

TOPIC

Production, Costs and Specialisation



Factors of production

Factors of production are the resources used to produce goods and to provide services. The four factors of production, or factor inputs, are:

-  **Land:** To economists, land means a little more than just real estate or property. Land also refers to all naturally occurring resources that can be used to produce things people want to consume. Land includes the weather, plant and animal life, geothermal energy and the electromagnetic spectrum
-  **Labour:** Labour includes the physical and mental effort that people contribute to the production of goods and services. The efforts of a teacher, a construction worker, an economist, a doctor, a taxi driver or a plumber all contribute to producing goods and services, and are all examples of labour.
-  **Capital:** Man-made machines, tools and structures that aren't directly consumed but are used to produce other things that people do directly consume. For example, a car that you drive for pleasure is a consumption good, whereas an identical car that you use to haul around bricks for your construction business is capital. Capital includes factories, roads, sewers, electrical grids, the Internet and so on
-  **Entrepreneurship:** Enterprise refers to the skills a business person requires to combine and manage successfully the other three factors of production and the ability to undertake risk. Entrepreneurship organises the other three factors of production and takes on the risks of success or failure of a business.

Specialisation

One of the ways in which more goods and services can be produced in the economy is through the process of specialisation. This refers to a situation where individuals and firms, regions and nations concentrate on producing some goods and services rather than others.

Specialisation at individual level



Specialisation can be illustrated at the individual level. Within the family there may be some specialisation in the performance of household tasks, with one person doing the ironing and gardening while another does the shopping and cooking.

Specialisation in the workplace

In the workplace, of course, the fact that some people are labourers or lorry drivers while others have office jobs is also a reflection of specialisation. At this level, specialisation allows individuals to concentrate upon what they are best at, meaning more goods and services will be produced.



With specialisation, however, although more is produced, no one is self-sufficient. It becomes necessary to exchange or trade goods and services. As an individual specialises, they will produce a surplus beyond their needs, which they can exchange for the surpluses of others.

Regional and national specialisation

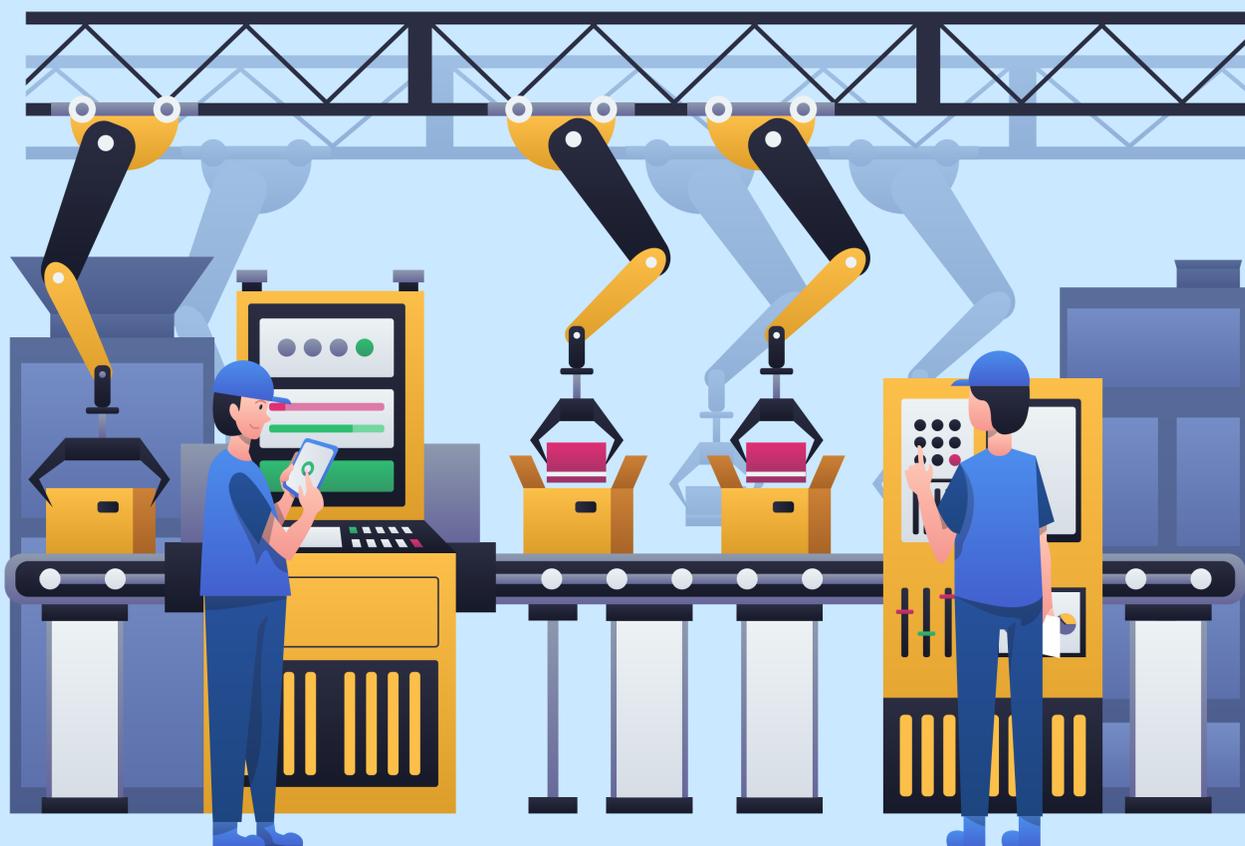
With the expansion of trade and the development of markets, the benefits of regional and national specialisation became apparent. Surpluses produced by regions and countries were bought and sold, allowing world living standards to rise. Just as individuals concentrated on what they were best at, so did regions and countries.



Division of labour

Division of labour is the splitting of a task into smaller, more specialized jobs where the worker repeats a given sequence of operations.

Modern manufacturing processes are usually split up into a number of tasks. A typical example is in a garment factory where each operative produces one part of an item of clothing such as a shirt sleeve or button holes. This division of labour is usually quicker and cheaper than having one person complete each garment on their own. It also allows workers to become more specialised and can lead to an increase in productivity and an improvement in the quality of the finished product.



Types of Division of labour

Simple

This refers to the division of the working population in society into different occupations eg., doctors, lawyers, technicians and teachers.

Complex

This occurs in productive processes in factories where no one worker makes a complete product. Thus, the production of the good is broken up into several processes each carried out by a different individual or group of individuals.

Territorial (localisation of industries)

This occurs when certain areas specialise in the production of a good. Thus one can find a fishing port or village; or a business district. Different industries are localised in different parts of the country.

Advantages of Division of labour

There are several advantages among which those cited by Adam Smith remains relevant.

Productivity yields

Adam Smith illustrated using the pin factory. If pin-making is divided into 18 separate operations, then the men can produce 48000 pins a day; meaning one man produces 4800 pins a day. But without division of labour, it is hardly possible for one man to produce even one pin let alone ten.

Improvement in dexterity and skill

Practice makes perfect. Doing a repetitive task day in and day out, a worker inevitably becomes an expert.

Creativity and inventiveness encouraged

Workers are free to expand thoughts on how to improve a particular process or product as he spends all his time on the same job process. He might be able to think of other ingenious ways to do the job and save more time and effort.

Savings in time and training as workers need few instructions on how to do the job.

Savings in tools and implements. As a worker does only part of a job, eg., making the seats of chairs, he does not have to have a complete set of tools. A set of tools can be used by many workers at different stages of production.

Efficiency can be increased when workers are paid piece-meal.

It creates a **diversity of jobs** in an economy and employment becomes more diversified.

Disadvantages of Division of labour

As Chapman explains, "Productiveness of a method of production is not the sole test of its value - to get many commodities is not the only end in life." Man has been affected by the practice of division of labour in more ways than one. Some of the disadvantages include:

Repetitive and monotonous tasks can blunt intelligence and imagination.

Work becomes a drudgery; something to be done and got over with quickly. Repetitive tasks can impair a person's mind and creativity.

Factory is dehumanised

Many workers combine to produce one product. They do not see the end product as their own work. As such, the individual worker quickly loses pride and the sense of responsibility in his work.

Limited skill

The expert carpenter begins to lose his skills when he is only employed to varnish furniture.

Danger of unemployment

Because a worker is skilled in only part of a job, the collapse of the industry he works in will mean that he will have to look for another where his limited skill will be relevant. A difficult task and he becomes quickly "unemployable".

Overcrowding and unhealthy work conditions especially where a set-up has become too large can frustrate workers. Such conditions can also be demeaning to workers. Sometimes, management does not want to bother with assembly-line workers' point of view, giving little recognition for individual effort and initiative.

Conclusion

Division of labour is here to stay in today's age of mass consumption and mass production. To overcome the negative effects, measures such as reducing working hours; having leisure activities and improving skill and education of workers plus looking after worker's welfare can improve workers' life under specialisation distinctly.

Costs of production

Time period

Businesses operate within a time period.

The short-run period – is a period when there is at least one fixed factor and so output can be adjusted only by making the variable factor eg., labour, work overtime or by using more raw materials. The time is too short however for altering fixed plant and equipment. The short run is a period of constraints.

The long run period – is a period which is sufficiently long enough for output to be adjusted not only by altering the variable factors but also the fixed factors.

Types of cost

Fixed costs

Fixed costs are costs that do not change directly with output. They are payments to factors whose quantities are fixed in the short run eg., factory rent, insurance, taxes, administrative expenses.

Variable costs (or direct costs)

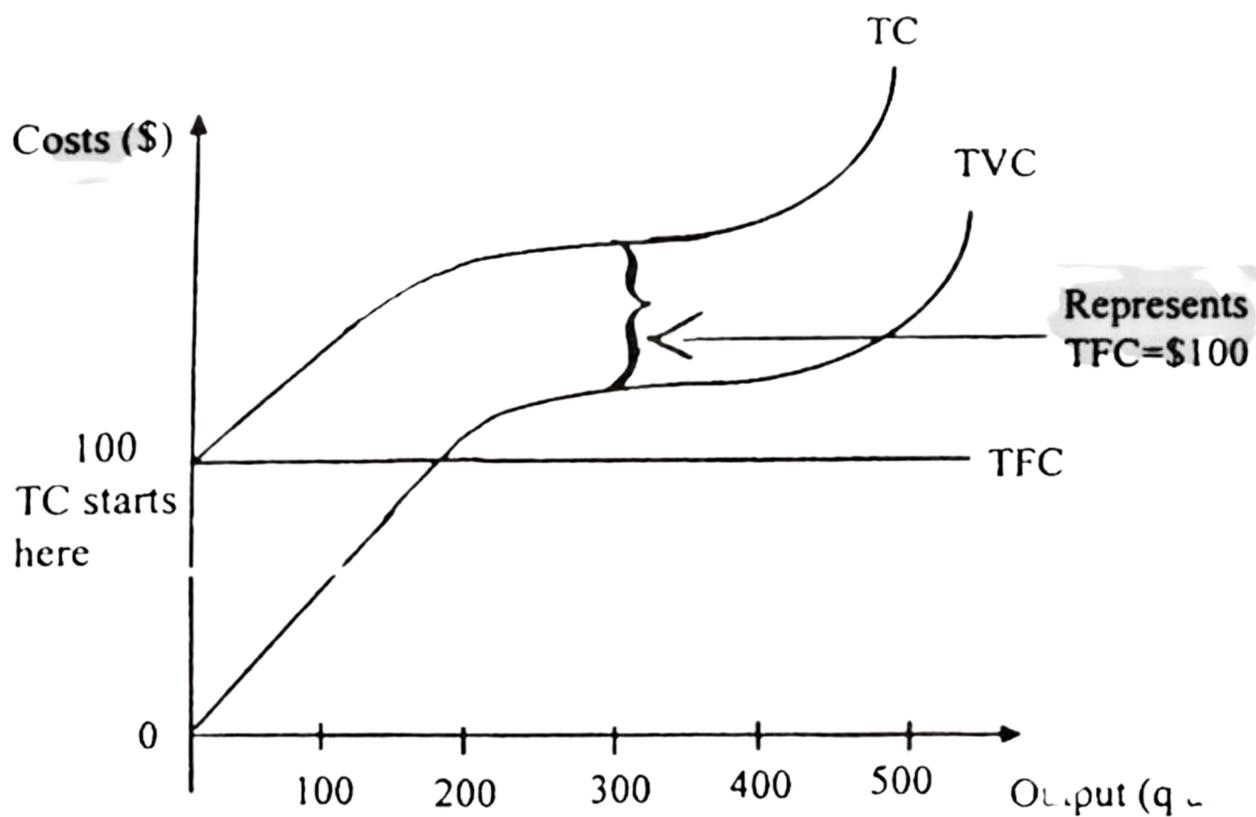
These are costs that vary directly with the level of output. In the short run period of production, these include payments to factors of production that can be altered in quantity eg., payments to labour, raw materials, fuel and power. Variable costs are also known as direct costs.

Total costs

Total costs is the sum of all costs incurred in producing any level of output. Total cost varies directly with output.

Total costs (TC) = Total Fixed Costs (TFC) + Total Variable Costs (TVC)

Relationship between TFC, TVC and TC



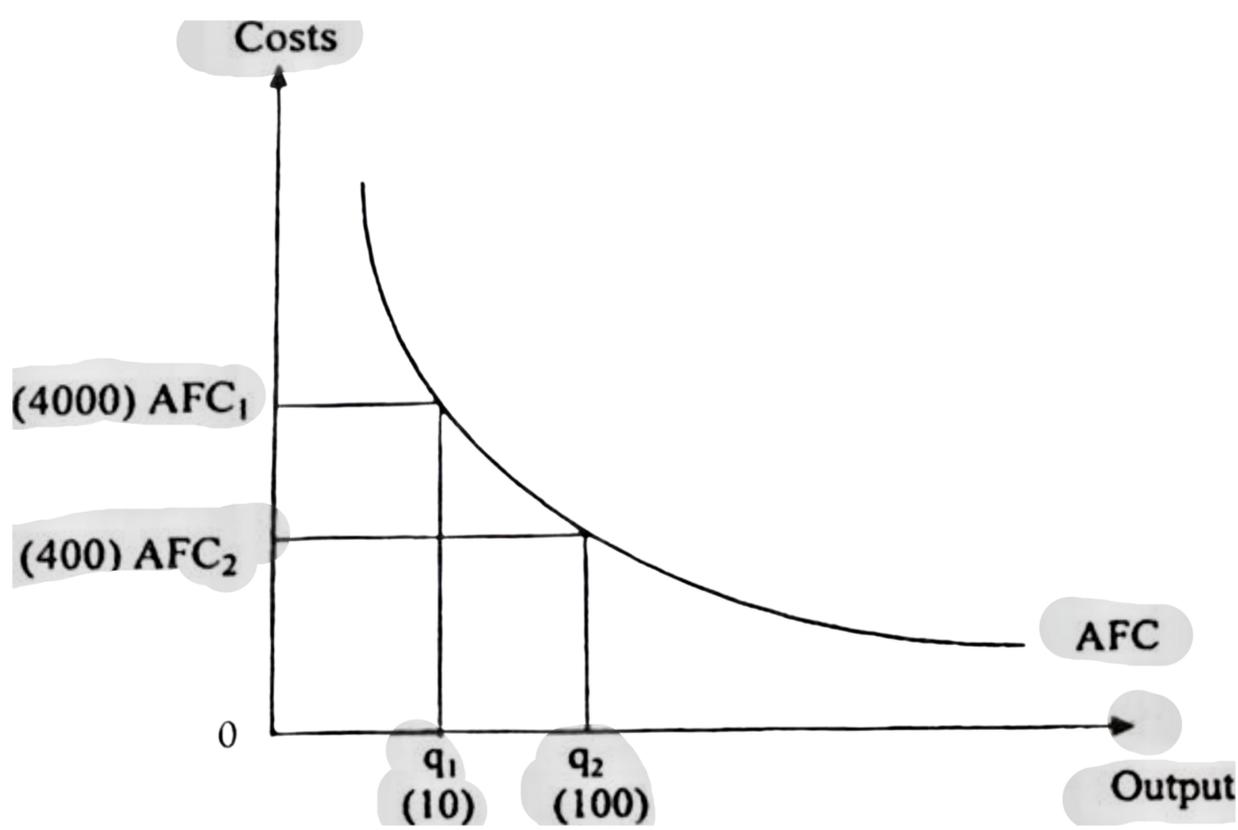
TFC is a horizontal line as fixed costs is not affected by changes in output in the short-run. TC starts at \$100 even at zero output as fixed costs have already been incurred eg., insurance, rent. Total costs is a summation of total fixed costs and total variable costs.

Average cost (AC) is the cost of producing any unit of output. AC is also known as unit cost.

$$AC = \frac{TC}{Output(q)};$$

$$AC = AFC + AVC$$

where Average Fixed Costs (AFC) = $\frac{TFC}{Output}$ \Rightarrow which implies that as output increases, and TFC remaining constant; AFC falls.



The rectangles beneath the AFC curves have the same areas ie.,

$$AFC_1 \times q_1 = TFC$$

$$AFC_2 \times q_2 = TFC$$

Thus for instance if $TFC = 40,000$, then $AFC_1 \times q_1 = 4000 \times 10$
 $= 40000$

$$AFC_2 \times q_2 = 400 \times 100$$

$$= 40000$$

Average variable cost

Average variable cost (AVC) = Total variable cost/Output

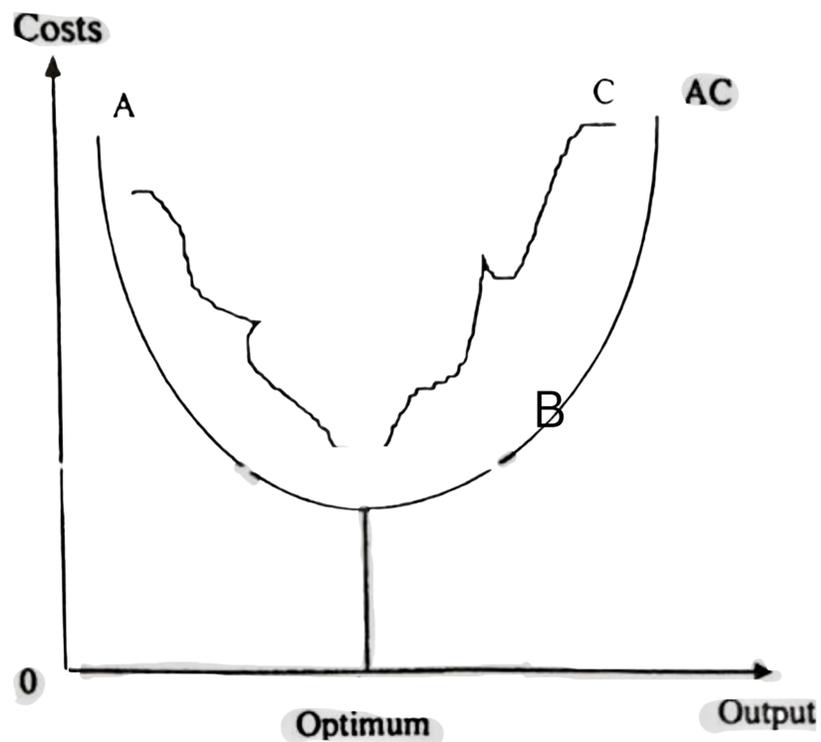
AVC first falls as output increases and then rises as output increases further.

At first, when output increases with the use of more variable factors, the plant and equipment are better utilized causing productivity to increase with efficient factor combination and specialisation. This sees AVC falling

When a level of output is reached where all the factors used are employed as efficiently as possible, AVC then falls to a minimum.

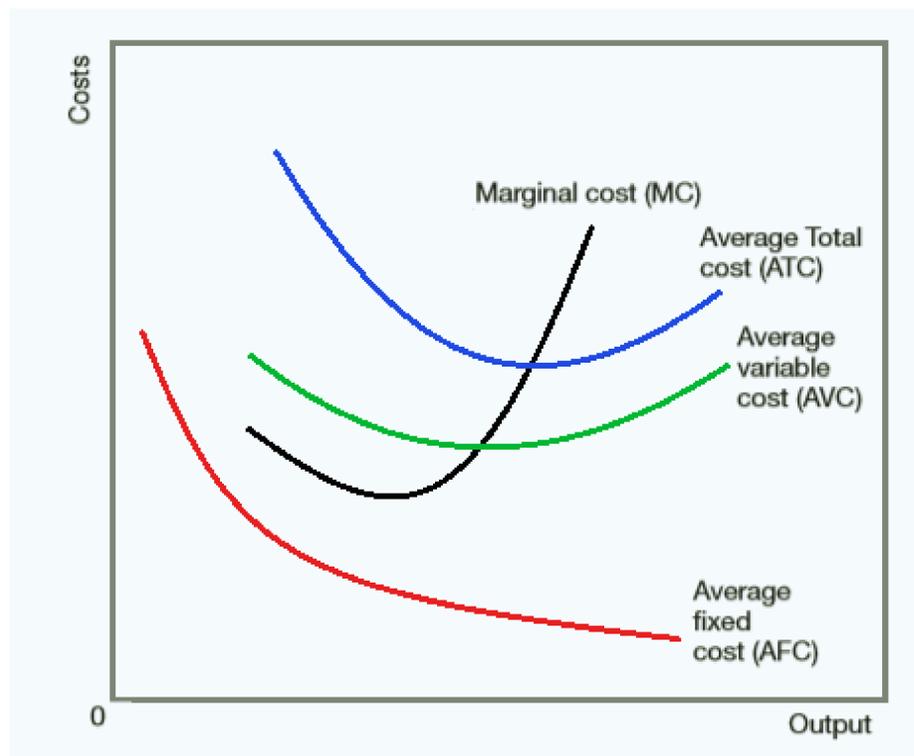
Beyond this output, further increases in output with a fixed plant designed for a certain optimum volume of production will cause the AVC to rise. When output exceeds this optimum capacity of the plant, the Law of Diminishing Returns applies.

In the range A to B, output is greater than costs. Costs keeps falling. At B, optimum output at lowest production cost is reached. In the range B to C, costs rise faster than output (diminishing returns have set in).



Marginal cost (MC)

This results from the increase in the use of variable factors. It is the increase in total costs resulting from the increase in output by one unit. The curve representing MC is J-shaped cutting the minimum points of both AVC and AC as it rises.



Average total cost (ATC)=
Average variable cost (AVC) +
Average fixed cost.

Optimum output occurs where AC
is at its lowest.

MC cuts at the minimum points of A VC and AC and these points are at different levels of output.

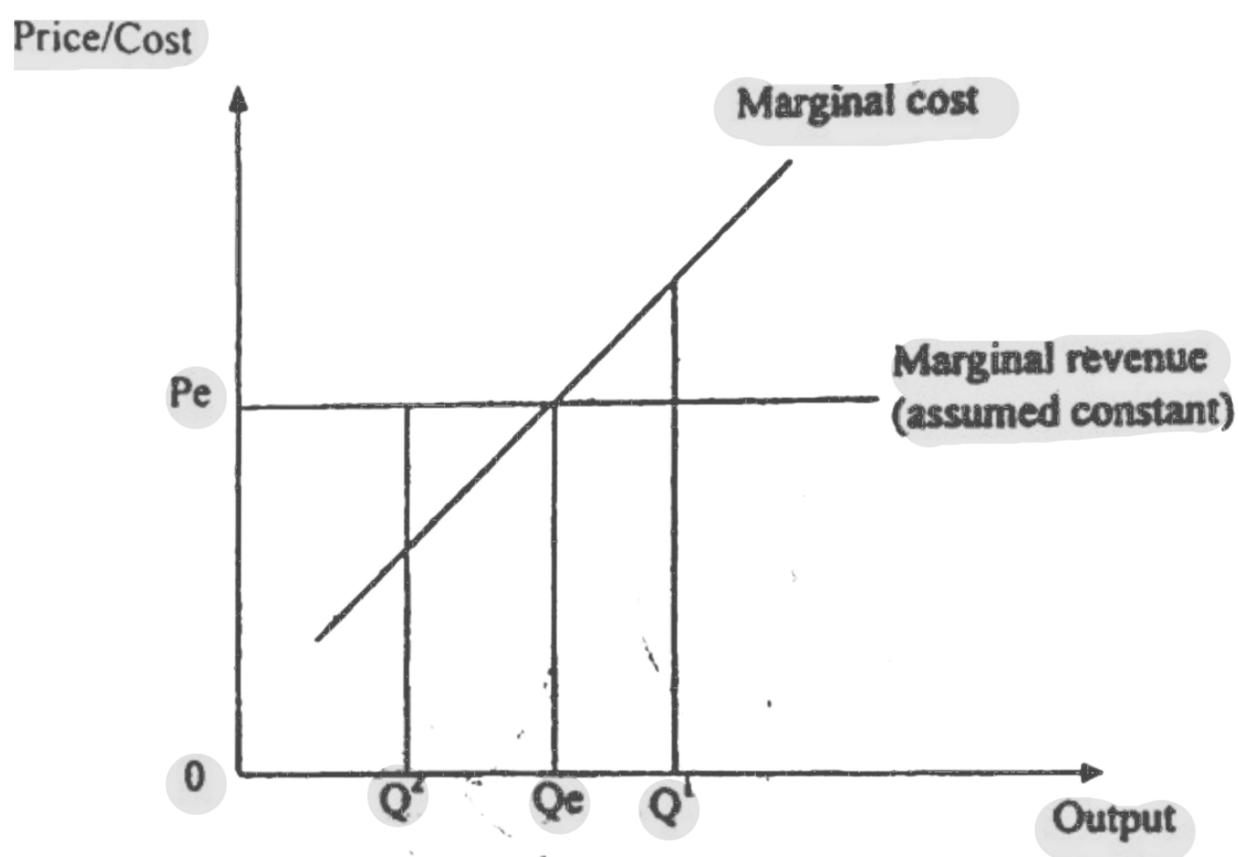
Relationship of marginal cost to average cost

1. ATC falls as long as MC is below it.
2. When ATC is rising, MC is above it.
3. When ATC is stationary ie., neither rising nor falling; MC intersects it (i.e AC = MC).
This is where ATC is at its minimum (optimum output).
4. When ATC is declining, MC may be falling, constant or rising.

Profit maximisation

Profit is that surplus created when total revenue is more than total costs;
 $\text{Total revenue} - \text{Total cost} = \text{Profit}$

All firms operate to maximise profits or minimise losses. Profits in economics, is maximised where marginal cost equal marginal revenue with marginal cost cutting marginal revenue from below. At this point, the extra cost of producing one more unit of the product exactly equals the marginal revenue obtained from the sale of one more unit of the product.



At Q_1 , marginal cost from producing one more unit of the product exceeds marginal revenue from the sale of one more unit of the product. It is not profitable for production to take place here as revenue is less than costs.

At Q_2 , revenue from the sale of an additional unit of the product is greater than the marginal cost of producing one more unit of the good. Revenue or profits can be further increased by increasing output at this stage.

Profit maximisation occurs at Q_e where $MC = MR$. This condition which applies to all market types (i.e. perfect and imperfect).

Long run costs of a firm

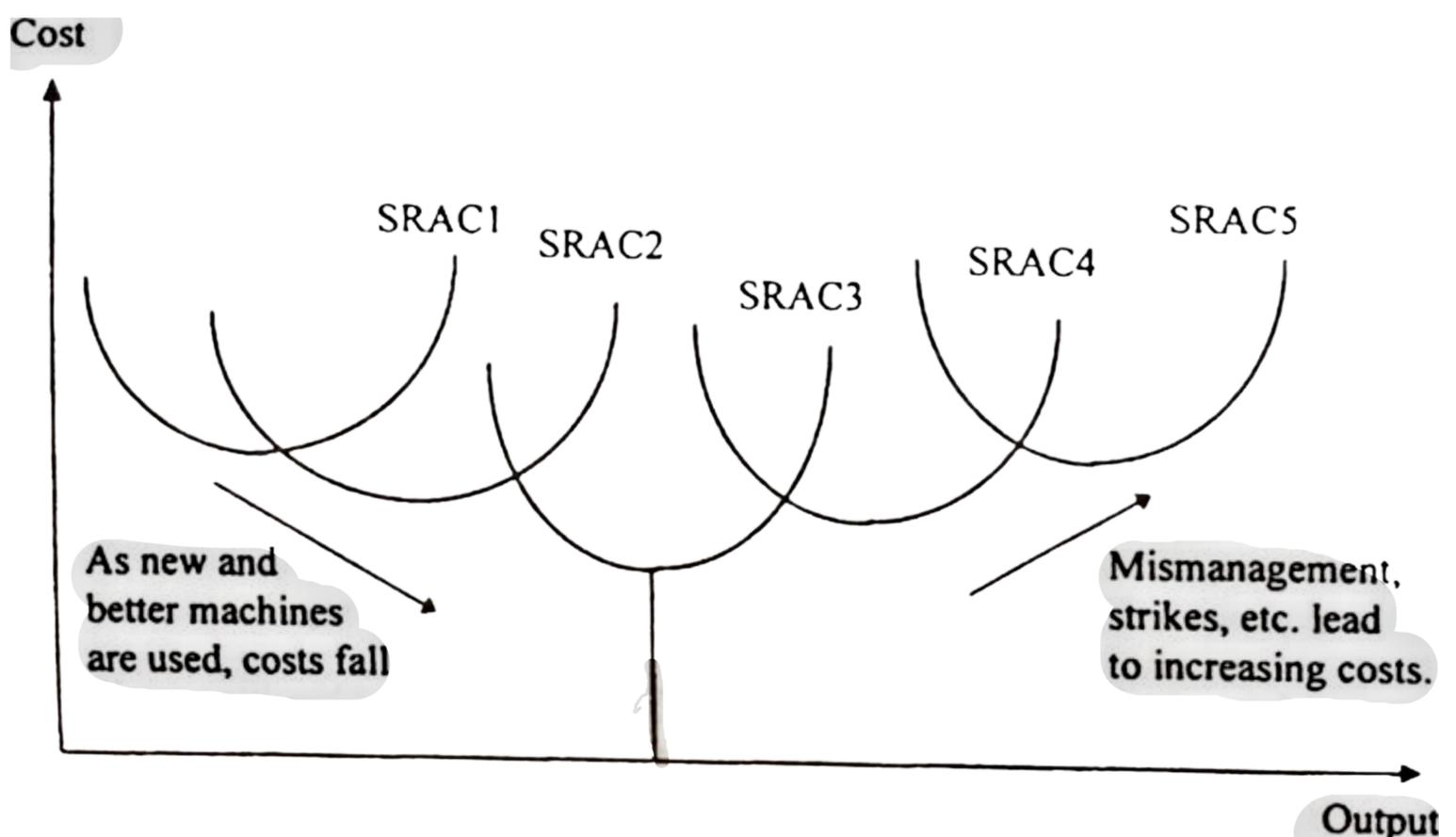
In the long run period of production, the firm can expand its output by changing the Size and organisation of the firm. There being no fixed factors, the firm can adjust quantity used of all factors to produce any required output in the most efficient way.

For each level of output, the firm tries to achieve optimum factor combination with an optimum (ie., efficient) plant size so as to minimise cost. The long run cost curve shows the lowest attainable cost of production for each level of output.

Deriving long run average cost curve (LRAC)

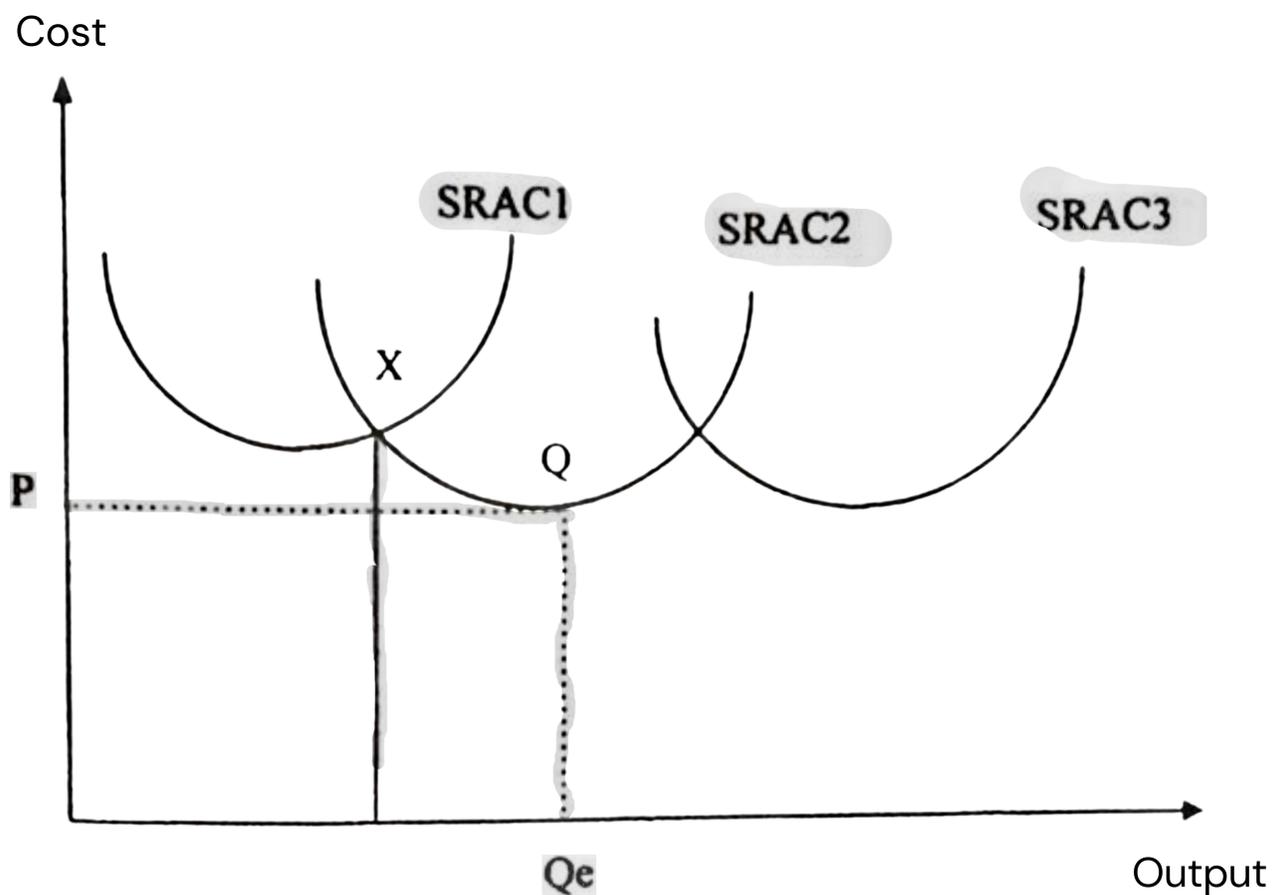
Each time the scale of operations changes in the long run, we represent it with a new short-run average cost curve SRAC

How LRAC is derived



In the short run the shape of the cost curve depends on the action of the law of diminishing returns usually taking capital and management as fixed factors. In the long run, since all factors can be used in differing proportions, the scale of operation can be altered. The slope of the long-run average cost curve depends on returns to scale.

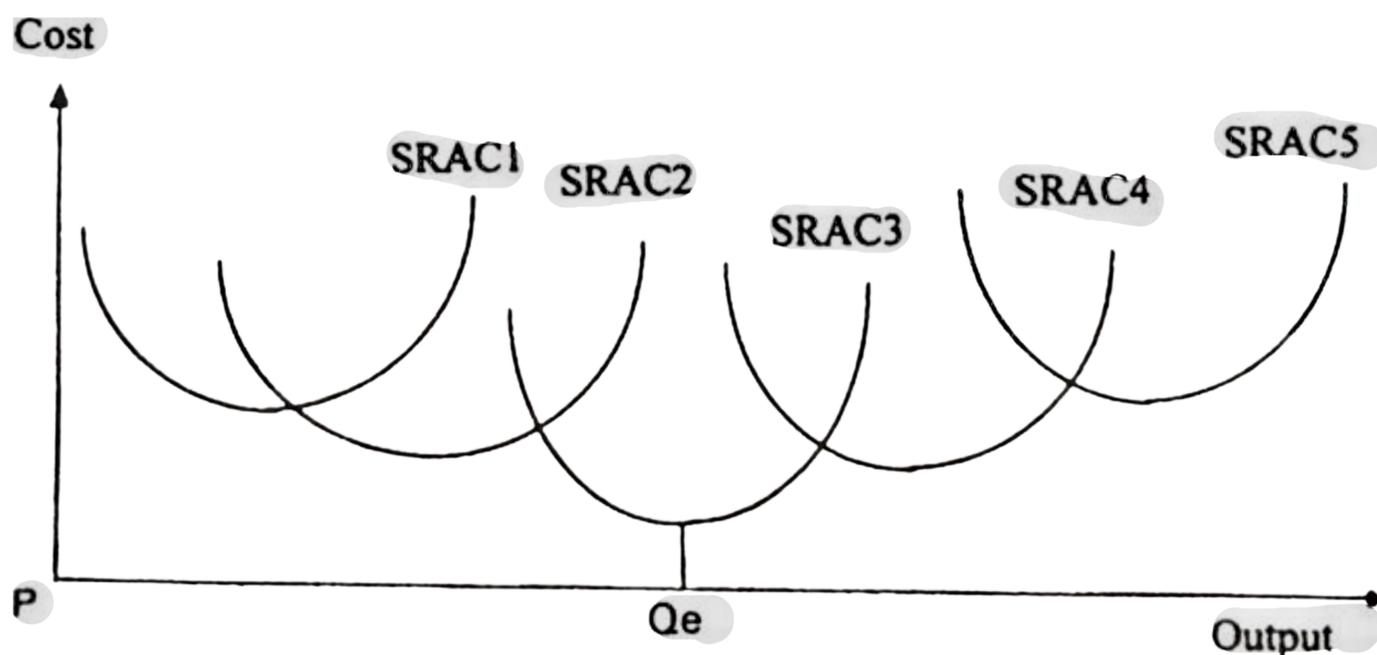
Figure - How LRAC is derived



Referring to the figure above, assume the firm operates with 2 machines SRAC₁ and SRAC₂:

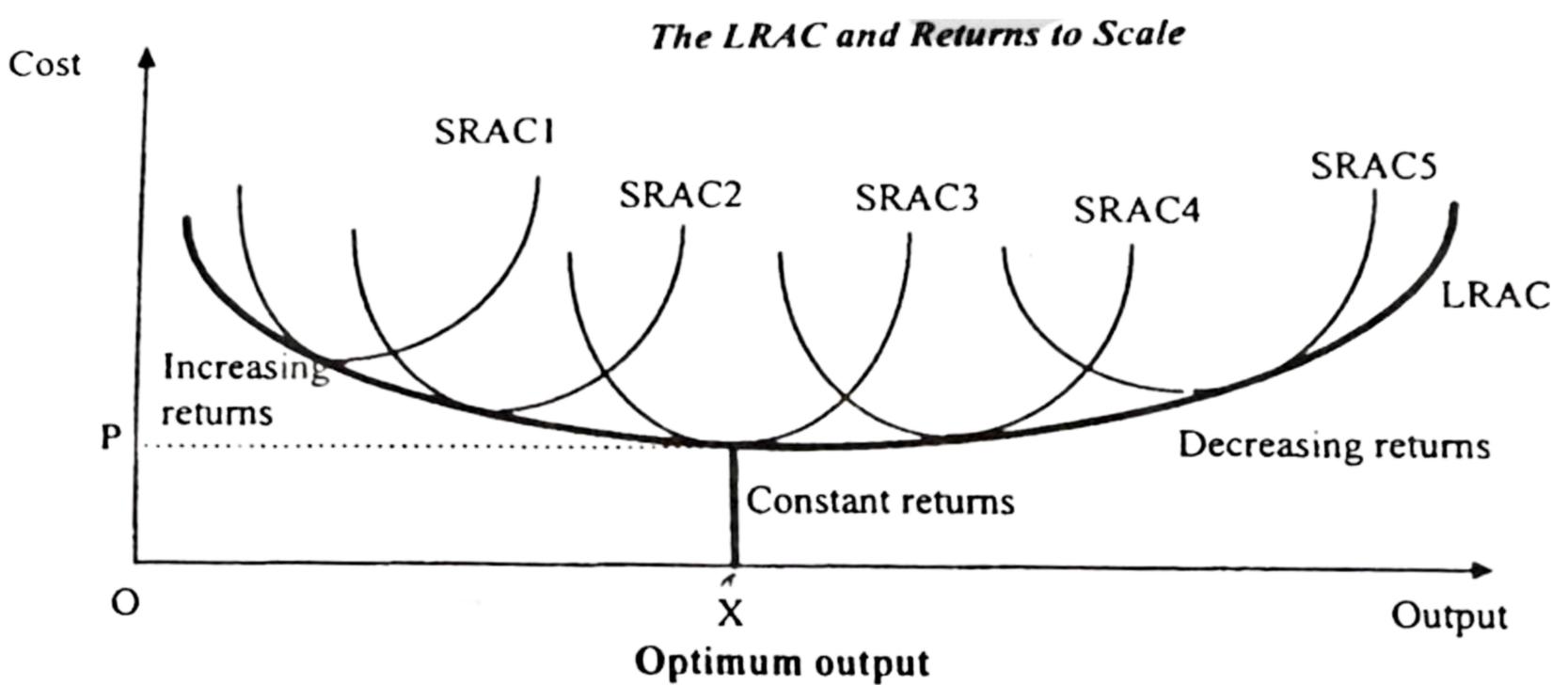
1. Q_e represents optimum output produced at lowest attainable cost. A new machine if installed - SRAC₃, can see cost reducing further yet.
2. After the point X, where SRAC₁ cuts SRAC₂, all levels of output will be more cheaply produced using the new machine (SRAC₂). The rule is that a new machine is wanted if increased output can be produced at lower cost.

The LRAC Curve



Referring to the figure above, the bold parts of all the SRAC curves make up the scallop format of the LRAC curve, it is along this range that output can be produced most cheaply and efficiently. The LRAC curve is an envelope curve containing a series of SRAC curves. It takes that shape (scallop) as machines used are indivisible. If machines can be broken down then the cost curves will be closer to one another. The more SRACs there are, the smoother the LRAC curve.

It should be observed that the LRAC does not touch the minimum points of each SRAC curve. Only at the lowest SRAC, is long run optimum output attained.



Output less than the optimum is produced along the falling parts of all the SRACs.

Output beyond optimum is produced along the rising part of all SRACs.

It is obvious by now that the LRAC curve is obtained by drawing a curve tangent to the falling portions of the SRAC curves. The LRAC curve is U-shaped as it experiences increasing, constant and decreasing returns to scale. The declining portion of the LRAC is due to the existence of economies of scale. Such economies result in a more than proportionate rise in output corresponding to an increase in input.

Long run optimum output in the figure above is at point X. At this point, the firm would have achieved its lowest long run cost. Beyond the optimum size, if the scale of operation is expanded further, decreasing returns set in. This causes long run costs to rise. However, new advances in technology can reverse this trend.

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10. Market structures
11. Behavioural economics
12. Types of goods
13. Costs and benefits
14. Market failure
15. Microeconomic policies
16. Population
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18. Inflation and deflation
19. Policies to correct inflation and deflation
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01

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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)

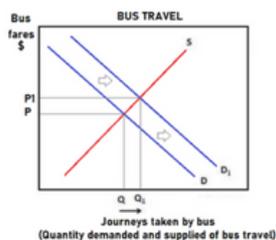
Demand refers to both the willingness and the ability of customers to pay a given price to buy a good or service. There are several factors which could lead to an increase in the demand for bus travel in the future.

(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

Economics Data Questions.

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

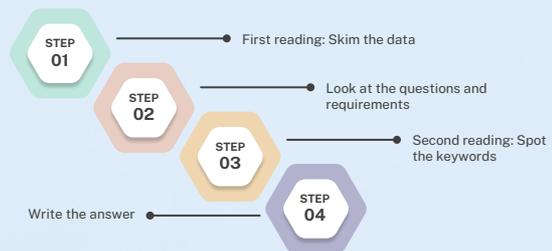
LOOK AT THE TITLE
Look at the title as it may give some clues about its content.

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.

(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.

PARAGRAPHS

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.

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.

SIMPLE ENGLISH

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.

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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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 Expenditur
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

Topic

Questions

Paper and year

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/P2/02]

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/P2/04]

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/P1/05]

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/P2/03]

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 cost of the production of ovens
 [211/P2/01]

6. What is meant by the economic problem?
 A how to satisfy everyone's needs with limited resources
 B how to satisfy the needs of the public and private sectors
 C how to satisfy unlimited needs 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 amount of resources. The second uses a limited amount 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 the cost of producing ovens
 C the cost of producing washing machines
 D the cost of the production of ovens
 [211/P2/01]

8. A firm has two production processes. The first uses an unlimited amount of resources. The second uses a limited amount 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 the cost of producing ovens
 C the cost of producing washing machines
 D the cost of the production of ovens
 [211/P2/01]

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
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