

TOPIC

Introducing Economics

John Maynard Keynes came to the modern definition of economics.

Economics is "a social science concerned with the proper uses and allocation of resources for the achievement and maintenance of growth with stability and with determinants of income and employment"



The basic economic problem

In every country, resources are limited in supply and decisions have to be made by governments, firms (businesses) and individuals about how to allocate scarce resources to satisfy unlimited needs and wants.

This is the basic economic problem that exists in every economy: how to allocate scarce resources to satisfy unlimited needs and wants



Scarcity, choice and opportunity cost

The fundamental economic problem is: 'scarce resources in relation to unlimited wants'.

In economics, a need is not the same as a want; consumer wants are not always satisfied because of limited income whereas a need tends to be more important in a scale of priorities.



The concept of scarcity and choice

The fundamental problem in economics is that resources are **scarce** and **wants are unlimited**, so there is always a **choice** required between competing uses for the **resources**.

Scarcity: a situation in which wants and needs are in excess of the resources available.

Wants: needs that are not always realised.

Choice: underpins the concept that resources are scarce so choices have to be made by consumers, firms and governments.

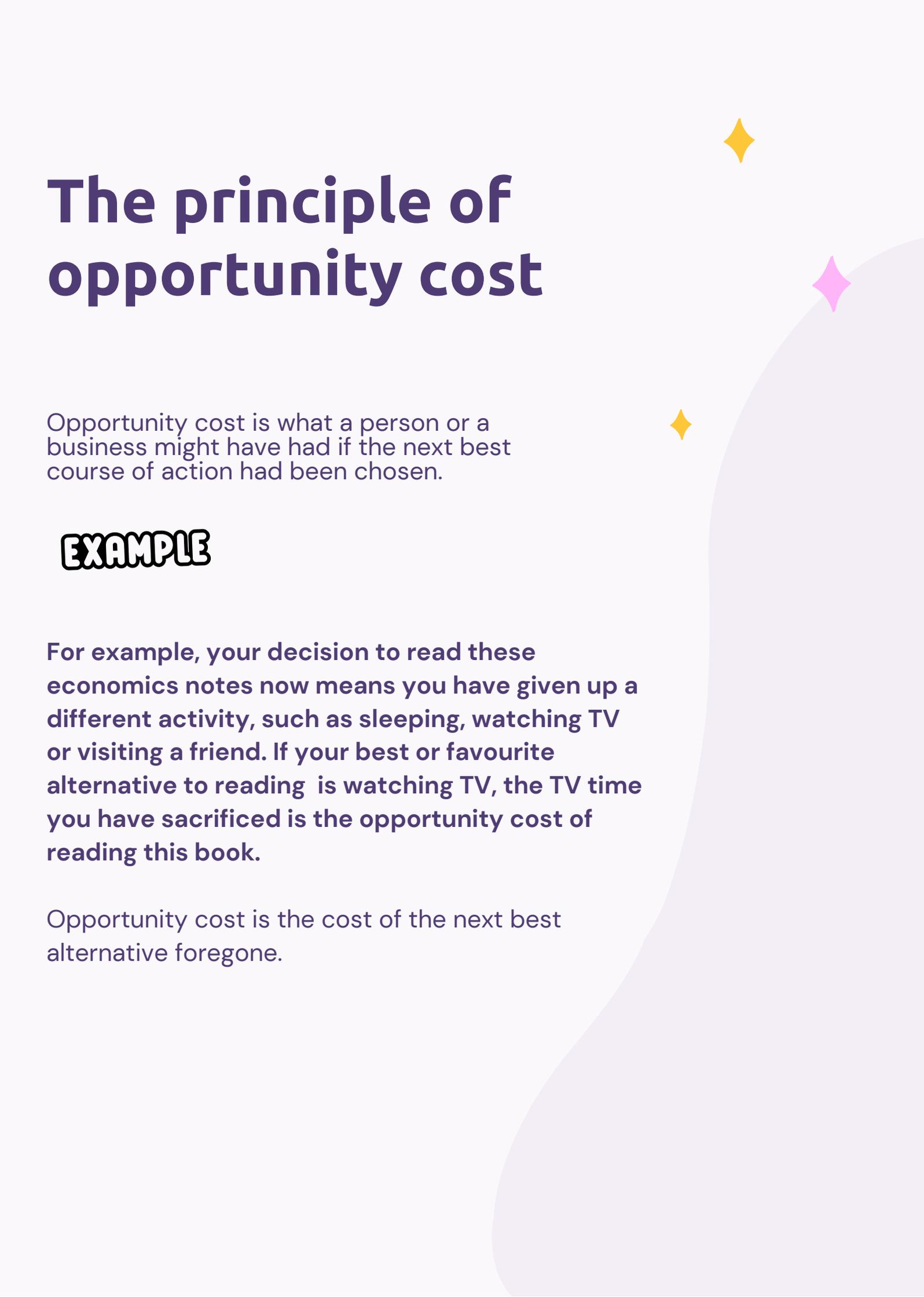
Resources: inputs available for the production of goods and services. (land, labour, capital, enterprise)

EXAMPLE

An individual, faced with a time limitations, may have to decide between going for a walk in the park or watching a television programme in his leisure hour. We say that his time is scarce and he, therefore, needs to make a choice between going for a walk or watching television



The principle of opportunity cost



Opportunity cost is what a person or a business might have had if the next best course of action had been chosen.

EXAMPLE

For example, your decision to read these economics notes now means you have given up a different activity, such as sleeping, watching TV or visiting a friend. If your best or favourite alternative to reading is watching TV, the TV time you have sacrificed is the opportunity cost of reading this book.

Opportunity cost is the cost of the next best alternative foregone.

The Production Possibility Curve (PPC)

What is PPC?

A PPC shows the various possible combinations of goods that a society is capable of producing given a certain level of technology and full utilization of resources (i.e. no idle capacity)

Assumptions

1. That the economy produces any two goods
2. All available resources are used in the production of these two goods
3. The state of technology remains unchanged.

A production possibility schedule

The table below shows a production possibility schedule. It shows various combinations of the good 'maize' and the good 'weapons' the economy can produce with its existing resources and level of technology.

In the table, X represents the good 'weapons' and Y the good 'maize'



Possibilities	X (Units)	Y (Units)
1	0	20
2	1	16
3	2	12
4	3	8
5	4	4
6	5	0

Suppose all the available resources are used in the production of X, then the maximum amount of X that can be produced (from the table) is 5 units. And if all resources are used in the production of Y, the maximum amount of Y that can be produced is 20. In between these two possibilities, there are various other possible combinations of both X and Y. From the table, as we move from 1 to 5, we are transferring resources from the production of Y (maize) to X (weapons).

The Production Possibility Curve (PPC)

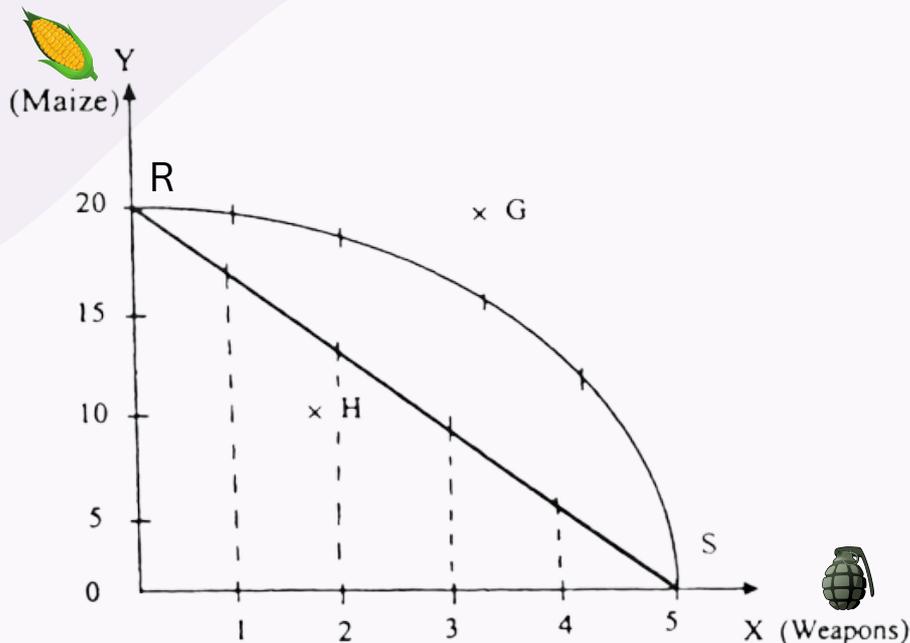


Diagram explained

1. The PPC is represented by the line RS. That all points along RS is attainable and employs resources fully.
2. Points within RS, for example, point H, is attainable but inefficient as more of both goods can be produced if idle resources are put to use.
3. Points beyond RS is unattainable as resources are insufficient to meet that production scale.

Properties of the Production Possibility Curve

- 1.** The PPC is a **boundary**. It shows the limits to what an economy can produce with the existing technology and the resources it has. This boundary separates combinations that can be produced (attainable) from those which cannot (unattainable).
- 2.** All points along the PPC represent the **maximum production points** at which all resources are fully and efficiently employed.
- 3.** The PPC has a **negative slope**. The negative slope indicates that more of one good can be produced only if less of the other good is produced. It represents the opportunity cost of producing more than one good in terms of another
- 4.** The PPC is **concave to the origin**. This concavity is explained by the **Law of Increasing Opportunity Costs**. The law states that in order to get equal amounts of one good, society must sacrifice an ever increasing amount of the other good.

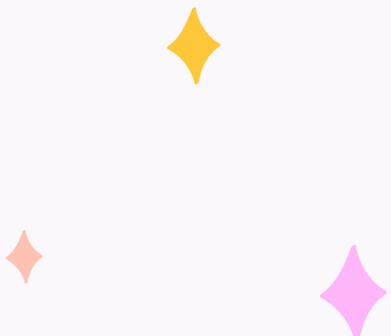
The economic problem

The basic economic problem then raises the need to make decisions in production, such being:

1. What to produce?
2. How to produce?
3. For whom to produce?
4. Where to produce?



Economic questions



For whom to produce?

- 1.** Because we cannot satisfy all the wants of all the population, decisions have to be taken concerning how many of each person's wants are to be satisfied.

What to produce?

- 2.** Because we cannot produce everything, we need to decide what to produce and in what quantities.

How to produce?

- 3.** This question arises since resources are scarce in relation to unlimited wants; we need to consider how resources are used so that the best outcome arises.

Economic systems

How an economy deals with the basic economic question of scarcity is also an expression of its cultural values and political ideology.

We shall look at three systems namely **the free market economy**, **the centrally planned economy** and the most common to be found in the democratic world, the **mixed economy**.



The free enterprise economy

The French expression “laissez-faire” means to “let people do as they choose”. In such a system people are free to do as they please. There are no or very few government regulations or controls. The emphasis is on freedom of the individual both as a consumer and as the owner of a factor of production (the factor labour) to act in his best interests.

Features

1. There is **private ownership** of all productive assets for example land, factories, machines and equipment.
2. The dominating motive is **self-interest**. Each tries to do what is best for itself. Firms engage in economic activities that give them the highest returns. Consumers spend on things that give them the most satisfaction. The belief is that if each economic agent is allowed to make free choices in satisfying its best interest, inevitably the interest of all will be served.
3. **Competition** exists in such competitive markets; (i) there is a large number of buyers and sellers; (ii) there is perfect knowledge of prices and the types of goods and services available in the market; (iii) there is free entry and exit of firms into any particular industry.
4. Production and distribution are governed by the **price mechanism**. The government does not decide what goods are to be produced, for whom, how they are to be produced and where. It is the price mechanism which decides all these in a free enterprise state.

Freedom of choice in the free market

5. When making economic decisions, consumers, businesses and resource suppliers exercise **freedom of choice**. There is no government interference. This freedom of choice is most obvious in the following areas:

1 Freedom of enterprise

Businesses purchase and utilise resources to produce any product they desire and sell them to a market of their choice. What a firm decides to sell very much depends on the amount of profits to be made.

2 Consumer Sovereignty

Businesses purchase and utilise resources to produce any product they desire and sell them to a market of their choice. What a firm decides to sell very much depends on the amount of profits to be made.

3 Free movement of resources

Businesses purchase and utilise resources to produce any product they desire and sell them to a market of their choice. What a firm decides to sell very much depends on the amount of profits to be made.

The price mechanism in the free market

6.

The decisions of consumers determine the demand for goods and services; the decisions of producers determine the supply of a good (for example if cost of production is high, producers produce less). It is this interaction of **demand and supply** that determines the price of a good. Changes in demand and supply lead to changes in market prices which in turn affect the ways in which resources are allocated.

The price mechanism works through the interaction of prices; such prices being:

1

the prices of goods and services determine what consumers will buy

2

the price of factors of production determines the cost of production to producers

3

the profit motive of producers

Advantages of the free market system

1 Decentralised decision-making

Resources are allocated and distributed efficiently with no need for an expensive central authority. Prices indicate people's preferences for different goods and services. Prices signal to producers what goods to produce and what not to produce.

2 Consumer Sovereignty

Provided they have the money, consumers are free to choose what they wish to have, goods and services are not imposed upon them.

3 Efficiency

Competition among firms ensures goods are produced using least-cost production techniques. Besides avoiding waste, consumers are assured of the best prices (lowest possible prices). All resources are put to their best or most profitable use.

Demerits of the free market system

1 Misallocation of resources

Consumers having greatest purchasing powers control the market. Misallocation of resources is inevitable as resources are devoted to meet the ostentatious needs of the rich rather than used for producing necessities for the poor. Although we can put the blame for this on unequal income and wealth distribution; in such a system it is in the end, the market mechanism that increases and worsens this disparity.

2 The case of public goods

Public goods such as defence, justice, highways, streetlighting may not be provided by the private sector in a laissez-faire economy because, the cost is high or because many firms providing such services may duplicate one another or because it may not be profit-yielding. Whatever the reason, in capitalist states, the government undertakes to provide such services covering expenses with public taxes.

3 Merit goods

The provision of merit goods such as education and health if left to the price mechanism may not be provided in adequate amounts. Also, if left to the private sector, such merit goods may be priced too high. Because the consumption of such goods is considered desirable, governments undertake their provision at heavily subsidised prices to ensure consumption. In some countries, basic primary education is provided free by the government.

4 Monopolies

For the price system to work, it is assumed that competition exists and that there are many buyers and sellers so that no one can influence price singly. However, in practice, this may not always be true. A situation arises when firm attempt to cut out competition. Consumer sovereignty is affected, weakening their bargaining position. The seller's (the monopolist's) position is strengthened considerably. He can restrict output so his product can sell at a higher price to make more profits. Again, misallocation of resources results as prices are artificially fixed by one or two sellers.

5 Public welfare

The profit motive that drives the private sector may not always ensure that public welfare is maximised. In their pursuit of profits, negative externalities may be generated which impose a social costs upon society. Such negative externalities can take the form of pollution – air, noise, land.

The planned economy

Also known as a command economy, the system offers an alternative method of resource allocation. The State issues directives to firms telling them what to produce, the quantities to produce, how and for whom to produce. This is usually accompanied by rationing for consumers which leaves them with little choice over their purchases. But in reality, some space for household choice is allowed.

Features

- 1.** The State or central authority decides on the allocation of resources. The state allocates goods and services to consumers through rationing via coupons (for essential goods) or by fixing prices.
- 2.** Productive resources are publicly owned.
- 3.** Prices are not determined by the forces of demand and supply. Prices are state controlled



Merits of the centrally planned economy



Some of the defects of the free enterprise economy disappear in the command economy.

The state can:

ensure greater equality in the distribution of wealth and income.

ensures that public interest is maximised

wipe out inefficiencies resulting from competition

ensure enough resources are devoted to public and merit goods.

consider external costs and benefits in production decisions

ensure full-employment of labour

Demerits of the planned economy

1 Limited choices for the individuals

As the state decides what goods and services are to be produced, a more restricted choice is available. Goods produced are standardized, reflecting little of consumer's tastes and preferences.

2 Less incentive to increase efficiency.

Because the profit motive is absent, there is less incentive to increase efficiency. Increased efficiency leads to lower costs of production, lower prices and increased profits – a powerful motivator for research and development of new products.



3 Bureaucracy and 'red tape

Because power is given to the State in directing the people's lives, there is a tendency for a dictatorship to develop. Instead of the state existing to serve the needs of the people; the situation becomes reversed as people exist to serve the state

4 Dictatorship

Competitive advertising can lead to a wastage of resources. Because there are no barriers to entry, there may be too many small firms producing the same product preventing the realisation of large-scale production which usually means lower production costs and hence prices.

The mixed economy

Fortunately in the world today, most countries do not make absolute choices in regard to the two extremes discussed. Most choose a 'middle' ground; having the state to act on behalf of its public, in essential areas like housing education, defence, justice and transportation while allowing for a private sector to flourish (subject to State's regulations). It represents the way in which countries can attempt to get "the best of both worlds". In such a system, there is a large private sector and a smaller, but not less important, public sector.



Demerits of the free market system

Because the government performs different roles in different economies, it is difficult to be exact about the nature of the mixed economy. However, certain functions performed by the government in most economies can be identified. These are:

1 Monopoly regulation

Laying down legal framework of rules to ensure fair between producers and to protect the individual consumer or worker from exploitation by monopolies. Examples are the industrial relations act, the labour law and the employment act

2 Provision of merit goods and demerit goods

The government provides public and merit goods which would otherwise not be provided by the private sector or provided in inadequate amounts.



3 Modifying the price system

The government through taxes and subsidies on goods and services can influence price: a tax usually raises the price of a good (especially imposed on undesirable goods like cigarettes and liquor) and it is usually aimed at discouraging consumption of such goods. A subsidy lowers prices making the consumption of such desirable goods (like education, housing, health care) attractive.

4 Redistributes income and wealth for greater equality

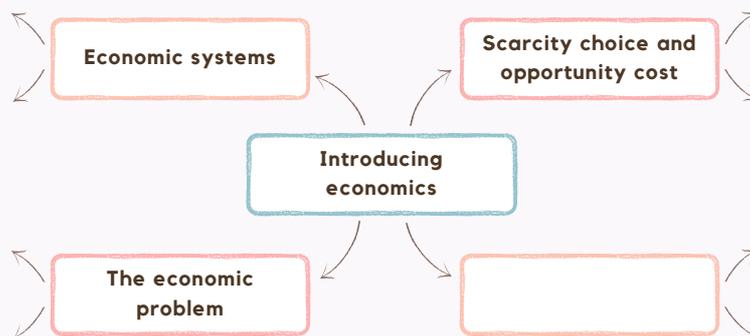
Through a system of taxation, governments intervene in economies to create greater equality in the distribution of income and wealth than would otherwise exist.

5 Control of the economy

The government controls the economy with definite economic objectives in mind. These can be summarised as follows:

1. to ensure a high and stable level of employment
2. to ensure prices remain stable without inflation
3. to ensure a healthy balance on the balance of payments
4. to ensure national product grows at a steady rate.

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- 9.Firm's cost structure
- 10.Market structures
- 11.Behavioural economics
- 12.Types of goods
- 13.Costs and benefits
- 14.Market failure
- 15.Microeconomic policies
- 16.Population
- 17.Aggregate demand and supply
- 18.Inflation and deflation
- 19.Policies to correct inflation and deflation
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- 22.International Trade
- 23.Exchange rates
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24. Balance of payments
25. Policies to correct Balance of payments Disequilibrium

The fundamental economic problem

The fundamental economic problem is:

'scarce resources in relation to unlimited wants.'

1 2 3

1 Scarcity: The excess of human wants over what can actually be produced to fulfil these wants

2 Resources: inputs available for the production of goods and services.

3 Wants: needs that are not always realised.

Choice

Choice underpins the concept that resources are scarce so choices have to be made by consumers, firms, and governments.



Sacrifice

Choice involves sacrifice. The more food you choose to buy, the less money you will have to spend on other goods.



Opportunity cost

In other words, the production or consumption of one thing involves the sacrifice of alternatives. This sacrifice of alternatives in the production (or consumption) of a good is known as its opportunity cost.

Opportunity cost is the cost expressed in terms of the best alternative that is forgone.

EXAMPLE

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Question

'Both the take-up rate and number of journeys per bus pass have been falling in recent years.'

Explain two factors which could lead to an increase in the demand for bus travel in the future.

(10 marks)

Category: Demand and supply

AQA AS ECONOMICS November 2020

Answer

Tip: Generally, AQA exam questions are accompanied by an extract (although we have not included it here for simplicity). To score higher marks, refer back to the data (facts and figures) given in the extract, when writing your essay! Note that in this question you are asked to 'explain TWO factors'. In this case, it's a good idea to break your essay into two parts: Factor 1 and factor 2.

(Step 1: Define 'demand' in the introduction)

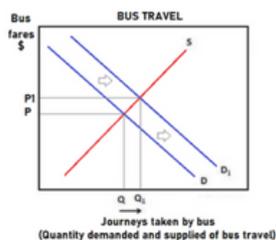
Demand refers to both the willingness and the ability of customers to pay a given price to buy a good or service. There are several factors which could lead to an increase in the demand for bus travel in the future.

(Step 2: Explain TWO factors which could increase the demand for bus travel)

Factor 1: A change in tastes or social norms will increase the demand for bus travel.

Today, travelling by bus has the image of being unpleasant, unreliable and for the 'lower class'. However, more awareness is being raised about air pollution, climate change and CO₂ emissions. People in the future may perceive bus travel as being more ecologically and economically efficient. Furthermore, with the introduction of smart lanes and electric buses, the experience of travelling by bus will improve with time. These factors will encourage people to take the bus.

If more people become aware that travelling by bus is environmentally friendly, more people will opt for bus travel to reduce their carbon footprint. The demand for bus travel will increase. The effect of an increase in demand for bus travel can be shown using a diagram. The diagram below shows the demand and supply curves of bus travel.



Initially, people are unaware of the environmental benefits of bus travel, the equilibrium price (bus fare) is P and the equilibrium quantity (number of journeys taken by bus) is Q . Following campaigns raising awareness about air pollution, more people will be encouraged to travel by bus instead of using their cars. The demand curve for bus travel shifts rightward from D to D_1 . The quantity demanded and supplied for bus travel increases from Q to Q_1 .

Factor 2: If the price of substitutes such as car travel increases, then people will turn to bus travel instead because of its more favourable relative price.

Substitutes are alternative goods and can satisfy the same want or need. Examples of substitutes are car travel and bus travel. For example, if the price of car travel increases significantly, people will look for cheaper alternatives, such as bus travel.

The cost of travelling by car can increase in the future, for instance, due to higher fuel prices. Consequently, if the cost of travelling by car goes up in the future, people will avoid travelling by car, and take the bus instead. The demand for bus travel will increase.

The government may also subsidise bus travel in the future, making bus fares cheaper. This will encourage people to switch away from using their cars to travelling by bus.

(Step 3: Conclude)

To conclude, the demand for bus travel could increase in the future if people perceive buses as being more ecologically and economically efficient. Also, if the price of substitutes such as car travel increases, then people will turn to bus travel instead because of its more favourable relative price.

MARKING SCHEME

- Relevant issues include:
 - meaning of demand
 - lower relative price and/or greater availability compared with substitute goods
 - increased subsidy
 - changes in tastes and/or social norms
 - changes in income and/or consideration of bus travel as an inferior good
 - increased population and/or changes in age structure
 - the significance of elasticities.

Level 3

- An answer that:
 - identifies two valid factors
 - shows sound knowledge and understanding of relevant economic terminology, concepts and principles
 - includes good application of relevant economic principles and/or good use of data to support the response
 - includes well-structured analysis with a clear, logical chain of reasoning
 - may include a relevant diagram to support their explanation

EXAMPLE

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03

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SKIM THE DATA
Start by skimming the data. Read the text quickly to get a general idea of meaning.

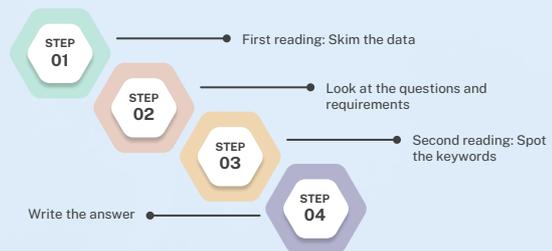
LOOK AT THE TITLE
Look at the title as it may give some clues about its content.

ANALYSE FACTS, FIGURES AND TABLES
Analyse facts, figures tables and diagrams. See if you know what they mean. Pick out any notable features of a chart or diagram.

COMPETITION IN THE SKIES OVER EUROPE

It was predicted that this would lead to an increase in the market share for the top five European airlines from 50% of the European market in 2019 to match the top five United States (US) airlines, which control 77% of the US market.

STEPS TO ANSWER A DATA RESPONSE QUESTION



Read the Requirements

Always read the requirement first as this enables you to focus on the detail of the question with the specific task in mind.

What is the point in reading a scenario if you don't know what you are looking for? If you don't read and understand the requirements carefully, then you will find that you are not actually answering the question. If you are not answering the question, then you are not earning marks.

Pay attention to (1) The content and (2) The instructions

Explain what is meant by a contestable market and discuss how making the airline market more **contestable** could benefit passengers.

... contestable market...benefit

THE CONTENT
When you read each part of the requirement, highlight the 'content'. This is simply what the question is about. This helps you to focus your mind on answering the actual question rather than answering what you thought the question was going to ask you.

THE INSTRUCTIONS
This instruction could be a whole variety of verbs ranging from numerical requirements such as calculate and apply, or more wordy requirements such as describe, interpret, outline or compare. The verb used has been carefully thought about by the examiner, taking into account any restrictions imposed by the syllabus.

Explain

Explain what is meant by a contestable market and discuss how making the airline market more contestable could benefit passengers.

(d) Explain two reasons why a government may privatise an industry. [4]

There are several reasons why a government may privatise an industry, such as air travel.

STRUCTURE

CLEAR HEADINGS

Reason 1: Privatising an industry may lead to an increase in government revenue.

The government may earn more tax revenue if it privatises a state-owned industry. This is because a privately owned industry has to pay corporation tax. A corporation tax is a tax levied on companies profits.

PARAGRAPHS

The sale of a state-owned enterprise to the private sector will also raise money for the government.

REFERENCE TO THE DATA

In the data, it was mentioned that a successful sale of Air India to the private sector would have raised money for the Indian government.

More tax revenue will enable the government to increase its spending on education, healthcare or infrastructure. This will help to promote development in the country.

SIMPLE ENGLISH

Reason 2: The government may privatise an industry because the industry is making a loss.

The need to use tax revenue to finance the loss-making industry will be reduced. The private sector may also manage the industry with greater efficiency and turn the loss into a profit. This is because the private sector, motivated to make a profit, will increase productivity and reduce costs.

EXAMPLE

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Questions

Paper and year

Topic

Answers and Explanations

Scarcity, Choice and Opportunity Cost Multiple Choice Questions

1. Which terms summarise the nature of the economic problem?
 A finite resources and limited wants
 B finite resources and unlimited wants
 C infinite resources and limited wants
 D infinite resources and unlimited wants
 [210/P220]

2. The government of a country with a rapidly increasing population decides to switch resources from investment to increased subsidies to farmers. What is the opportunity cost of this decision?
 A the profit earned by farmers
 B the rest of the land on which food is grown
 C the reduction in investment
 D the wages of the farm workers
 [210/P247]

3. Which economic change would increase the problem of scarcity?
 A a decrease in fish stocks
 B a discovery of a new oil field
 C an increase in labour productivity
 D a reduction in waste
 [110/P1/052]

4. What makes choice an important element in the basic economic problem?
 A increased demand leads to higher market prices.
 B limited resources have many alternative uses.

C Reaching a market equilibrium may take a long time.
 D Scarce economic resources are distributed equally.
 [10/P1/011]

A government of acid with their about to ending on the other side of the world.
 A conservation of resources
 B monetary policy
 C opportunity cost
 D substitution of factors
 [210/P202]

5. A firm decides stop manufacturing B and switch to C producing washing machines instead. What is the opportunity cost to the firm?
 A the additional washing machines produced
 B the cost of producing ovens
 C the cost of producing washing machines
 D the loss of the production of ovens
 [211/P201]

6. What is meant by the economic problem?
 A how to achieve the maximum utility for the least cost
 B how to allocate resources between public and private sectors
 C how to allocate unlimited wants against finite resources
 D how to decide which methods to use to exploit all resources

7. A firm has two production processes. The first uses an unlimited number of resources. The second uses a limited number of resources. Of what is this an example?
 A a government of acid with their about to ending on the other side of the world.
 B monetary policy
 C opportunity cost
 D substitution of factors
 [210/P202]

8. The problem of scarcity arises because in a free market economy, the total demand for goods and services exceeds the total supply of goods and services. What is the opportunity cost of this decision?
 A the profit earned by farmers
 B the rest of the land on which food is grown
 C the reduction in investment
 D the wages of the farm workers
 [210/P247]

9. Which economic change would increase the problem of scarcity?
 A a decrease in fish stocks
 B a discovery of a new oil field
 C an increase in labour productivity
 D a reduction in waste
 [110/P1/052]

10. What makes choice an important element in the basic economic problem?
 A increased demand leads to higher market prices.
 B limited resources have many alternative uses.

O level topics

01	Economic Problems
02	Factors of Production
03	Economic Systems
04	Demand, Supply and Equilibrium
05	Perfect Competition and Monopoly
06	Aims of Government and its Role
07	Market Failure
08	Public Expenditure vs Private Expenditure
09	Banks and Stock Exchanges
10	Labour Market
11	Motives for Spending, Saving and Borrowing
12	Different Types and Sizes of Firms
13	Production, Costs, Revenues and Profits

AS level topics

01	Basic Economic Ideas And Resource Allocation
02	Production Possibility Curves
03	Classification Of Goods And Services
04	The Price System And The Micro Economy
05	Price Elasticity
06	The Macro Economy
07	International Trade
08	Protectionism
09	Exchange Rates
10	Government Macro Intervention

A level topics

01	Law of Diminishing Marginal Utility, Indifference Curves and Budget Lines
02	Types of Cost, Revenue and Profit
03	Firms and Market Structures
04	Efficient resource allocation
05	Equity and Policies towards Income and Wealth Redistribution
06	Labour Market Forces
07	National Income Statistics
08	The Circular Flow of Income
09	Money Supply (theory)
10	Economic Growth, Economic Development and Sustainability
11	Government Macroeconomic Policy Aims

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ECONOMICS

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