will not believe the commitment of criminals to be credible.

(v) Explain the role of a gun restriction law and how it will modify the outcome of the game, if it is strictly applied and is efficient in achieving its goals? (2 marks)

Strict gun restriction law, if efficiently applied, serves as a credible commitment and tries to achieve the (1, 2) mutually beneficial outcome.

(vi) Would criminals find it in their best interest to support a gun restriction law? (2 marks)

Criminals would find it in their best interest to support the gun restriction law, because that will move them from the Nash (3,3) outcome to the (1, 2) outcome, i.e. they are better off with the laws as they go from outcome 3 to outcome 2 for them. Thus, criminals would rather fight a non-armed homeowner, than risk fighting an armed one. Same applies to homeowners.

2. Consider the following quote from the Future Shop web site, www.futureshop.ca:

> ***Our Lowest Price Guarantee***
>
> **Get it for less. Guaranteed™.**
> **We will beat any advertised price by 10% of the difference.**
>
> **Three great reasons to buy at Future Shop.**
>
> 1. If you find a lower advertised price we will beat it by 10% of the difference.
> 2. If you find a lower advertised price within 30 days* of your purchase we will beat it by 10% of the difference.
> 3. If our own price is reduced within 30 days* of your purchase, bring in your receipt and we will refund the difference.
>
> *14 days for computers, laptops, monitors, printers, camcorders, digital cameras, portable DVD players, radar detectors, projectors and air conditioners.

(i) Based on this clip only (disregard your answers below), do you think Future Shop is a company that cares about its customers and wants to guarantee them a lower price for what they buy? (2 marks)

Yes, it looks like Future Shop tries to provide the best value for its customers and genuinely cares about them.

(ii) What would happen if you found that Best Buy, a competitor, offers the same product for less? (2 marks)

I would go to Future Shop and tell them that I found a cheaper product and make them abide by their policy to offer me an even lower price – what they say they will do in their policy.

(iii) What is the incentive for Best Buy to offer a lower price than Future Shop? (2 marks)

Knowing this would happen, Best Buy has no incentive to undercut Future Shop, as if it would, it would not gain customers, people would just go and ask Future Shop for an even lower price, according to its policy.

(iv) Explain how Future Shop's policy acts to reinforce collusion between the two firms and leads to anti-competitive behavior? (2 marks)

The lowest price guarantee serves as a disincentive mechanism for competitors to lower prices and thus reinforces an anticompetitive behavior. In this case, monitoring for cheating (lowering prices) is done very easily, by deal-hungry customers.

(v) As a result, is the customer better or worse off because of Future Shop "Lowest Price Guarantee" policy? (2 marks)

To the extent that a customer prefers competitions and lower prices and higher quality, she could actually be hurt by the "Lowest price guarantee" policy.

3. Consider the following news clip:

Ottawa wants Competition in Internet Phone Markets

November 15th, 2006 Globe and Mail Update

Toronto — Industry Minister Maxime Bernier confirmed his free market credentials in Toronto on Wednesday, thumbing his nose at the federal telecommunications regulator by removing regulations on Internet-based telephone services.

The result could be significantly lower telephone bills for consumers and businesses across.

"It is time to have a level playing field from which consumers and small businesses will benefit." Mr. Bernier told the Economic Club of Toronto.

The decision signals that Mr. Bernier will aggressively move forward with his plan to overhaul Canada's highly regulated telecom sector, even though the Conservatives have only a minority government.

Mr. Bernier, a staunch advocate for free markets, wants to let consumers determine the winners and losers. VoIP-based phone services have been taking thousands of customers away from established phone firms such as Bell Canada and Telus Corp. For consumers, Internet-based calling has meant more competition and lower prices in a market traditionally dominated by regional monopolies that had their prices set through the government.

Even though local phone markets were opened up for competition seven years ago, the large incumbents still control about 97 per cent of the market.

(i) The above article suggests that by allowing smaller companies to compete freely in the internet phone market, consumers and businesses may end up paying lower prices. Discuss one economic reason why this may not necessarily be true. (3 marks)
Ans: Smaller firms may not be able to reap economies of scale by producing high output levels.

(ii) Contrast one single supplier (monopoly such as Bell) versus a market with many small firms (highly competitive such as Teksavvy and Skype): Use relevant economic concepts to argue whether we should expect more innovative products being introduced to the market or fewer of such products. (3 marks)
Ans: Tough competition induces the firms to innovate, but tough competition drives down economic profits, so the firms may not have the resources to innovate.

(iii) The article says even though local phone markets were opened up for the past seven years, the large existing firms still control the majority of the market. Why is this so? Relate your answer to the relevant economic concept. (4 marks)

Ans: Fixed costs are very high in setting up traditional phone companies.

The End