Exam Success in Economics for Cambridge AS & A Level

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Oxford University Press
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Introduction

The *Exam Success* series has been designed to help you reach your highest potential and achieve the best possible grade. Each book fully covers the syllabus and is written in syllabus order to help you prepare effectively for the exam. In contrast to traditional revision guides, these new books contain advice and guidance on how to improve answers, giving you a clear insight into what examiners are expecting of candidates, and include a unique section on how students can repair an answer that is incorrect or inadequate. Each of the *Exam Success* titles consists of two parts: the first part covers the content of the subject, with clear syllabus references, while the second part contains exam-style questions and advice on how to improve your performance in the exam. All of the titles are written by authors who have a great deal of experience in knowing what is required of candidates in exams.

*Exam Success in Cambridge International AS and A Level Economics* has been written specifically to meet the requirements of the AS Level and A Level Cambridge 9708 Economics syllabus. The first part of the guide consists of 10 units. The first five of these cover the content that is required for the AS exam, while the last five cover the additional content that is required for the A Level exam. Each unit closely follows the syllabus and includes diagrams to help you fully understand the content, with exam tips and worked examples throughout. There is a revision checklist at the end of each unit, which you can use to ensure you have covered all of the topics. There are also examples of exam-style questions at the end of each unit, covering both multiple choice questions (featured in Papers 1 and 3) and structured questions (featured in Papers 2 and 4). In the second part of the guide, in Units 11 and 12, there are further examples of exam-style questions and useful advice on how you can best prepare for the Economics exam. There is also an appendix on maths skills for Economics, which includes worked examples to show how mathematics can be used by economists, and a list of the more important formulae that you may need to use in the exam.

Each of the titles in the *Exam Success* series contains common features to help you do your best in the exam. These include the following:

**Key terms**
These give you easy-to-understand definitions of important terms and concepts of the subject.

**Common errors**
These give you a clear indication of some of the errors that students have made in exams in the past, helping you to avoid making the same kinds of mistakes.

**Exam tips**
These give you guidance and advice to help you understand exactly what the examiners are looking for from you in the exam.

**What you need to know**
These provide you with useful summaries of the main features of topics you would need to demonstrate an understanding of in the exam.
Remember
These include key information that you will need to remember in the exam if you are to achieve your highest possible grade.

Raise your grade
In these sections, you will be able to read answers by candidates who do not achieve maximum marks. This feature provides advice on how to improve the grade for these answers.

Revision checklist
Each unit has a revision checklist, which gives you the opportunity to check whether you have fully understood all of the material that is covered in the unit.

Exam-style questions
Each unit contains examples of exam-style questions so you understand the sort of questions you can expect to see on each topic when you take your exam. There is also a complete unit of exam-style questions towards the end of the book in Unit 12, which are arranged by paper. These questions provide ample opportunities to practise the skills and techniques required of you in the exam.

The answers to all of the exam-style questions included in the book can be found on the OUP support website.

Repairing an answer
Unit 11, ‘Raising your achievement’, contains advice and guidance on how an incorrect or inadequate answer can be improved or ‘repaired’, through making appropriate revisions or additions to the answer.

Tables
Unit 11 also includes tables to show how to analyse knowledge and ideas on particular topics.

The Exam Success series is clearly focused on giving you practical advice that will help you to do your best in the exam. The ‘sample’ candidate answers, in particular, are extremely useful as they include examiner commentary and feedback. The expectations of examiners are made very clear throughout the books, so you can fully understand what is expected of you in the exam. This will also help to boost your confidence as you approach the exam.

Access your support website for additional content here:
www.oxfordsecondary.com/9780198412717
1.1 Scarcity, choice and opportunity cost

This topic is concerned with:

- the fundamental economic problem
- the meaning of scarcity and the inevitability of choice at all levels (individuals, firms, governments)
- the basic questions of what will be produced, how and for whom
- the meaning of the term, ‘ceteris paribus’
- the margin and decision making at the margin
- short run, long run and very long run.

The fundamental economic problem

The fundamental economic problem refers to a situation where there is a relative scarcity of resources in relation to the unlimited wants and needs of people.

What you need to know

You need to understand that the fundamental economic problem occurs in all economies, including both developed and developing economies.

Common error

It may appear that certain resources are not scarce in some countries. For example, there may be a high level of unemployment, suggesting an abundant supply of labour, and yet there may be an insufficient supply of labour with the right skills and/or in the right places.

It is important that the fundamental economic problem, which applies to all economies, is not confused with particular economic problems that can occur in specific countries, such as a relatively high rate of inflation or level of unemployment.

Economic problem: the situation of the relative scarcity of resources in relation to the unlimited wants and needs of people.

Exam tip

Do not confuse the existence of the fundamental economic problem, which is a universal problem, with particular economic problems in specific countries, such as a high level of unemployment.

Remember

Resources are limited, whereas the needs and wants of people are unlimited.
The meaning of scarcity and the inevitability of choice at all levels

*Scarcity* refers to a condition where there are insufficient resources to satisfy all the *needs* and *wants* of people. This makes *choice* inevitable, because there will be a requirement to make decisions about the possible alternative uses of scarce economic resources. These decisions will be taken in terms of *opportunity cost*; this is the next best alternative that is foregone, as a result of taking a decision. Choice will involve all levels of economic decision making, i.e. at the level of individuals, firms and governments.

**Key terms**

- **Scarcity**: a condition where there are insufficient resources to satisfy all the wants and needs of people.
- **Needs**: the demand for something that is essential, such as food or shelter.
- **Wants**: the demand for something that is less important than the demand for a need (such as a new television) and which is not necessarily achieved by a consumer.
- **Choice**: the need to make decisions about the possible alternative uses of scarce resources, given the existence of limited resources and unlimited wants and needs.
- **Opportunity cost**: the cost of something in relation to a foregone opportunity, i.e. it indicates the benefits that could have been obtained by choosing the next best alternative.

**Exam tip**

The concept of opportunity cost does not only apply to production decisions; it can be applied to consumption decisions as well.

**Remember**

Economic resources have alternative possible uses and so a choice will need to be made about the use of each particular resource.

**Common error**

Make sure you don’t refer to opportunity cost in terms of any choice that is made. The foregone opportunity needs to be seen in terms of the next best alternative that is foregone, not just any possible alternative.

The inevitability of choice applies at all levels in an economy, i.e. at the level of individuals, firms and governments.

**What you need to know**

You need to understand that the existence of scarcity makes choice inevitable.

The basic questions of what will be produced, how and for whom

There are three basic questions that need to be asked in every economy:

- **What will be produced?**: decisions will need to be taken about what is going to be produced with the economic resources and how much will be produced. For example, a decision will need to be made in terms of how many agricultural products will be produced in an economy and how many industrial products.

- **How will it be produced?**: production involves the combination of the four factors of production – land, labour, capital and enterprise – and decisions will need to be taken in terms of exactly how these factors will be combined to produce the required output.

- **For whom will it be produced?**: if it is not possible to satisfy the needs and wants of people in an economy, decisions will need to be taken as to which needs and wants will be satisfied, i.e. how is the output to be distributed?

**Exam tip**

These three basic questions will be asked in every economy, however developed it is.
Basic economic ideas and resource allocation

What you need to know

You need to understand that answers to the three questions on the previous page will provide a very good indication of the nature of different economies.

Common error

You need to recognise that a decision to produce more of one product, such as agricultural products, may lead to a lower production of another product, such as industrial products. This will be considered later in terms of the production possibility curve.

Candidates often focus on production, but it is also necessary to consider how the output that has been produced is to be distributed to different people in an economy.

Remember

There are different ways of producing a given output. For example, to what extent production is capital-intensive, i.e. where there is a relatively high proportion of capital used relative to labour, or labour-intensive, i.e. where there is a relatively high proportion of labour used relative to capital.

The meaning of the term 'Ceteris paribus'

The term ‘ceteris paribus’ literally means ‘all other things being equal’. This is important in Economics because it emphasises that the other factors which could influence a relationship between two variables are assumed to remain constant.

Economics is regarded as one of the social sciences and yet it would be very difficult to regard it as a science, in the same way that chemistry, biology or physics can be regarded as sciences, given that it is concerned with human behaviour. The very nature of the subject matter of Economics can therefore cause difficulties.

Remember

The use of ‘ceteris paribus’ means that for the purposes of establishing a theory or a model in Economics, it can be assumed that other possible influences on behaviour, apart from what is the focus of the theory or model, are held constant.

Key term

Ceteris paribus: literally ‘all other things being equal’, i.e. the other factors which could influence a relationship between two variables are assumed to be constant.

Exam tip

Make sure that you fully understand what is meant by the term ‘ceteris paribus’ and can explain its importance in relation to the claim of Economics to be a social science.
Decision making at the margin

Economists, when analysing decision making, will often concentrate on decisions that are taken at the margin. This is the point at which the last unit of a product is consumed or produced.

Key term

Margin: the point at which the last unit of a product is consumed or produced.

Exam tip

In answering a question on the satisfaction of people when consuming a good, it is important to distinguish between marginal utility and total utility.

Common error

Make sure you can clearly distinguish between average, total and marginal data. For example, there can be confusion between average cost, total cost and marginal cost. You need to understand that average cost is the total cost divided by the output produced, total cost is all the costs of production added together and marginal cost is the cost involved in producing just one more product.

What you need to know

You need to be able to distinguish between marginal and average data.

Short run, long run and very long run

Economists distinguish between three different time periods:

➤ The short run refers to a time period in which only some variables may change, i.e. some factors of production will be fixed and some will be variable. Technical progress is held to be constant.

➤ The long run refers to a time period in which all of the factors of production will be variable. Technical progress is held to be constant.

➤ The very long run refers to a time period in which it is possible for supply to change as a result of technical progress. This distinguishes the very long run from both the short run and the long run.

Common error

Don’t be confused into thinking that the short run and the long run refer to a specific period of time, this is not the case. The period of time involved before the short run becomes the long run will vary from one industry to another. It could be a matter of weeks or months in one industry and a matter of years in another.
Raise your grade

Explain why the fundamental economic problem makes choice inevitable at all levels of an economy. [8]

The fundamental economic problem refers to the fact that the needs of people are unlimited and that there are not enough economic resources to satisfy those needs. There is therefore a situation of scarcity, and, as a result, choices will have to be made and decisions taken in relation to the alternative possible uses of those resources. Choice is therefore inevitable for individual consumers and individual firms.

How to improve this answer

1. The candidate has referred to the fact that the needs of people were unlimited, but not to the fact that this also applies to wants as well as needs.

2. The candidate could have explained the term ‘scarcity’ more clearly, making it clear that this situation arises where there are insufficient economic resources to satisfy all the people.

3. The candidate could have referred to the concept of ‘opportunity cost’, as this concept focuses on the different possible uses that can be made of the scarce resources in terms of the next best alternative that is foregone as a result of taking one decision rather than another.

4. The candidate recognises that choice is inevitable for individual consumers and for individual firms, but makes no reference to the third level, i.e. government. Governments also have to take decisions in relation to the different possible outcomes of resource allocation. For example, whether to build a new road or a new school.

Knowledge and understanding: 2/4
Application: 2/4
Total: 4/8
1.2 Positive and normative statements

This topic is concerned with:

➤ the distinction between facts and value judgements.

**The distinction between facts and value judgements**

Candidates need to be able to clearly distinguish between a **positive statement** and a **normative statement**. A positive statement is one that is based on factual evidence, i.e. it will be objective rather than subjective. A normative statement is one that involves making a **value judgement** or expressing an opinion, i.e. it will be subjective rather than objective.

**Key terms**

- **Positive statement**: a statement that is based on facts and factual evidence.
- **Normative statement**: a statement that is based on beliefs rather than on factual evidence.
- **Value judgement**: a judgement that is a reflection of particular values or beliefs.

**Exam tip**

Don’t confuse positive and normative statements and objective and subjective statements. Understand how they are different.

**Remember**

A positive statement usually uses the word ‘is’, e.g. ‘value added tax is an example of an indirect tax’. Whereas a normative statement usually uses the words ‘ought’ or ‘should’, e.g. ‘the government should spend more money on defence than on transport’.

1.3 Factors of production

This topic is concerned with:

➤ the rewards to the factors of production: land, labour, capital and enterprise
➤ the role of the factor enterprise in a modern economy
➤ specialisation and division of labour.

**The rewards to the factors of production**

It has already been pointed out that there are four factors of production, and each one is paid its own reward:

➤ rent is paid to **land**
➤ wages or salaries are paid to **labour**
➤ interest is paid to **capital**
➤ profit is paid to **enterprise**.

**Key terms**

- **Land**: the factor of production that is concerned with the natural resources of an economy, such as farmland or mineral deposits.
- **Labour**: the factor of production that is concerned with the workforce of an economy in terms of both the physical and mental effort involved in production.
- **Capital**: the factor of production that relates to the human-made aids to production, such as tools and equipment.
- **Enterprise**: the factor of production that takes a risk in organising the other three factors of production. The individual who takes this risk is known as an entrepreneur.

**Exam tip**

Make sure that you can distinguish between labour, in the form of human capital, and capital, in the form of machinery or equipment.
Basic economic ideas and resource allocation

Common error

Make sure you don’t get confused by the term ‘land’. It doesn’t just mean land in the sense of a space that can be used for agricultural production, e.g. a farm, or industrial production, e.g. a factory. It has a wider meaning in the sense of referring to the natural resources of an economy, including forests, lakes and rivers.

The term ‘labour’ can also be confusing. It refers to all aspects of labour, including both physical and mental work. The term can also be used to apply to the skills, knowledge, experience and abilities of the labour force, which is why labour is also frequently referred to by economists as human or intellectual capital.

Capital, in the sense of being an economic resource or factor of production, can also be a misleading term. In this sense, it refers to the human-made aids to production, such as tools, machinery and equipment. It can also refer to factories. It should not be confused with the word ‘capital’ when it is used to mean money.

The term ‘enterprise’ can also cause difficulties. It refers to the role of the entrepreneur in combining, organising and coordinating the other three factors of production to enable production to take place and this involves taking a risk.

The role of the factor enterprise in a modern economy

The factor enterprise has already been referred to above and it is important to understand its role in a modern economy, both in terms of organising the other factors of production and, in doing so, taking a risk.

In many countries, there has developed what can be called an ‘enterprise culture’ which encourages the emergence of entrepreneurs, although in some of these countries the encouragement has come from a variety of government initiatives.

Specialisation and division of labour

Specialisation refers to concentration on the provision of particular goods and services rather than other products. Specialisation allows for, and encourages, a concentration on what producers are best at doing and so enables production to increase. When there is specialisation of economic activity by product or process, this is known as the division of labour.

Key terms

Specialisation: the process by which individuals, firms, regions and whole economies concentrate on producing those products in which they have an advantage.

Division of labour: the process whereby workers specialise in, or concentrate on, particular tasks.

Remember

The element of risk-taking is fundamental to the factor enterprise and it is that characteristic that distinguishes the entrepreneur from other workers. The risk involved in what they do arises from the situation of uncertainty that is associated with any initiative that they take.

Exam tip

Make sure you can write about both the advantages and disadvantages of specialisation and division of labour. These advantages and disadvantages can be seen from the viewpoint of the worker, the firm and the whole economy.

What you need to know

You need to understand that specialisation does not only refer to the situation where individual workers concentrate on performing particular tasks. Specialisation can also refer to the process by which firms, regions and whole economies concentrate on producing those products in which they have an advantage.
Some people think that there are only advantages to the division of labour, such as the fact that there can be a saving of time or that the application of technology is easier. However, you need to remember that there are also potential disadvantages, such as the fact that it can lead to boredom and alienation and that this could contribute to making workers less motivated and less productive.

1.4 Resource allocation in different economic systems and issues of transition

This topic is concerned with:

➤ decision making in market, planned and mixed economies
➤ issues of transition.

Decision making in market, planned and mixed economies

There are three types of economic system:

➤ market economies
➤ planned economies
➤ mixed economies.

A market economy, or market system, is one that is characterised by a relatively low level of state or government intervention in the economy where decisions about the allocation of resources are taken in the private sector by producers and consumers. The price mechanism is the means through which these decisions are taken, bringing about changes in the allocation of resources in such an economy.

A planned economy, or command economy, is one that is characterised by a relatively high level of state or government intervention in the economy where decisions about the allocation of resources are taken by a central planning agency on behalf of the government. These decisions are usually taken within the context of a five year plan.

Key terms

Market economy or market system: a type of economic system where decisions about the allocation of resources are taken in the private sector by producers and consumers.

Price mechanism: the process by which changes in price, resulting from changes in demand and/or supply, bring about changes in the allocation of resources in a free market economy.

Planned economy or command economy: a type of economic system in which decisions about the allocation of resources are taken by the state or by government agencies.
Basic economic ideas and resource allocation

**Key term**

Mixed economy: a type of economic system in which decisions about the allocation of resources are taken in both the private sector and the public sector.

**Key term**

Transitional economy: an economy that is in the process of changing from a planned or command economy to more of a mixed economy where market forces have greater importance.

**Common error**

The disadvantages of a planned economy, operating through government commands or instructions, are often stressed, but it also has to be understood that such a system can have some advantages, such as the fact that unemployment could be lower than in a market economy and the distribution of income and wealth more equal.

It should be clear that both market and planned economies have a variety of advantages and disadvantages and so most economic systems in the world today can be regarded as mixed economies, combining elements of both a market economy and a planned economy.

The balance of the mixed economy can change over a period of time. For example, in 2008-2009, a number of financial institutions in different countries experienced difficulties and many of these had to be supported by government. In the UK, two of the major banks, Royal Bank of Scotland and Lloyds Banking Group, had to be supported by the government to prevent them from going out of existence.

**Common error**

Don’t be confused into thinking that there is one ‘type’ of mixed economy that will be the same all over the world, but in actual fact this type of economic system can vary enormously between countries. For example, in one economy, the mixture might be 25% public sector and 75% private sector, while in another economy the mixture might be 75% public sector and 25% private sector.

**Issues of transition**

Economies are not ‘static’. They can be regarded as ‘dynamic’ entities and many economies are going through a process of transition from one type of economic system to another. In most cases, this process of transition will be from a planned economy to a market or mixed economy.

This development has given rise to what has been called a transitional economy, i.e. an economy that is in the process of changing from a planned economy to more of a mixed economy.

**What you need to know**

You need to understand that this process of transition is one that will take a number of years and will not happen ‘overnight’.

During this process, the economy is likely to experience difficulties, such as when government commands are increasingly replaced by price signals as the main determinant of a change in the allocation of resources.

You should also be aware that encouragement of economic reforms that involve a change from government control to competitive markets has come from the World Bank.

**Exam tip**

Show that you understand that a mixed economy is not ‘static’, and give an example of how the balance of the economy can change.

**Remember**

Nationalisation and privatisation will change the nature of a mixed economy. Nationalisation increases the size of the public sector relative to that of the private sector and with privatisation having the opposite effect.
Discuss to what extent a transition from a planned economy to a market economy will always be a smooth process.

Many economies have in the past been planned economies. These are economies where major economic decisions are taken by the state. Most of the economic resources are owned, or at least controlled, by the state and in most cases there is no price mechanism operating as there would be in a market economy, with prices generally determined by the government. These economies, known as transitional economies, are now going through the process of change towards more of a market economy. China is an example of such a transitional economy. There are also a number of examples in eastern Europe, including Russia, Poland, Hungary, Bulgaria and Ukraine. The state is reducing the extent of its influence on economic decision making, with a greater role being given to market forces and the price mechanism and as the public sector has reduced in importance, the private sector has increased in importance.

In some of these countries, the process has been relatively smooth, if slow. However, in others, the process has been accompanied by increases in unemployment and/or inflation.

How to improve this answer

1. The candidate’s analysis could have been developed more fully, such as in relation to exactly how prices are determined by the government, although there is a useful contrast with what happens in a market economy.

2. There is a reference to the fact that these economies are in the process of changing from one type of system to another are known as transitional economies, but there is no definition of exactly what is meant by a transitional economy.

3. The candidate has again referred to a market economy, but has not really gone very far in their analysis of this type of economic system.

4. The candidate has included some appropriate examples of countries that are going through this process of change.

5. There are some passing references to ‘market forces’, the ‘price mechanism’ and the ‘private and public sectors’, but this needed to be developed more fully.

6. There is some attempt at evaluation in the final paragraph, but this is rather limited and really needed to be developed more fully.

Analysis: 4/8  
Evaluation: 1/4  
Total: 5/12
1.5 Production possibility curves

This topic is concerned with:

➤ the shape and shifts of the curve
➤ constant and increasing opportunity costs.

The shape and shifts of the curve

A production possibility curve (PPC) can be used to show the maximum possible output that can be achieved in an economy given the use of a particular combination of resources and technology in a given time period. If an economy is operating on its PPC, in order to increase the output of one type of product, it will be necessary to reduce the output of the other. This can be seen in Figure 1.1, where a movement from X to Y along the PPC leads to an increase of BD industrial output and a decrease of AC agricultural output. It can be seen that the shape of the PPC is a curve.

▲ Figure 1.1 A production possibility curve

Figure 1.1 shows a movement from one point on a PPC to another, but it is also possible for there to be a shift of the whole PPC. This is shown in Figure 1.2, where there is a movement of the PPC to the right from PPC₁ to PPC₂. When this happens, an economy can produce more of both types of good, i.e. there can be an increased output of both agricultural products and industrial products.

▲ Figure 1.2 A shift to the right of a PPC
You need to understand that a production possibility curve can also be called a ‘production possibility frontier’ or a ‘production possibility boundary’.

You need to understand that a PPC illustrates the total output of two products given the availability of resources in an economy in a given time period. This output of two products is within the constraint of a given level of technology in a given time period.

There will be an element of opportunity cost involved with a movement from one position to another on a PPC, i.e. it is not possible to have an increase of output of both products. However, if it is possible to shift a PPC to the right, then it becomes possible to produce a greater output of both products.

**Constant and increasing opportunity costs**

It has already been pointed out that a PPC is drawn as a curve rather than as a straight line. If there was a situation of constant opportunity costs, then it would be possible to draw a PPC as a straight line. However, it is usually the case that there will be a situation of *increasing opportunity costs*, i.e. there will not be an equal sacrifice of resources as there is a movement along a PPC.

You need to understand that a PPC can only be drawn as a straight line, rather than as a curve, when there are constant opportunity costs, i.e. when there is a movement along a PPC, the amount of production sacrificed by agricultural products and gained by industrial products are the same.

However, this is unlikely to happen because of the existence of the law of diminishing returns. This stresses that as extra units of a resource are used in production, they will lead to successively smaller increases in output. This is because not all factor inputs are equally suited to the production of different products.

As a position is reached that is closer to either end of a PPC, ever increasing amounts of one type of product will need to be sacrificed to produce more of the other, because of the fact that different factors of production have different qualities, and that is why a PPC is usually drawn as a curve rather than as a straight line.
Raise your grade

Describe a production possibility curve and explain why it is usually drawn as a curve rather than as a straight line. [8]

A production possibility curve shows the maximum output that it is possible to produce given the availability of resources in an economy at any one time. It shows the output of just two products, one on the vertical axis, such as agricultural output, and one on the horizontal axis, such as industrial output.

It could be drawn as a straight line, but this would only apply if there were constant opportunity costs. This is not likely to be the case in most situations, and it is more likely that there would be increasing opportunity costs as a movement up or down a PPC is made. This is why a PPC is usually drawn as a curve rather than as a straight line.

How to improve this answer

1 The candidate has demonstrated some knowledge and understanding of a production possibility curve, but this could have been developed more fully, e.g. by pointing out that the output is also constrained by the technology of a given time period.

2 The candidate could have emphasised how a PPC is a simplified version of what can be produced in an economy with its resources, contrasting this with the reality of production of many different types of products.

3 The candidate refers to the idea of ‘constant opportunity costs’, but there is no attempt to explain what this actually means.

4 The candidate refers to the idea of ‘increasing opportunity costs’, but again there is no attempt to explain what this actually means. For example, it would have been helpful if the candidate had brought in the law of diminishing returns to help explain why a PPC is drawn as a curve rather than as a straight line.

Knowledge and understanding: 2/4
Application: 2/4
Total: 4/8
1.6 Money

This topic is concerned with:

➤ the functions and characteristics of money in a modern economy
➤ barter, cash and bank deposits, cheques, near money and liquidity.

The functions and characteristics of money in a modern economy

Money performs four functions in a modern economy:

➤ a medium of exchange
➤ a measure of value or a unit of account
➤ a standard for deferred payment
➤ a store of value or a store of wealth.

Money has a number of distinctive characteristics and these include the following:

➤ acceptability
➤ divisibility
➤ portability
➤ durability
➤ recognisability
➤ scarcity
➤ uniformity
➤ stability of supply
➤ stability of value.

What you need to know

Money as a medium of exchange essentially depends on its general acceptability in an economy as a way of financing transactions.

Money as a measure of value or as a unit of account makes it relatively easy to compare the value of different goods and services, something that was very difficult to do with barter.

Money as a standard for deferred payment enables people to borrow money and pay it back at a later date; this encourages the provision of credit and so is vital to the development of trade.

Money as a store of value or wealth could be adversely affected if a country experiences a relatively high rate of inflation because inflation will erode the purchasing power of a given sum of money over a period of time, so even though money enables saving to take place, the real value of those savings will fall if an economy experiences inflation.

Remember

In a ‘modern economy’ money in the form of cash is becoming less important and should be seen not just as cash, but in terms of balances held in different financial institutions.

Common error

A common error of candidates is to confuse the functions of money with the characteristics or attributes of money.

Barter, cash and bank deposits, cheques, near money and liquidity

Barter refers to the situation that occurs where, instead of using money, transactions involve the direct exchange of goods and services without the use of any monetary mechanism. The main reason that barter was replaced

Key terms

Barter: the direct exchange of one good or service for another.
Money: anything which is universally acceptable as a means of payment for goods and services and a settlement of debt.
by money is that it relies on a **double coincidence of wants**, i.e. one person offering a good or service needs to be able to find someone who wants the particular good or service and that person also needs to be offering something in exchange that the seller wants.

Money is often regarded as **cash**, but in many economies there is a move towards a cashless society. It is therefore important, in a modern economy, that money is seen as **bank deposits** in a variety of financial institutions, including banks, building societies, friendly societies and credit unions. A **cheque** is simply a means of transferring money; it is not money. **Near money** refers to financial assets that could settle some, but not all, debts. **Liquidity** refers to how easy or quick it is to turn a financial asset into money.

### Key terms

- **Double coincidence of wants**: the situation where, in a barter system of exchange, a seller needs to find a buyer who not only wants what the seller is selling, but also has something that the buyer wants.
- **Cash**: the notes and coins in existence in an economy; this is the most liquid form of asset.
- **Bank deposits**: money that is held in accounts with a financial institution, such as a bank, a building society, a credit union or a friendly society.
- **Cheque**: a written instruction to a financial institution to pay an amount of money from an account; although a method of payment, a cheque is not a form of money.
- **Near money**: an asset that can be transferred into money relatively easily and quickly, but is not actually money; it is therefore sometimes known as ‘quasi money’.
- **Liquidity**: a term used to indicate when a financial asset is turned into cash.

### Remember

Money should not be viewed in terms of just cash. As economies move towards a cashless society, most money is held in the form of bank deposits, frequently accessed through a variety of cards and electronic transactions.

### Common error

Make sure you recognise that barter refers to the direct exchange of goods and services without the use of money, as well as understanding that the main limitation of barter is that it relies on the existence of a double coincidence of wants, with two people each wanting what the other has to sell.

A number of candidates regard a cheque as a form of money, but this is incorrect; a cheque is simply a means of transferring money from one account to another.

You should also understand that near money refers to financial assets that can settle some, but not all, debts and so it is unable to perform all of the functions of money. In particular, it cannot be used as a medium of exchange because it will not be generally acceptable.

Make sure you can explain the concept of liquidity. The term simply refers to the ease with which it is possible to turn a financial asset into money. For example, cash is the most liquid type of financial asset.
Raise your grade

Explain how money, in performing its various functions, can facilitate a country's economic progress. [8]

Money is said to have four functions or roles that it performs in a modern economy:

Firstly, it acts as a medium of exchange, enabling individuals, firms and governments to finance transactions. In this role, it is much better than barter which relied on a direct exchange of goods and services without the use of money.¹

Secondly, it acts as a measure of value or unit of account. This allows the value of a product to be directly compared, something that was not easily provided for in a barter system.²

Thirdly, it has the function of operating as a standard for deferred payment. This is very important in a modern economy as it enables people to borrow money and to pay it back at a later date. Payments can be spread over a period of time and this encourages the provision of credit.³

Finally, the fourth function of money is as a store of value or wealth. This is where wealth can be stored in the form of money and savings are therefore encouraged.⁴

How to improve this answer

1. The candidate has referred to money as a medium of exchange, but it would have been helpful if the candidate had pointed out that this role could only be performed effectively if money was generally accepted as a means of payment for goods and services in an economy. For example, there could have been a reference to the idea of ‘legal tender’.

2. The candidate correctly refers to this second function of money, but it would have been helpful if the candidate had also pointed out that this function helps consumers to make economic decisions in terms of buying one product rather than another.

3. The candidate has stressed the importance of money operating as a standard for deferred payment, especially in terms of encouraging the provision of credit, but this point could have been developed more fully, especially in relation to the purchase of products through the use of credit cards, a major factor in the increase in consumption.

4. The candidate has referred to the function of money as a store of value or wealth and has linked this to the encouragement of savings. However, this point could have been developed more fully, such as through pointing out that the savings that are deposited in financial institutions enable these firms to lend to others. The candidate could also have pointed out a limitation of this function in countries with relatively high rates of inflation where saving may be discouraged due to the erosion of the real value of those savings.

Knowledge and understanding: 2/4
Application: 2/4
Total: 4/8
1.7 The classification of goods and services

This topic is concerned with:

➤ free goods, private goods (economic goods) and public goods
➤ merit goods and demerit goods as the outcome of imperfect information by consumers.

**Free goods, private goods (economic goods) and public goods**

A *free good* is one which does not involve the basic condition of scarcity, i.e. there is a sufficient quantity of it to satisfy demand and so there is no necessity for there to be an *allocative mechanism*. Examples of free goods include sunshine, air and sea water.

A *private* or *economic good*, on the other hand, is one which does involve the basic condition of scarcity. As a result of such scarcity, there needs to be an allocative mechanism to decide which people are able to consume it and which are not. This will be through the existence of the price mechanism. A private good, such as a bicycle, a car or an item of clothing, will have three essential characteristics: it is rival, excludable and rejectable.

Another type of good is that of a *public good*, such as street lighting or a flood control system. Public goods have three essential characteristics and these are the opposite of those of a private good: they are *non-rival*, *non-excludable* and *non-rejectable*. A particular feature of non-excludability is that it would be impossible to exclude anybody who had not paid for a product, e.g. street lighting; this gives rise to the existence of the *free rider* problem, i.e. a person who has no incentive to pay for the use of a public good because there can be consumption without any payment being made.

**Key terms**

- **Free good**: a good which is not scarce and so therefore does not need a mechanism to allocate it; the demand for a free good is equal to the supply of it at zero price.
- **Allocative mechanism**: a method whereby scarce resources are distributed in an economy.
- **Private or economic good**: a private good that is relatively scarce and so will need to be allocated to a particular use in some way through an allocative mechanism.
- **Public good**: a good which has the three characteristics of being ‘non-rival’, ‘non-excludable’ and ‘non-rejectable’.
- **Non-rival**: if one person consumes a product, it does not reduce the extent of its availability to other people.
- **Non-excludable**: a situation where it is not possible to exclude any person from its use.
- **Non-rejectable**: the idea that certain public goods cannot be rejected by people.
- **Free rider**: a person who has no incentive to pay for the use of a public good because there can be consumption without any payment being made.

**Exam tip**

Do not confuse a free good, such as air, with a product that is provided for free by a government. A product such as healthcare may be free, in that a fee may not be paid directly to a doctor, but it is still an economic good because the resources involved in the provision of the healthcare have alternative uses.
You need to know that as free goods are not scarce, there is no cost involved in the consumption of them, unlike the consumption of a private good, so no price is charged. There is no need for there to be a mechanism to allocate a free good because the demand for, and the supply of, the free good are equal at zero price.

Although air may be regarded as an example of a free good, fresh air may be a less helpful example.

When one person consumes a private good, it reduces the quantity that is available to others. It is excludable in that potential consumers can be excluded from consuming a product because of the producer charging a price for it. It is rejectable in that if a person wishes to reject the opportunity to purchase a private good, they can do this simply by not buying it.

The characteristics of a public good are the opposite of those of a private good. It is non-rival in that if one person consumes a product, it does not reduce its availability to others. It is non-excludable in that it is not possible to exclude people from benefiting from the consumption of the good, giving rise to the free rider problem where it is impossible to charge consumers for the use of a public good. It is also non-rejectable in that people cannot reject the security they are afforded by the existence of a police force or a country's armed forces.

It is therefore possible to distinguish between private goods and public goods, but candidates should understand that in some cases it may not be easy to clearly differentiate between private and public goods and so in this situation, these products are referred to as quasi-public goods (‘quasi’ meaning ‘near’ or ‘almost’).

**Merit goods and demerit goods as the outcome of imperfect information by consumers**

A merit good is a private good and so has the characteristics of being rival, excludable and rejectable. However, it is likely to be under-produced and under-consumed in a market because of imperfect information on the part of consumers. They may not be fully aware of the potential benefit of the product, not only to themselves but to the whole society, i.e. they fail to take into account the possible external benefits, or positive externalities, of the consumption of such goods. Examples of merit goods include education, health care, public libraries and museums.

Figure 1.3 shows how a merit good can be under-produced and under-consumed in a market. The demand curve D₁ represents the marginal private benefit of consuming a good such as education. However, the demand curve D₂ represents the marginal social benefit of the consumption of education, i.e. it comprises not only marginal private benefit, but also marginal external benefit. The equilibrium position of MSB and MSC (marginal social cost) would therefore be at quantity Q₂ and price P₂.

**Key term**

**Merit good**: a product which has positive externalities, but which would be under-produced and under-consumed in a market economy as a result of the imperfect information held by consumers.
Basic economic ideas and resource allocation

A demerit good, like a merit good, is an example of a private good, but it is likely to be over-produced and over-consumed in a market because of imperfect information on the part of consumers. They may not be fully aware of the potential damage to themselves of consuming the product, nor of the potential damage to the whole society, i.e. they fail to take into account the possible external costs, or negative externalities, of the consumption of such goods. Examples of demerit goods include cigarettes and alcohol.

**Key terms**

Demerit good: a product which has negative externalities and which would be over-produced and over-consumed in a market economy as a result of the imperfect information held by consumers.

Imperfect information: a situation in which people, including both consumers and producers, do not have the full information needed to make rational decisions, reducing the extent of efficiency.

Figure 1.4 shows how a demerit good can be over-produced and over-consumed in a market. The demand curve $D_1$ represents the marginal private benefit of consuming a good such as tobacco. However, the demand curve $D_2$ represents the marginal social benefit of the consumption of tobacco, i.e. it comprises not only marginal private benefit, but also marginal external benefit. The equilibrium position of MSB and MSC (marginal social cost) would therefore be at quantity $Q_2$ and price $P_2$.
What you need to know

You need to know that both merit goods and demerit goods are private goods.

The under-consumption of merit goods and the over-consumption of demerit goods by consumers is the outcome of the imperfect information held by consumers, i.e. consumers underestimate the potential benefits of merit goods, both for themselves and for society as a whole, and underestimate the potential dangers of demerit goods, both for themselves and/or society as a whole.

You need to be able to understand these wider implications of the consumption of merit and demerit goods. For example, in the case of a merit good such as education, a more educated workforce in a country is not only likely to gain higher wages or salaries for themselves, but is also likely to benefit the whole society in the form of higher productivity. In the case of a demerit good such as tobacco, smokers are not only likely to damage their own health, but also the health of those in close contact with them (‘passive smokers’) and they are also likely to take up a significant proportion of a country’s health expenditure.

Common error

Make sure you don’t confuse a merit good with a free good because some merit goods, such as education, are free at the point of consumption. However, a free good does not require an allocative mechanism whereas a merit good does.
Raise your grade

Outline what is meant by imperfect information and explain how this can apply to the consumption of merit goods and demerit goods.

Imperfect information refers to the fact that consumers do not always have sufficient information to make an informed decision about the consumption of particular products available in an economy. For example, consumers may underestimate the potential benefits of some products, both to themselves and to the wider society, and underestimate the potential dangers of other products, both to themselves and to the wider society.

In the case of merit goods, consumers may under-consume certain products because they do not fully realise the potential benefits. For instance, education can be regarded as an example of a merit good because there is a close link between a person's educational qualifications and the wages or salaries they receive for their work. Not only do they benefit, but the society also benefits in the form of a better educated workforce being more productive and more innovative, contributing positively to a country's economic progress.

In the case of demerit goods, consumers may over-consume certain products because they do not fully realise the potential dangers of such consumption. For example, cigarettes can be regarded as an example of a demerit good because not only can they damage the health of a person, they can also damage the health of other people, known as 'passive smokers', and can cost a great deal in hospital treatment.

How to improve this answer

1. The candidate has outlined what is meant by imperfect information, but could have developed this more fully, such as in relation to the idea of 'information failure'.

2. Although some examples are provided later in the answer, it would have been useful if the candidate had supplied some examples at this point.

3. The candidate could have referred to other appropriate examples, such as health care, museums or libraries.

4. This section could have been developed more fully, both in terms of bringing in other examples, such as the consumption of alcohol, and in relation to the fact that other people may not be able to receive hospital treatment of their problems.

Knowledge and understanding: 2/4
Application: 2/4
Total: 4/8
## Revision checklist

**I can:**

- understand what is meant by the fundamental economic problem
- understand the meaning of scarcity and why this makes choices inevitable, leading to decision making by individuals, firms and governments; and I understand how decision making is linked to the concept of opportunity cost
- fully appreciate the three basic questions of what will be produced, how will it be produced and for whom will it be produced
- understand the meaning of the term, ‘*ceteris paribus*’, and how this relates to the idea of Economics as a social science
- understand what is meant by the margin and why much decision-making in Economics is at the margin
- distinguish between the short run, the long run and the very long run
- understand what is meant by positive statements and normative statements
- understand the distinction between facts and value judgements
- understand the four factors of production and the rewards that are paid to these factors
- appreciate the role of the factor enterprise in a modern economy
- understand the concepts of specialisation and division of labour
- understand how resources are allocated in different economic systems, including decision making in market, planned and mixed economies
- understand that there are likely to be issues of transition as a country moves from one economic system to another
- understand the shape and shifts of production possibility curves
- distinguish between constant and increasing opportunity costs
- understand how opportunity costs can affect the shape of production possibility curves
- understand the functions and characteristics of money in a modern economy
- understand what is meant by barter, cash, bank deposits, cheques, near money and liquidity
- understand how goods and services provided in an economy can be classified
- distinguish between free goods, private or economic goods and public goods
- understand that the consumption of merit goods and demerit goods is the outcome of imperfect information held by consumers.
Basic economic ideas and resource allocation

Exam-style questions

1 Which is the best definition of opportunity cost?
   A  An alternative that is foregone.
   B  The best alternative foregone by firms.
   C  The next best alternative foregone.
   D  The next best alternative foregone by consumers.  [1]

2 The term, ‘ceteris paribus’, means:
   A  all other things being equal
   B  at the margin
   C  choice is inevitable
   D  opportunity cost.  [1]

3 Which of the following statements about the short run is correct?
   A  All variables are fixed.
   B  All variables can change.
   C  Some variables can change and some are fixed.
   D  The short run is never more than three months.  [1]

4 Which of the following is a positive statement?
   A  Economic growth is measured through changes in Gross Domestic Product.
   B  Governments should spend more on education.
   C  The pay of nurses should be doubled.
   D  Trade unions ought to avoid taking industrial action.  [1]

5 The reward to capital is:
   A  interest
   B  profit
   C  rent
   D  salary.  [1]

6 A transitional economy is one which is:
   A  in the process of reducing its rate of inflation
   B  increasing the length of the plan from five to ten years
   C  introducing more nationalisation
   D  moving from one type of economic system to another.  [1]

7 Which of the following will shift a production possibility curve to the left?
   A  An increase in unemployment.
   B  Improved technology.
   C  Improved training of workers.
   D  New mineral deposits.  [1]

8 A production possibility curve is likely to be curved rather than straight because of:
   A  ceteris paribus
   B  constant opportunity costs
   C  inflation
   D  the law of diminishing returns.  [1]

9 Which of the functions of money has encouraged people to buy on credit?
   A  Medium of exchange.
   B  Standard for deferred payment.
   C  Store of value.
   D  Unit of account.  [1]

10 The free rider problem refers to the fact that:
   A  a demerit good is likely to be over-produced and over-consumed
   B  a free good requires some form of allocative mechanism
   C  a merit good is likely to be under-produced and under-consumed
   D  it would be impossible to exclude those who had not paid for a public good.  [1]

11 (a) Explain why opportunity cost is crucial to the decisions of individuals.  [8]

   (b) Discuss why some goods and services are provided through the private sector and some through the public sector in a mixed economy.  [12]

12 (a) Explain why enterprise is so important in the development of a modern economy.  [8]

   (b) Discuss whether lighthouses should be provided as a private good or a public good.  [12]