Revision – Section 1 Topics

Opportunity cost and important definitions

Scarcity: The world's resources are limited, but human wants and needs are unlimited. Therefore scarcity exists. Scarcity is the basic economic problem. Because scarcity exists, resources have to be allocated. To the economist, all goods and services that have a price are considered to be scarce relative to people's demand for them.

Opportunity cost: Because scarcity exists, and people do not have infinite income, choices have to be made. When a choice is made, something is inevitably sacrificed. That which is sacrificed is called the opportunity cost. Opportunity cost is the value of something in terms of the next best alternative that was given up.

Free goods: A free good is unlimited in supply. When a free good is consumed, there is no opportunity cost. Free goods have no price.

Utility: Utility is an economics term that refers to the value of something to consumers. Utility reflects the satisfaction that a good brings to a consumer.

The basic economic problem

The choices that have to be made in economics about rationing scarce resources are often expressed in terms of three questions and are known as the basic economic problem:

1. What should be produced (and in what quantities)?
2. How should things be produced?
3. Who should things be produced for?

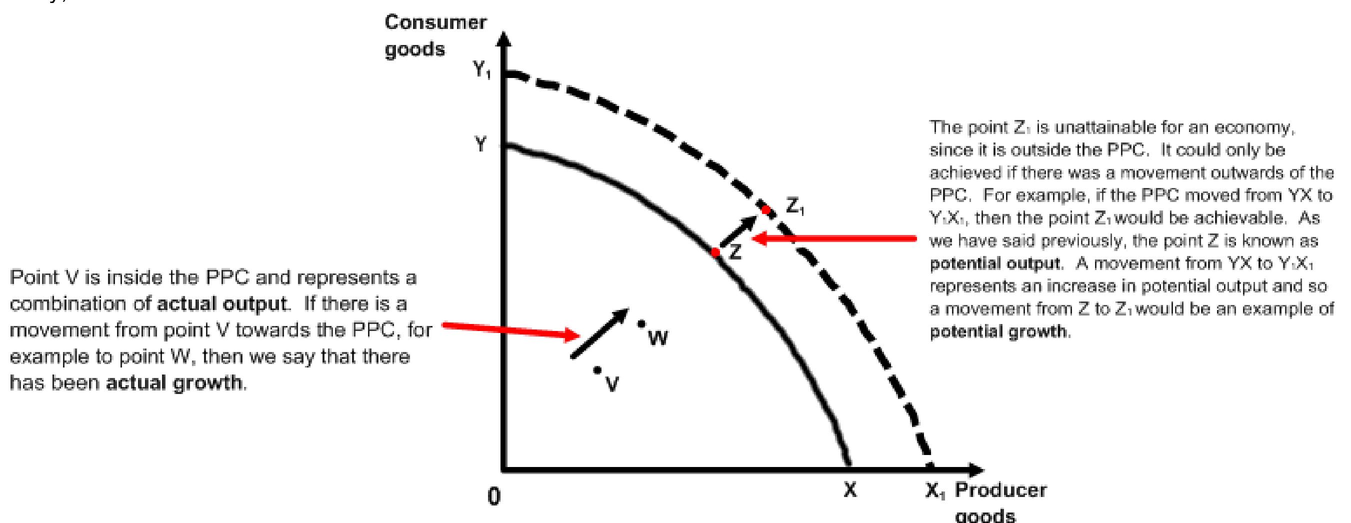
The problems all relate to the allocation of resources. Resources are also known as factors of production. Factors of production allow an economy to produce its output (goods and services). Economists separate resources into 4 factors of production:

- Land: these are the natural (resources that come from nature) resources that are used to produce goods and services. For example, land itself, lumber, trees, and oil. The payment to land is rent.
- Labour: these are the human resources that are used to produce goods and services. This includes the workers that produce goods, such as factory workers and the workers that produce services, such as teachers. The payment to labour is wages.
- Capital: this includes all equipment, machinery and factories that are used to produce goods and services. Capital includes anything that was made by human and is used to make goods and services. The payment to capital is interest.
- Entrepreneurship (management): this includes the risk-taking and creative activities of people when they are bringing together the other factors of production. The payment to management is profit.

Production possibilities curves (PPCs)

A **production possibility curve** (PPC) shows the maximum combinations of goods and services that can be produced by an economy in a given time period, if all the resources in the economy are being used fully and efficiently and the state of technology is fixed. It is said to show **potential output**.

Any point inside the PPC is possible to achieve, but it means that not all of the factors of production in the economy are being used and/or some of the factors are being used inefficiently. In reality, of course, economies are always producing within their PPC´s, since there are always some unemployed factors of production in a country. For example, there is not a single economy in the world where the entire workforce is actually working at any given time. There will always be some unemployment in an economy, no matter how small.



An outward shift of the PPC can only be achieved if there is an improvement in the quantity and/or quality of factors of production. If achieved, it means that there is an increase in potential output but, of course, this does not necessarily mean that there is an increase in actual output. That would require a movement of the present point of actual output towards the new PPC. If there were to be a fall in the quantity of factors of production, then this would cause the PPC to shift inwards. This might be due to war or natural disasters.

Positive and normative economics

A **positive statement** is one that may be proven to be right or wrong by looking at the facts. A **normative statement** is a matter of opinion and cannot be conclusively proven to be right or wrong. It is usually easy to spot because it uses value-judgement words such as 'ought', 'should', 'too much' and 'too little'.

Positive economics deals with areas of the subject that are capable of being proven to be correct or not. **Normative economics** deals with areas of the subject that are open to personal opinion and belief. Whilst it is easier to be confident in matters of positive economics, it is often more interesting dealing with questions in normative economics, even though a conclusive outcome is very unlikely.

Economic growth, economic development and sustainable development

Economic growth is an increase in a country's national output, measured by an increase in Gross Domestic Product. It is a one-dimensional concept that includes only a monetary measure of the increase in output.

Economic development is a multidimensional concept and so it is much harder to define. If economic development occurs, then the standard of living a country's citizens is improving. People enjoy more choices and more freedoms. They enjoy better health, better education and greater access to goods and services.

Though there are many development indicators, a commonly-used one is the **Human Development Index (HDI)**. This is a composite measure that sums up three indicators of development: **life expectancy**, to gain an understanding of the health of the population; **literacy and school enrolment** to gain an understanding of the education of the population and **GDP per capita (at $PPP)** to gain an understanding of the population's access to goods and services.

Sustainable development: Sustainable development refers to economic development that meets the needs of present generations but does not compromise the ability of future generations to meet their needs.

Planned and free market economies

1. **Planned economies -** In a planned economy, sometimes called a centrally planned economy, or a command economy, decisions as to what to produce, how to produce, and who to produce for, are made by a central body, the government. All resources are collectively owned. Government bodies arrange all production, set wages, and set prices through central planning. Decisions are made by the government on behalf of the people and, in theory, in their best interests.

2. **Free market economies -** In a free market economy, sometimes called a private enterprise economy, or capitalism, prices are used to ration goods and services. All production is in private hands and demand and supply are left free to set wages and prices in the economy. The economy should work relatively efficiently and there should be few cases of surpluses and shortages.

   Individuals make independent decisions about what products they would like to purchase at given prices and producers then make decisions about whether they are prepared to provide those products. The producers' decisions are based upon the likelihood of profits being made. If there are changes in the pattern of demand, then there will be changes in the pattern of supply in order to meet the new demand pattern. A change in the demand of consumers sends 'signals' that bring about a chain of events that re-allocates factors of production and makes sure that the wishes of the consumers are met. The free market system is a self-righting system.

In reality, all economies are **mixed economies**. What is different is the degree of the mix from country to country. Some countries, such as China, have high levels of planning and government involvement in the economy. Even in the seemingly free economies, such as the USA, the UK, or even Hong Kong, government intervention is very much a part of the economic system. Government involvement is deemed essential, since there are some dangers that will exist if the free market is left to operate without interference.

Disadvantages of a Free Market Economy	Disadvantages of a Planned Economy
1. Demerit goods (things that are bad for people, such as drugs or child prostitution) will be overprovided, driven by high prices and thus a high profit motive.	1. Total production, investment, trade and consumption, in even a small economy, are too complicated to plan efficiently and there will be misallocation of resources, shortages and surpluses.
2. Merit goods (things that are good for people, such as education or healthcare) will be underprovided, since they will only be produced for those who can afford them and not for all.	2. Because there is no price system in operation, resources will not be used efficiently. Arbitrary decisions will not be able to make the best use of resources.
3. Resources may be used up too quickly and the environment may be damaged by pollution, as firms seek to make high profits and to minimise costs.	3. Incentives tend to be distorted. Workers with guaranteed employment and managers who gain no share of profits are difficult to motivate. Output and/or quality will suffer.
4. Some members of society will not be able to look after themselves, such as orphans, the sick, and the long-term unemployed, and will not survive.	4. The dominance of the government may lead to a loss of personal liberty and freedom of choice.
5. Large firms may grow and dominate industries, leading to high prices, a loss of efficiency, and excessive power.	5. Governments may not share the same aims as the majority of the population and yet, by power, may implement plans that are not popular, or even corrupt.