
> Unit 1

Basic economic ideas and resource allocation (AS Level)

> Chapter 1

Scarcity, choice and opportunity cost

LEARNING INTENTIONS

In this chapter you will:

- explain the fundamental economic problem of scarcity
- explain the need for individuals, firms and governments to make choices
- define the meaning of opportunity cost
- explain how opportunity cost results from the need to make choices
- explain the basic questions of resource allocation.

KEY TERMS

Choice Fundamental economic problem Needs Opportunity cost Resources Scarcity Wants

Key skills exercises

Knowledge and understanding

To answer the questions in this chapter, you need to know and understand:

- what the fundamental economic problem means
- why there is a need for individuals, firms and governments to make choices
- the meaning and significance of opportunity cost
- why opportunity cost is a consequence of the need to make choices
- the three basic questions of resource allocation.

- 1 What is the fundamental economic problem?
- 2 What are resources?
- 3 Describe the difference between a want and a need.
- 4 Why does scarcity occur?
- 5 Explain why individuals, firms and governments have to make choices.
- 6 Define the term 'opportunity cost'.
- 7 Describe the three basic questions of resource allocation.

TIP

Learners sometimes confuse what is meant by a need and what is meant by a want. A need is something that is essential. A want is something that someone would like to have.

1 Scarcity, choice and opportunity cost

Analysis

Government spending in India, 2014–2020

The Union budget of India for 2019–2020 included measures to improve the rural economy, strengthen agriculture and help those who are economically less privileged.

Figure 1.1 shows the pattern of estimated spending compared to average spending over the previous five budgets.

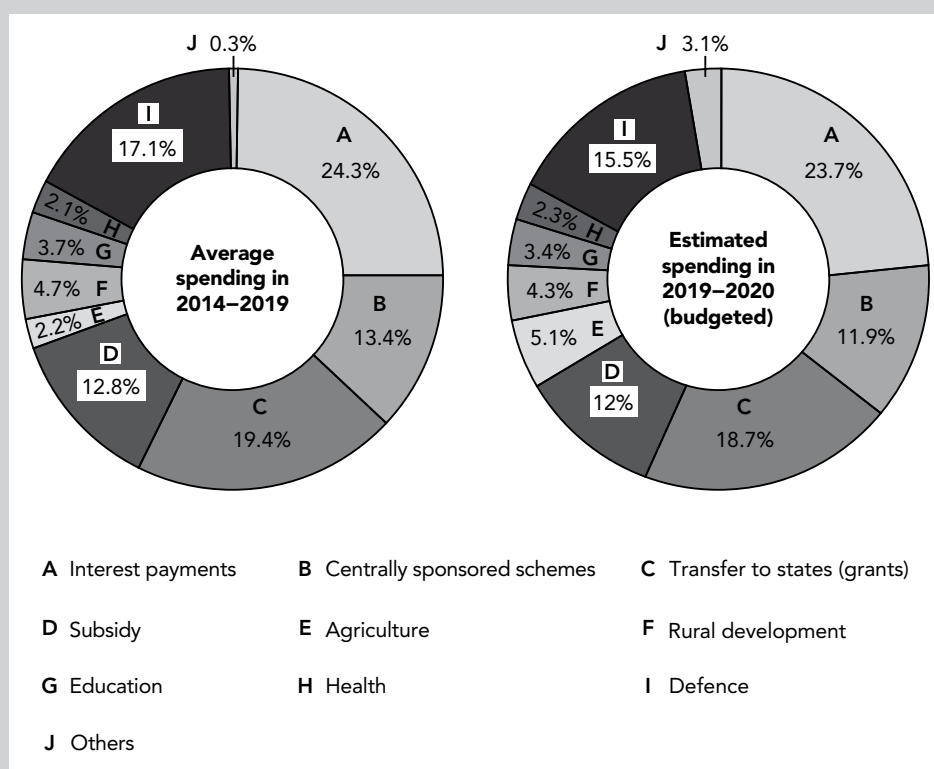


Figure 1.1: Government spending in India, 2014–2020

Source: Centre for Monitoring Indian Economy (CMIE)

The 2019–2020 budget is in deficit, with government spending more than government income.

- 8 Explain why the Indian government faces a fundamental economic problem when planning a budget.
- 9 What does the Indian government need to think about when setting its budget?
- 10 Explain how opportunity cost can be applied to the budgetary choices that have to be made.
- 11 Explain which of the three resource allocation questions the Indian government has addressed in its budget.



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PRACTICE QUESTIONS

Data response question

- 1 a Using the data in Figure 1.1, describe **three** ways in which the estimated 2019-2020 budget differs from average spending in 2014-2019.
- b Explain possible reasons for these three differences.

WORKED EXAMPLE FOR Q1

- a Three differences are:
- expenditure on defence is planned to fall
 - expenditure on agriculture is planned to increase
 - expenditure on health is planned to increase **[K]**.
- b The new budget would appear to provide more government funding for the well-being of the people. This is a likely reason for the increase in healthcare funding. This will have an early and visible impact. The increased expenditure for agriculture is likely to improve the incomes of farmers and may be a way of increasing agricultural exports. Defence still takes up a large percentage of the budget compared to most other areas of government spending **[A]**.

Essay question

- 1 Explain how the fundamental economic problem affects your family **and** consider how opportunity cost can be applied to the problem of resource allocation.

Improve this answer

This is a sample answer to essay Q1.

The fundamental economic problem is very important when studying economics. It affects firms, governments and families. All face the problem because resources are scarce and wants and needs are unlimited **[K]**. This means choices have to be made.

In the case of my family, the income we receive is limited since there are only two family members who earn income from employment. Our wants and needs are many, so we have to make choices to make sure our limited income is shared in the best way possible **[A]**.

All of us want more things. I would like a better mobile device or a newer scooter **[A]**. Until I start earning, these luxuries will have to wait.

Opportunity cost is defined as the cost expressed in terms of the next best alternative that is sacrificed for something else **[A]**. Opportunity cost can apply to our family in all sorts of ways. Our limited income means that there is a fixed sum for groceries and other expenses but there is often other money left to spend. Ideally the different ways of spending this additional money should be ranked in order of their benefit for the family. This will allow informed choices to be made **[A]**.

Your challenge

See whether you can improve this answer. The answer covers the main parts of the question. The first paragraph is good but the remainder of the answer would benefit from being written in an analytical style. The answer should also define the difference between wants and needs. A better answer is given in the workbook answers – but write yours out first.

> Chapter 2

Economic methodology

LEARNING INTENTIONS

In this chapter you will:

- explain why economics is a social science
- differentiate between facts and opinions (positive and normative statements)
- explain why economists use the term *ceteris paribus*
- explain when to refer to a time period such as 'short run', 'long run' and 'very long run'.

KEY TERMS

ceteris paribus Long run Macroeconomics Microeconomics Model Normative statements
Positive statements Short run Very long run

Key skills exercises

Knowledge and understanding

To answer the questions in this chapter, you need to know and understand:

- the difference between microeconomics and macroeconomics
- why economists use models
- the difference between a positive statement and a normative statement
- the significance of the term *ceteris paribus*
- the difference between the short run, the long run and the very long run time periods.

- 1 What is microeconomics?
- 2 What is macroeconomics?
- 3 Explain why economists use models.
- 4 What is a positive statement?
- 5 What is a normative statement?
- 6 What is the significance of the term *ceteris paribus*?
- 7 Explain the difference between the short run, the long run and the very long run time periods.

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Analysis

What is economics?

In your first economics lesson, you may have had very little idea what the subject was about. You were probably aware that economics has something to do with ‘money’ (but the subject is much wider) or even something to do with ‘economical’ (again the subject is wider).

The American Economic Association explains the social science of economics:

- Why are some countries rich and some countries poor?
- Why do women earn less than men?
- How can data help us understand the world?
- Why do we ignore information that could help us make better decisions?
- What causes recessions?

Economics can help us answer these questions.

Economics can be defined in a few different ways. It’s the study of scarcity, the study of how people use resources and respond to incentives, or the study of decision-making. It often involves topics like wealth and finance, but it’s not all about money. Economics is a broad discipline that helps us understand historical trends, interpret today’s headlines, and make predictions about the coming years.

Economics ranges from the very small to the very large. The study of individual decisions is called microeconomics. The study of the economy as a whole is called macroeconomics. A microeconomist might focus on families’ medical debt, whereas a macroeconomist might focus on sovereign debt*.

What do economists do?

Economists have all kinds of jobs, such as professors, government advisors, consultants, and private sector employees. Using theoretical models or empirical data, they evaluate programs, study human behavior, and explain social phenomena. And, their contributions inform everything from public policy to household decisions.

Economics intersects many disciplines. Its applications include health, gender, the environment, education, and immigration.

Why should I care about economics?

Economics affects everyone’s lives. Learning about economic concepts can help you to understand the news, make financial decisions, shape public policy, and see the world in a new way.

* Sovereign debt: the amount of money a country’s government has borrowed

Source: American Economic Association, *What is economics? Understanding the discipline*

Economists use both simple and complex models to represent real world situations. These models enhance our understanding of economic relationships and allow economists to make forecasts. Economic models often require just one variable to change – all other variables remain the same. This situation is called *ceteris paribus*.

2 Economic methodology

- 8 Which of the questions in the bulleted list on the previous page can be classified as microeconomics?
- 9 Which of the questions in the bulleted list on the previous page can be classified as macroeconomics?
- 10 Explain why all of the questions in the bulleted list on the previous page are normative statements.
- 11 Convert each of the questions in the bulleted list on the previous page into positive statements.

Evaluation

- 12 Comment on why economics is a social science.

PRACTICE QUESTION

Multiple-choice question

- 1 Which of these best describes the definition of the long run time period in economics?
 - A No change can be made to production.
 - B All resources used in production can be changed.
 - C It is possible to think even further ahead in time.
 - D Only one of the resources used in production can be changed.

WORKED EXAMPLE FOR Q1

B.

In the long run time period, all resources are variable. A is wrong and does not apply to any of the time periods used in economics. C could apply to any of the time periods. D refers to the short run [K].

This chapter does not contain an 'Improve this answer' feature.

> Chapter 3

Factors of production

LEARNING INTENTIONS

In this chapter you will:

- define the meaning of factors of production: land, labour, capital and enterprise
- explain the importance of the factors of production
- describe the rewards to the factors of production
- explain the difference between human capital and physical capital
- explain the division of labour and specialisation
- explain the role of the entrepreneur in the organisation of factors of production in 21st century economies and as a risk taker.

KEY TERMS

Capital Division of labour Economic growth Enterprise Entrepreneur Factors of production
 High-income countries Human capital Labour Land Low-income countries Lower middle-income countries
 Physical capital Specialisation

Key skills exercises

Knowledge and understanding

To answer the questions in this chapter, you need to know and understand:

- what is meant by a factor of production
- the meaning of land, labour, capital and enterprise as factors of production
- why factors of production are important
- how the use of factors of production is rewarded
- the difference between physical and human capital
- the role of the entrepreneur.

- 1 Define the term 'factor of production'.
- 2 Define 'land' as a factor of production.
- 3 Define 'labour' as a factor of production.
- 4 Define 'capital' as a factor of production.
- 5 Define 'enterprise' as a factor of production.
- 6 Describe the differences between a low-income country, a lower middle-income country, an upper middle-income country and a high-income country.
- 7 Explain the difference between physical capital and human capital.
- 8 Define the term 'economic growth'.
- 9 Explain the meaning of specialisation.
- 10 Explain the meaning of division of labour.

TIP

The classification of countries by the World Bank is used throughout the Workbook. It is based on Gross National Income (GNI) per head in 2018. The following levels apply:

- Low-income country \$1025 or less
- Lower middle-income country \$1026 to \$3995
- Upper middle-income country \$3996 to \$12375
- High-income country \$12376 and above

You will find it helpful to familiarise yourself with which countries fall into which of the four categories. Note the wide range of GNI per head for middle-income countries.

Analysis

Mauritius: an upper middle-income economy

Mauritius, an island state in the Indian Ocean, has a population of 1.3m people. The country's economy is growing at a steady pace. Mauritius's economy is driven by construction and service industries such as tourism, banking and financial services and ICT. The country also has more traditional manufacturing and sugar production industries. However, the sugar production industry has declined in recent years.

As a tourist destination, Mauritius is best known for its beaches, lagoons and reefs as well as inland forests and wildlife. The importance of tourism results in significant risks due to external shocks such as downturns in the economies of high-income countries and pressures to cut back on emissions from flying to combat climate change. Mauritius is also very vulnerable to tropical storms.

The country's development has been financed internally and externally. Mauritius now has a growing number of wealthy entrepreneurs, such as Bashir Currimjee and P Arnaud Dalais, both of whom have headed companies with interests in all sectors of the island's economy. Although the unemployment rate is low, there is a lack of job opportunities for women. Youth unemployment is also an issue due to a skills mismatch and wages below the expectations of those entering the labour market.

- 11 Identify two examples of land in Mauritius.
- 12 Identify two examples of labour in Mauritius.
- 13 Identify two examples of capital in Mauritius.
- 14 Explain the risks facing entrepreneurs in Mauritius.

Evaluation

- 15 Consider how the two entrepreneurs have organised their businesses to minimise risk.

WORKED EXAMPLE FOR Q15

The second paragraph of the information states that Mauritius's economy is vulnerable to external shocks affecting the economies of high-income countries. The COVID-19 pandemic is an extreme example. Other external shocks include more regular recessions and a growing concern to reduce flying to combat climate change. Firms are also affected by annual tropical storms that hit the island [A]. The entrepreneurs have tried to minimise risk by diversifying their businesses to cover most of the key sectors that contribute to the island's economy. Tourism is the most vulnerable activity. Banking, finance and ICT are likely to be more stable [E].

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PRACTICE QUESTIONS

Multiple-choice question

- Human capital is often referred to as a form of investment. Why is this?
 - Labour is required to produce all goods and services.
 - Improved human capital can lead to increased economic growth.
 - Human capital is costly like any investment.
 - Top earners are able to invest some of their earnings.

Essay questions

- Explain how capital and labour are needed for the manufacture of cotton garments **and** consider how an entrepreneur responds to an increase in demand for these garments.
- Explain the difference between human capital and physical capital **and** consider which is likely to be most important for an entrepreneur to have when growing a business.

TIP

When writing essays avoid the use of 'I'. Try to make your answers impersonal.

Improve this answer

This is a sample answer to essay Q1.

A factor of production is something that is required in an economy for production to take place. Economists recognise four, namely land, labour, capital and enterprise **[K]**. I will now explain what is meant by capital and labour and then how each are needed in the manufacture of cotton garments.

Capital is defined as an aid to production that is human-made. It refers to many different things such as factory buildings, machinery, power supplies, IT systems, warehouses and container vessels. In a garment manufacturing business, the factory building and the machinery used to manufacture garments are examples of capital **[K]**. In a competitive industry, such as clothing, the quality of the capital employed rather than quantity is of considerable relevance. Old machinery that keeps breaking down is more likely to restrict production and productivity than the latest production technology, even if this is no more than high-quality sewing machines **[A]**.

The quality and quantity of labour is also important. A garment manufacturer is likely to need most staff to have particular skills that can be applied in the production process. If there is a skill shortage then workers will have to be trained. Most manufacturers will also need low skilled and high skilled workers to complete the input of labour into the production process **[A]**.

Enterprise is the role of the owner of the garment factory. This person needs to be able to know what is required in order to produce and sell the garments that are produced **[A]**. If successful, the business will grow.

Your challenge

See whether you can improve this answer. The first three paragraphs are generally good. Now, look at the concluding (final) paragraph. The paragraph is weak and does not explain how an entrepreneur might respond to an increase in demand for garments. Your challenge is write a new concluding paragraph. A better answer is given in the workbook answers – but write yours out first.