1 The nature and purpose of economic activity

In this unit you will learn that economic activity is concerned with the ways in which the scarce resources of the earth are used to produce goods and services.

Businesses produce goods and services:

- Goods are things you can touch and use, or consume, such as clothes, food and books.
- Services are things that other people do for you, such as cutting your hair or selling you goods in a shop.

To produce goods and services businesses use resources or other goods that are made from resources that are found naturally occurring on or in the earth.

Business in context

Shell is one of the world’s largest oil companies. The company makes products such as petrol and diesel from crude oil. Crude oil is unrefined oil that is found occurring naturally in deposits within the earth. To produce the petrol that people buy from garages Shell must first extract the crude oil from the earth. The company does this by drilling oil wells, many of which are under the sea.

Questions

1. What does Shell produce? (>)
2. Where can you buy Shell’s product? (>)
3. What is Shell’s product made from? (>)
Scarcity, choice and the allocation of resources

Everything found on earth is finite, or in other words in limited supply. This is as true of resources, such as oil and the human labour required to operate the refineries that turn the oil into petrol, as it is of the money that is used to build the refineries, pay the wages of the employees, or used by customers to pay to fill their cars at filling stations.

The supply of some resources, such as air, is plentiful enough to satisfy everybody’s needs. But the supply of most resources is not and, where this is the case, the resource is said to be scarce. This is so even though some resources, like trees or wheat, are renewable and replace themselves either naturally or through careful management.

Since the resources needed to produce goods and services are scarce, a choice must be made as to what to produce from them. For example, timber is used to make furniture and to build houses. However, a tree that has been cut down to produce furniture cannot also be used in the frame of a house. A choice has to be made between using the tree for furniture or houses.

Similarly, if you have $100 you can spend it on a mobile phone but you cannot also spend it on a pair of trainers. And the government cannot train additional doctors with the money it has already put into refurbishing schools.

Needs and wants

We all have needs that must be satisfied in order to sustain life. Wants are the ways in which we choose to satisfy our needs, and also to gain a level of satisfaction and enjoyment. For example, we need things like food and drink, shelter and clothing, but may choose to satisfy those needs with a burger or a pizza, a house or an apartment, and jeans or a suit, because these are the things we want. We also want refrigerators, radios and cars, because these things make life easier and more enjoyable, although they are not necessary to sustain life.
While resources are scarce, however, people’s needs and wants are potentially unlimited:

- In time, most things that you buy wear out and need to be replaced.
- Fashions and people’s tastes change.
- As technology develops, new or improved products become available.

**Demand and effective demand**

When you want something, you create a demand for it. However, you cannot satisfy your want unless you have the money and are willing to pay for it. For example, while you may want a new pair of trainers you cannot satisfy your want unless you have the money to pay for the trainers, and are willing to spend it on them (you may prefer to spend the money on books or a sweater).

Even so, your demand for trainers will not be effective unless other people want trainers and are able and willing to pay for them, too. **Effective demand**, therefore, is created when enough people want something and are able and willing to pay for it. Demand is cumulative: the greater the number of people who want something and are able and willing to pay for it, the stronger the demand for it. The stronger the demand, the more likely a business or other organisation will supply the item demanded.

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**Effective demand**

Demand for a product that is backed up by an ability and willingness to pay for it.
Allocating resources

Satisfying our wants from scarce resources involves a choice. For us as individuals, the choice is: which of our wants do we satisfy? If you want a pair of trainers and a T shirt, but only have enough money to buy one, you have to choose between them.

This choice, although it may be difficult, is fairly straightforward. When you consider that all the different wants of everybody in society have to be satisfied from scarce resources, however, choosing which wants should be satisfied is far more complex. It involves allocating resources to the satisfaction of those wants.
We saw that if you want a pair of trainers and a T-shirt but only have enough money to buy one of them, you have to choose between them. Both the trainers and the T-shirt cost money – that is their financial cost. They also have an **opportunity cost** – the opportunity to purchase and enjoy the use of the other thing you would have liked to buy. If you buy the trainers, the opportunity cost of the trainers is the T-shirt and the enjoyment you would get from it.

Every choice made by an individual or society, by the government or a business, involves an opportunity cost. If a government decides to spend an extra $100 million improving roads, the opportunity cost is spending it on other things such as schools or hospitals. The opportunity cost of society wanting more cars is the other things that could be produced using the extra labour and materials allocated to car production, such as houses or aeroplanes.

**The emergence of specialisation, the division of labour and exchange**

**Exchange in early societies**

In the earliest societies, people had to produce everything they wanted for themselves. They had to grow their own food, build their own shelters and make their own clothes. The reasons for this were that there were not so many people alive as there are today, and with the tools (technology) available they could only produce what they required for their own needs.

As societies developed, however, so too did technology. New technology meant that one person could produce more than he or she needed. The result was that some people had a surplus of the goods they produced and found they were able to **exchange** this surplus for the surplus goods and services produced by other people.

People began to specialise in producing the goods and services they were best at producing, because they knew they could exchange them for other goods and services. **Specialisation** and exchange meant that society as a whole could produce more goods and services than when individuals had to produce everything they needed for themselves. Goods and services were also of a higher quality.
Money as a means of exchange

In the early days of specialisation, goods and services could only be exchanged by a system of barter, or swapping one product for another. The problem with this was that somebody who produced, say, cabbages and wanted a cart needed to find a person who not only produced carts but wanted cabbages and was prepared to exchange a cart for them. This introduced another problem: how many cabbages was a cart worth?

Money was developed to solve this problem. In the past, many things have been used as money: cattle, cocoa beans, maize, beeswax, shells, teeth, gold rings, iron swords and axe heads have all served as money. Most societies, however, have settled on the type of metal coin and paper note money familiar today.

Whatever is used as money, it must be accepted as a means of exchange for different types of goods. People who accept money in exchange for goods or services must be able to exchange it again for other goods or services. Money must also serve as a measure of value so that comparisons of the value of different goods and services can be made.

The development of firms and the division of labour

In the eighteenth century, the development of specialisation and of money as a means of exchange, coupled with developments in technology, gave rise to the growth of firms and the division of labour. A firm, or business, is able to specialise in one type of good or service because the owners of the firm can sell (exchange for money) their goods and services and buy those produced by other firms.

Similarly the employees of a firm (the people who work in the business) can specialise in one type of activity, such as accountancy or operating a computer, as they can exchange their labour for money to buy the goods and services they need. The specialisation of individual employees is known as the division of labour.

This is only one level of specialisation, as can be seen in Figure 1.3. Each level depends on the principle of exchange and on money as both a means of exchange and a measure of value.
Levels of specialisation. At the highest level, countries may specialise in the production of goods for which they have a natural advantage (such as an abundance of natural resources). Within a country, industries specialise in types of goods (level 2). Individual businesses within an industry specialise in different stages of production, for example production and retailing (level 3), and a firm may have different units (e.g. factories or branches) to manufacture different parts of the product (level 4). Finally, people employed by a business will specialise in the type of work in which they have the greatest skills or abilities (level 5).
International and regional specialisation

Geographical, geological and climate factors make some areas of the world more suitable than others for the production of certain goods. For example, tea is grown in tropical and subtropical areas such as eastern Asia and South America and is bought by countries elsewhere, and copper cannot be mined in countries where there are no deposits. Countries also differ in the amount of machinery and other technology, or the availability and cost of labour to produce goods and services. These factors influence the types of goods a country produces, and most countries specialise in producing those goods in which they have a natural advantage. Any surplus is then exported to (sold to) countries from which other goods are imported (bought).

Similar conditions often lead to specialisation between areas or regions within a country. The availability of factors such as a workforce with skills appropriate to a particular industry tends to concentrate industries in particular areas. The result is that it is often difficult for competing firms in the same industries to be established outside those regions.

Summary

- Goods and services are produced using scarce resources.
- Businesses supply goods and services to meet the needs and wants of consumers.
- An effective demand for a product is created when sufficient people want the product and are willing and able to pay a price at which the producer will make a profit.
- Resources are allocated to the production of goods and services by the government or by the forces of demand and supply.
- Individuals, businesses, regions and countries tend to specialise in producing or supplying the types of goods and services for which they are most suited.
- Money allows individual employees and businesses to exchange their services or the goods they produce for other goods and services.