The Economic Problem

Scarcity and Choice

The term consumer means? A consumer is an individual who buys and uses a product

What is a household? A household is made up of individuals who live in the same dwelling and whose spending decisions are connected.

Explain wants and needs. A need is something essential for survival eg food satisfies hungry people. A want is something desirable but not essential to survival eg cola quenches thirst.

How are wants and needs satisfied? Consumer wants and needs are satisfied (met) by consuming (using) products

Why are wants unlimited? Almost everyone always wants more goods and services

Define products, goods & services

- A product is an item that satisfies a want or a need and can be either a good or a service
- A good is physical items such as food or a car that satisfies a need or a want
- A service is a non-physical item such as education that meets a need or a want.

What are resources? Resources are items used to produce goods & services (products) eg workers and machines and are often referred to as inputs

How are products made? Products are made by using resources such as labour and land

What is a firm? A firm hires and organises resources to produce goods and services.

Explain scarcity. Scarcity occurs because our limited resources are insufficient to make all the products consumers want. Some individual and collective wants are left unsatisfied.

What is the economic problem? Unlimited wants and scare resources mean no society can produce sufficient products to satisfy everyone’s wants. Choices have to be made. This means the economic problem is how to allocate scarce resources between alternative uses

Define choice. Selecting one option between alternatives.

Explain trade-offs. Given scarcity, economic choices involve deciding between more of one item for less of another. Trade-offs refer to the decision making process in deciding on whether or not to give up one product to gain another.

Define opportunity cost. Choices involve deciding between alternative courses of action. Opportunity cost measures the cost of an economic activity in terms of the best forgone alternative ie the product, time, income or resource sacrificed in choosing one course of action

Give examples of opportunity cost for a product, time, income and use of resources. Making a choice involves sacrifice. Opportunity cost is the best alternative foregone. Eg

- Consumers decide what products to buy with limited income: a computer or a holiday
- Workers decide how to use time: extra hour overtime for pay or more leisure time.
- Producing wheat means land cannot be used that year to harvest potatoes.
- Government may have to decide between building a new hospital or four new schools
- An economy investing in capital goods sacrifices current production of consumer goods.

Explain economic goods. Any product produced using scarce resources is an economic good.

What are free goods? Any product created without using scarce resources is a free good eg sunlight and fresh air. Consuming free goods involves no opportunity cost.

Are goods supplied free of charge free goods? No. free Products supplied, eg health care on the NHS, use up limited resources and so are economic goods with an opportunity cost.
Resources

What are factors of production? The term used in economics to categorise resources

List the four factors of production and their reward

<table>
<thead>
<tr>
<th>Factor</th>
<th>Description</th>
<th>Reward</th>
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<tbody>
<tr>
<td>Land</td>
<td>all natural resources (gifts of nature) including fields, mineral wealth, and fishing stocks</td>
<td>the reward for landlords for allowing firms to use their property is rent</td>
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<tr>
<td>Labour</td>
<td>The physical and mental work of people whether by hand, by brain, skilled or unskilled</td>
<td>the reward for workers giving up time to help create products is wages or salaries</td>
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<tr>
<td>Capital</td>
<td>Man made goods used to produce more goods including factories (plant), machines and roads.</td>
<td>the reward for creditors lending money to firms to invest in buildings and capital equipment is interest</td>
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<tr>
<td>Enterprise</td>
<td>An entrepreneur risks financial capital and organises land labour &amp; capital to produce output in the hope of profit.</td>
<td>the reward for individuals risking funds and offering products for sale is profit. Unsuccessful firms make losses.</td>
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How can the quantity of labour be increased? Through immigration, rising retirement age or encouraging people of working age without a job to take up employment increases

How is the quality of labour improved? Education and training increases the capability of workers and so raises output per worker (labour productivity), allowing more wants to be satisfied.

Identify different types of capital

- Physical capital is plant buildings and machinery. Capital goods increases productive capacity eg a fisherman can catch 10 fish a day by hand but a 100 with a simple fishing net.
- Financial capital refers to financial assets such as savings & shares
- Human capital is the skill knowledge and expertise workers acquire through experience education and training
- Social capital is society’s infrastructure eg roads, schools & hospitals.

Define investment. Investment is spending on new producer goods

What is the difference between consumer & producer goods? Consumer goods satisfy wants and needs now. Producer or capital goods such as offices, factories and machinery are useful not in themselves but are valued because they can help produce items in the future.

What is infrastructure? Infrastructure is the stock of underlying capital used to support the economic system and enable economic activity eg roads, airports, and satellites

What an entrepreneur In market economies, entrepreneurs risk their own financial capital (money) hiring and organising land labour & capital, to create output.

What are the risks and rewards of enterprise? Successful firms earn profits and attract competitors. Unsuccessful entrepreneurs make a loss and may have to leave the industry.

Distinguish between renewable & non-renewable resources. Renewable resources are replenished (replaced) by natural processes eg fish breed and replace themselves. Non-renewable resources are not replaced naturally eg oil, coal & natural gas are lost when used.
Production Possibility Curves

Define a production possibility curve (PPC)? A production possibility curve (PPC) shows the combination of two products an economy can make in a given time period with current resources and technology. A PPC shows the ability of a country to make goods & services ie its productive capacity. Some countries fail to make full use of their scarce resources.

What assumptions are made when drawing a PPC? A PPC is drawn assuming a country has a fixed quantity & quality of resources and a constant state of technology.

What is productive efficiency? This occurs when output is maximised from given inputs.

Draw a PPC to illustrate productive capacity and efficiency.

In the diagram opposite, LM is a production possibility curve

Points inside the PPC (eg A) imply unemployed or inefficiently used resources

Points along the PPC (eg B or C) indicate a full employment of resources and productive efficiency

Points outside the PPC (eg D) are beyond the current productive potential of the economy.

Use a production possibility curve to illustrate opportunity cost.

Switching resources involves an opportunity cost ie the best alternative sacrificed. The opportunity cost of producing OE amount of good X is LF - the amount of good Y that could have been produced instead.

The opportunity cost of reallocating resources from B to C to gain EG of good X is FH - the amount of Y sacrificed.

Why are PPCs drawn as straight lines? A straight line PPB indicates constant opportunity cost. Resources are equally efficient in the production of both items. Every extra unit of X involves the sacrifice of the same amount of good Y.

Why are PPCs drawn as a curve? A concave (bowed outwards) production possibility curve indicates increasing opportunity cost. Some resources are better suited to making one item than another. As more of good X is produced increasing amounts of good Y have to be foregone to produce an extra unit of good X.

Why do PPCs shift? An increase in the quantity or quality of resources increases an economy's productive potential and shifts the PPC curve to the right.

What is economic growth? Economic growth is an increase in the amount of products produced by a country (GDP) - enabled by an increase in the quantity or quality of resources.
What is potential economic growth? Potential economic growth is an increase in a country's ability to create products. It is entirely possible for a country to fail to use additional capacity.

Use a PPC to illustrate economic growth.

Reallocation of resources from consumer to producer goods reduces current consumption. If the economy moves from A to B, the opportunity cost of FH more capital (extra investment) is EG sacrificed consumer goods.

In the next time period, extra producer goods increase productive capacity shifting the PPC from LM to TV. The economy can now make more consumer & more capital goods.

Use PPCs to show an increase in productivity.

Productivity refers to output per input. If productivity increases for one product but not another, the PPC pivots.

In the diagram an increase in productivity means an increase from 0M to 0V in the amount of wheat that can be made with current resources.

Assuming productivity in maize is unchanged, the PPC pivots around L and becomes LM.

Categorising Economic Activity

Define a household. An individual or group of people who live at the same address

Define a firm. A firm is an organisation that hires and organises resources to make products

List the types of economic sector. Production can be classified into categories:

- **Primary sector** extracts natural resources eg farming, fishing, quarrying and mining.
- **Secondary sector** manufactures goods eg, cars, construction & energy utilities
- **Tertiary sector** creates services eg transport, tourism, banking, insurance and retail

What is the quaternary sector? Some economists put intellectual and information processing services into a quaternary sector eg scientific research, R&D, education, and IT.

What is the private sector? The private sector is made up of households and firms controlled by private individuals.

What is the public sector? The public sector is made up of the central government in London, local government, and public corporations (firms controlled by the state) eg the Post Office.
Economic Methodology

What is economic methodology? As a social science economics uses scientific methodology:

- **A model** is built describing the behaviour of economic variables (influencing factors). A model is a simplified view of complex relationships and processes.
- Economists use models to make **predictions** about **empirical** (real world) behaviour.

What is Ceteris paribus? Ceteris paribus means *all other things being equal*. Economists recognise that many factors affect an economic variable. Eg demand is influenced by the price of the good, income, taste, etc. To simplify and enable analysis, economists isolate the relationship between two variables by assuming ceteris paribus - ie that all other influencing factors are held constant. In analysing markets, we assume all factors influencing demand are being held constant except price.

**Explain positive and normative economics**

- **Positive economics** deals with statements of fact that can be proved or disproved, and shows how the economy actually works.
- **Normative economics** deals with statements of opinion which cannot be proved or disproved, and suggests what should be done to solve economic problems.

Specialisation & Trade

**Specialisation**

What is self-sufficiency? Self-sufficiency is where individuals regions or countries rely solely on their own output to meet all their wants and needs. There is no trade.

**Explain specialisation.** Specialisation is when individuals, firms, regions or countries concentrate on a particular product or task. Eg bakers spend all day making bread and trade the resultant surplus for items such as milk they have not had time to produce themselves.

What is trade? Trade is the exchange of products. Exchange means trading or swapping.

**Why do economies specialise and trade?** Individuals have different skills. Regions or countries have different factor endowments eg varied climate, labour force skills, and natural resources. This means some individuals, firms, etc are better at making certain products than others. It makes sense for them to concentrate on making those products they are best at making. Surpluses are then traded for items from other more efficient specialists.

**How does transport aid specialisation?** Transport increases the size of a market and allows production and consumption to take place in widely different locations eg China and the UK.

What is productivity? Productivity refers to output per input. Labour productivity is the number of items a worker makes in a given time period eg 100 units a day.

**What is the division of labour?** The division of labour is a particular type of specialisation where the production of a good is broken up into many separate tasks each performed by one person. An early economist, Adam Smith, suggested one worker alone can produce just ten pins in one day. However, in a pin factory where each worker performs one task, ten workers using the division of labour principle, produce a daily total of 48 000 pins. Output per person (productivity) rises from 10 to 4800 with the division of labour. Unit costs fall.

**Why does division of labour raise productivity?** Specialisation or the constant repetition of a task increases the skill and expertise and so increases the output per hour of a worker.

**What are the risks of the division of labour?** Eventually the division of labour may reduce productivity and increase unit costs because unrewarding, repetitive work lowers motivation and productivity. Workers begin to take less pride in their work and quality suffers.
What are the benefits of specialisation? Concentrating on a particular product or task means:

- Increased output so that more wants can be satisfied
- A greater variety of products on sale ie more and better choice
- An increase the size of the market offering opportunities for economies of scale

What are the risks of specialisation? Specialisation makes individuals, firms, regions or countries interconnected and interdependent, relying on others to supply key products

Explain interdependence. Trading partners become mutually dependent on one another.

How are specialisation, trade and interdependence linked? Specialisation creates surpluses. These surpluses are traded. Each party in exchange becomes dependent on the other.

Economic Systems

Markets

What is a market? A market is the place where buyers and sellers meet to exchange a product. Markets require consumers (buyers) producers or firms (sellers) and products to trade.

Do markets need a geographical area? No. Trade simply requires a method of communication eg face-to-face in a local market or via the Internet.

What is the scope of a market? Markets can operate at a local, national or global level

Give example of market types. Any item that can be bought or sold has a market. Examples include product, housing, labour, foreign exchange, and stock markets

What is a sub market? A submarket a market segment (part of the market) made up of customers with similar wants. The market for most goods broken down into sub markets eg

- Housing sub markets include terraced, semi-detached and detached homes
- Cars makers divide the car market into sub markets eg minis, MPVs, sports cars, etc.

What is an objective? An objective is a target an individual or organisation wants to achieve

List the objectives of consumers. Consumers want to maximise the satisfaction they gain from their purchases. They want low price, high quality products.

List the objectives of firms. Suppliers normally want to maximise the profits from selling products. Alternatively firms may seek to maximise sales, revenue or consumer welfare.

Explain the term profit. Profit is the difference between the revenue (income) earned from selling a product and the cost (expense) of making the item

How are markets connected? A change in the price of one product can affect the market for other linked products. Eg: if strawberries become more expensive then

- some consumers switch to buying substitute products such as raspberries, instead
- some consumers stop buying complement products used with strawberries such as cream
- some producers using strawberries as an input have higher costs eg jam suppliers
Economic Systems

What economic questions must all societies face? The economic problem of scarce resources and unlimited wants means all societies have to decide on:

- **What items to produce**: do we use scarce resources to build and run hospitals or hotels
- **How best to produce items**: what is the most efficient use of scarce resources
- **Who is to receive products**: eg who gets scarce hospital treatment - and who not?

What is an economic system? An economic system is the method used by society to deal with production, distribution and consumption ie what how and for whom to produce

List the three main types of economic system. Command, market and mixed

Define a command economy. A command or centrally planned economy is a type of economic system where the state owns and allocates resources.

How does a command economy work? In a planned economy, the state owns resources and decides what is to be produced, based on its own view of peoples’ wants. The state also decides how products are to be made; prices and wages; and who receives products. Products are often rationed or sold on a first-come-first served basis resulting in queuing

How does a market economy work? Households own most resources and markets allocate resources via the price mechanism. An increase in demand raises price and encourages firms to switch additional resources into the production of that product. The amount of goods and services consumed by households depends on their income. The role of government is limited.

What is a mixed economy? A mixed economy has a private and public sector and uses both market forces and state control to allocate scarce resources between alternative uses. Supply and demand allocates most consumer goods, but government makes decisions on the production and pricing of public services such health care and education.

List the advantages of a market economy

- Competition gives firms the incentive to produce items at lowest possible unit costs. Inefficient firms that cannot match the price of their rivals are forced out of the market.
- Consumer sovereignty: the profit motive means firms try to produce items consumers want.
- Quick response to changes in consumer taste. Eg suddenly popular products rise in price. Existing firms respond by hiring more resources. New firms are attracted to the market.
- Choice. Consumers, producers and workers are free to pursue their own self interest

State the disadvantages of a market economy Unregulated free markets can result in

- Self-interest working against public interests eg cost cutting firms polluting the environment
- A lack of information causing beneficial products such as health care being under consumed and harmful products such as cigarettes being over consumed.
- Monopolists charging high prices and earning supernormal profits
- Essential items such as street lighting and defence not being produced at all
- the poor being unable to buy health care or education for their children

What is market failure? Market failure occurs when the forces of supply and demand deliver an inefficient use of resources. This topic is covered in great depth later in the course