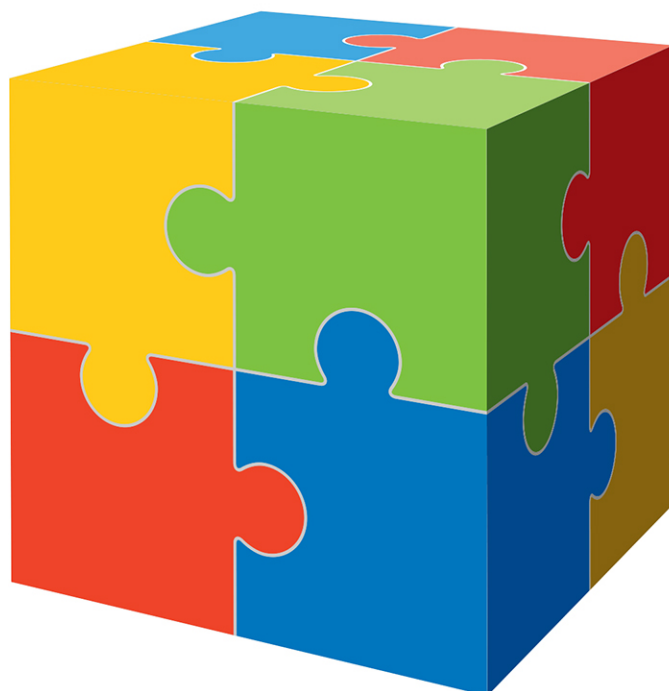


OCR

A-level

ECONOMICS

- + Plan and organise your revision
- + Reinforce skills and understanding
- + Practise exam-style questions



Simon Dyer
Liz Gregory

My Revision Planner

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1 The economic problem

What is economics?

Economics exists because there is a problem in the world. We (humans) have unlimited needs and wants and yet there are only a limited amount of resources in the world. So, we need to have a way of allocating these scarce resources among people.

Economic goods and free goods

REVISED

Most things that we have are **economic goods**. This means that they are **scarce** — there is not an unlimited supply of these goods.

However, there are some **free goods**. These are resources that are usually not seen as limited, such as air. Economists are interested in the allocation of economic goods.

The economic problem

REVISED

The economic problem is how we go about allocating scarce (economic) resources.

Economists ask the following questions:

- + What should be produced?
- + How should it be produced?
- + For whom should it be produced?

Microeconomics and macroeconomics

REVISED

- + Your Economics course is made up of two perspectives — micro and macro.
- + **Microeconomics** looks at the economic problem in terms of how individual consumers, producers and governments are involved in the allocation of a product.
- + **Macroeconomics** looks at the economic problem in terms of an entire economy, and how households, businesses and the government are involved in the allocation of all resources in that economy.

Economics The study of how scarce/limited resources are used in the world.

Economic goods Goods that are scarce, i.e. there is not an unlimited supply of these goods.

Scarcity When there is a limited amount of something.

Free goods Resources that are usually not seen as limited, such as sunlight or air.

The economic problem The problem of how to make the best use of limited or scarce resources.

Microeconomics The study of the behaviour of individuals, firms and governments in relation to the allocation of products and/or resources.

Macroeconomics The study of the behaviour and performance of an economy as a whole.

Normative and positive statements

- + In economics, some of what we deal with is fact and some of what we deal with is opinion. As economists you must be able to distinguish between the two.
- + **Positive statements** are factual. They are not necessarily correct but can be tested. For example, the UK has a population of over 66 million people.
- + **Normative statements** are opinion-based. They are value judgements with which you might agree or disagree. For example, there are too many people in the UK.

Positive statement

Factual statement that can be tested.

Normative statement

Opinion-based statement that one might agree or disagree with.

Now test yourself

TESTED 

- 1 Give an example of a free good.
- 2 Give an example of an economic good.
- 3 What three questions does an economist ask as part of the economic problem?
- 4 Are the following statements normative or positive statements?
 - a) My football club is top of the league table.
 - b) My school is a great place to learn.
 - c) I had sausages for lunch.
 - d) Everyone should become a vegan to save the planet.
 - e) Economics is an easy A-level.

Answers available online

Exam tip

In your longer answers you need to analyse and evaluate. Analysis and evaluation often require normative statements because you are making a judgement on what might/should/may happen. Make sure you do not write as if something will definitely happen. It irritates examiners and makes your answer seem naïve.

The role of economic agents

Economic agents are the key groups of people involved in the economic problem.

Economic agents Key groups involved in the economic problem, including governments, firms and households.

Households

REVISED 

Households have two key roles in the economy.

- 1 As users/consumers of goods and services. We buy things, e.g. a new car or a packet of crisps, to use them. We call this process 'consuming'. Therefore, households are consumers of goods and services.
- 2 Households provide the workforce for businesses/firms. Firms employ us in order to use our efforts to produce goods and services. For example, I am a teacher. I sell my time and academic ability to my school so that it can provide education. We call this 'labour', and we will explore this specific market later in the course. Households, therefore, provide the labour force to firms.

Making links

The role of households is discussed further in terms of demand in Chapter 5.

Firms

REVISED 

Firms have two roles in the economy.

- 1 They are producers of goods and services. For example, Coca-Cola is a producer of soft drinks.
- 2 They are purchasers of the goods and services they use in their production process. For example, a dairy farm may purchase land, cows and machinery to be able to produce packaged milk as a finished product.

Making links

The role of firms is discussed further in terms of supply in Chapter 6.

Government

REVISED

Government has many roles in the economy and various political parties have different views on what that role should be.

- Governments may use taxation and spending to influence the microeconomy (for a single product) and/or the macroeconomy (for the entire economy). For example, the UK government uses high taxation rates to affect the market for cigarettes. The government also gives benefits to the unemployed to manage poverty.
- The government has other tools with which it can influence the economy. Often these are employed to improve society.

However, not everybody agrees that the government is doing the right thing or making the right choices. This is where economics and politics often go hand in hand and also where normative judgements are made.

Making links

The role of the government in solving or minimising market failure is discussed further in Chapter 14.

Rationality

REVISED

- As economists we are often dealing with all three economic agents (households, firms and government) when looking at decision-making.
- This means that we have to look at decisions from all three perspectives.
- This can be difficult, especially when we consider that not every household, firm and government thinks the same way.
- Therefore, we have to make an assumption that each economic agent will act rationally.

Rationality is the assumption that each economic agent acts in their own best interests. Usually this means that:

- households aim to maximise their own satisfaction. For example, you will only buy a sandwich if you think that the value of the sandwich to you is at least as much as the money it took to purchase it. If it is not worth that much, you would prefer to keep the money.
- firms aim to maximise their profit. For example, a hairdresser would only employ a new worker to cut hair if they believed that the new worker would bring in more money than the additional wage cost to the firm. A firm may have different objectives, which we will explore later in the course.
- governments aim to maximise welfare. For example, a government is unlikely to decrease the taxation on sugary foods, as it believes that these foods are bad for people's health.

Rationality Assumption that each economic agent acts in their own best interests.

Exam tip

Economics is often about building up two sides of an argument. Usually this means starting by analysing the effects of something from a rational point of view. For example, when taxation of cigarettes goes up, consumers should smoke less.

However, a good way of evaluating the other side of the argument is often to suggest that this may not happen because the economic agent may not act rationally. For

example, a tax on cigarettes may not reduce smoking because people are addicted and therefore not acting rationally.

This is often the basis of a good economics answer, but you must remember to start with the rational analysis. Candidates who look only at how economic agents act irrationally usually receive low marks because their answer lacks the economic foundation.

Now test yourself

TESTED

- 5 Name the three key economic agents.
- 6 What would be the rational economic response to the following scenarios? Why might that economic agent not respond in this way?
- a) Households responding to an increase in the tax on mortgages.
 - b) Government responding to evidence that apples are good for your health.
 - c) Firms unable to get enough people to work in their factory for the minimum wage.

Answers available online

The factors of production

The **factors of production** are the building blocks needed for a business to operate and be able to produce goods and services. There are four factors: land, labour, capital and enterprise (see Table 1.1).

The business must pay to use the factors of production. This payment is known as the **reward for the factor of production**. Land is rewarded through rent, labour through wages, capital through interest and enterprise through profit.

Table 1.1 The four factors of production and their rewards

| Factor of production | What it is | Examples | Reward |
|----------------------|--|---|-----------------|
| Land | All the inputs that come from nature and are used in the production process. | Coal, fish, wood | Rent |
| Labour | The efforts of people who work within a business including mental and physical efforts. | Teachers, checkout operators, doctors | Wages, salaries |
| Capital | Man-made items that are needed to be able to produce goods and services. | Buildings, machinery, vehicles | Interest |
| Enterprise | The ability to take risks and bring together (organise) the other factors of production. | Problem solving, entrepreneurship, leadership | Profit |

Factors of production

Land, labour, capital and enterprise, the building blocks needed for a business to operate.

Reward for the factors of production

What needs to be returned by a business for using each of the factors of production.

Exam tip

Candidates often mix up capital and enterprise when looking at the rewards for the factors of production.

Capital items must be purchased by a firm: the firm could have left that money in the bank to earn interest. Therefore, the capital item needs to bring in more revenue than the money would have earned.

Enterprise can be hired through the labour of an organisation. However, natural entrepreneurs are likely to set up their own business to profit from their own ideas.

Now test yourself

TESTED

- 7 Can you identify each of the factors of production for the following business?
- In 2019, Carina Lapore won the business-styled television game show *The Apprentice*. The prize was a £250,000 investment from business magnate Sir Alan Sugar. Carina's business has two experienced bakers and produces many different breads and baked products.

Answers available online

Exam skills

You should make sure that you can do each of the following to the required level.

| | Explain | Draw | Calculate | Evaluate |
|--|---------|------|-----------|----------|
| Economic goods | | | | |
| Free goods | | | | |
| The economic problem | | | | |
| Normative statements | | | | |
| Positive statements | | | | |
| The role of government as an economic agent | | | | |
| The role of firms as an economic agent | | | | |
| The role of households as an economic agent | | | | |
| Land as a factor of production | | | | |
| Labour as a factor of production | | | | |
| Capital as a factor of production | | | | |
| Enterprise as a factor of production | | | | |
| The rewards of the factors of production | | | | |
| The problem of scarcity | | | | |
| The requirement to make choices | | | | |
| Rationality as a way of understanding the behaviour of economic agents | | | | |
| The different objectives of the economic agents in an economy | | | | |

Exam practice

- 1 Explain what is meant by economic goods. [2]
- 2 Identify the factors of production. [4]
- 3 Evaluate the extent to which the government always acts rationally. [20]

Answers available online

2 The allocation of resources

Incentives

Much of economics covers how economic agents respond to **incentives**.

For example:

- + consumers respond to lower prices by increasing demand
- + firms respond to higher profits by increasing supply

These responses form the basis of how economists model economic effects.

The assumption is usually that economic agents react rationally to incentives to achieve their objectives.

Incentive Something that motivates an action. In economics, this usually relates to profit, prices and social welfare (the objectives of economic agents).

The effectiveness of incentives

REVISED

The fact that economic agents respond to incentives is a basic economic assumption. In many cases it is likely to be true. For example, if you are searching for a new pair of jeans and find them on sale in a shop, you may be more likely to purchase them if you have enough money.

- + Will you always buy something just because it is cheaper?
- + Will a firm always use the cheapest methods of production to reduce its costs?
- + Will a government always ban something if it causes people harm?

Economic incentives are important, but they are not the only forces that act on decision-making. It is important to analyse what an economic agent should do based on the given incentives, but then to evaluate why this may not happen.

Now test yourself

TESTED

- 1 For the following scenarios, analyse the most likely, rational effect of the incentive. Then evaluate why that effect may not happen. The first one has been done for you.

| Scenario/incentive | Effect on | Analysis of the possible effect | Evaluation of why the effect may not happen |
|--|------------|---|--|
| The price of petrol increases | Consumers | Consumers purchase less petrol and buy electric cars instead. | The price increase might not be big enough to make consumers switch. |
| The cost of electricity increases | Producers | | |
| Research suggests that sugary drinks are the main cause of obesity | Government | | |

Answers available online

The effectiveness of incentives is likely to depend upon a number of elements, which can be used to evaluate:

- + the size of the incentive
- + the timescale involved
- + the type of good/service
- + the objectives of the economic agents
- + other changes in the market/economy

Exam tip

Economics often requires students to analyse the effect of an incentive on an economic agent and then to argue why this may not happen. Remember that your analysis should focus on the economic theory, i.e. how economics should work.

Market, planned and mixed economic systems

An economy is about finding a way to allocate scarce resources. There are three main types of economy.

- + **Planned economy:** the government controls the factors of production and decides on the allocation of resources.
- + **Mixed economy:** a combination of market forces and government policies decides the allocation of resources.
- + **Market economy:** the allocation of resources is decided by the interaction of supply and demand (market forces).

Most economies sit somewhere between the two extremes of a market economy and a planned economy — in other words, a mixed economy. For example, in the UK we allow market forces to decide the allocation of many goods, such as a haircut. However, the government controls the majority of the UK's healthcare services through the National Health Service (NHS).

Now test yourself

TESTED

2 Identify three goods or services where the government controls the allocation.

Answers available online

Planned economy The government controls the factors of production and decides on the allocation of resources.

Mixed economy Combination of market forces and government policies that controls the allocation of resources.

Market economy Allocation of resources is decided by the interaction of supply and demand (market forces).

Evaluation of economic systems

REVISED

Each economic system has advantages, as shown in Table 2.1.

Table 2.1 Advantages of the three main economic systems

| Planned economy | Mixed economy | Market economy |
|--|--|--|
| The government can focus resources on where they are most needed in the economy. | The government can decide which resources to control. | Having multiple businesses all competing against one another is likely to lead to lower average costs. |
| Prices can be controlled so that those most in need can access goods and services. | Market forces can be used for goods and services that are considered less important. | Competition between firms can lead to greater efficiency — firms focus on the areas in which they can be most efficient. |
| Fewer resources are wasted on duplicating goods and services. | | Firms are more likely to innovate when there is a profit incentive. |
| There can be less inequality of income and wealth. | | People have an incentive to work in order to earn money to purchase goods and services. |

Most countries operate a mixed economy to gain the advantages of both a planned economy and a market economy.

Which goods and services are controlled by the government and which are controlled by market forces depends upon a number of factors:

- + **The will of the people:** different political systems around the world prioritise different goods and services. In the UK we choose to have planned healthcare, but in the USA much of the healthcare industry is based on market forces.
- + **Government objectives:** some goods and services are considered particularly beneficial to a society and the control of these goods may be important. For example, the amount of money spent on defence has often divided different political parties.
- + **The availability of resources in a particular economy:** in Manhattan, New York, for example, there is so little space that the government uses rent control to control the price of accommodation.

Exam tip

Economics and politics often cross over. However, in an Economics A-Level answer you must make sure that you include the economic theory and not just a political argument.

Economic efficiency

Efficiency is one of the most important terms in economics. Economic efficiency is a situation where an economic system achieves both allocative and productive efficiency.

- + **Allocative efficiency** is a situation where production matches consumer preferences. It is when supply (production) equals demand (consumer preferences).
- + **Productive efficiency** is a situation where all of the resources in society are being used to produce as much as possible. It is when no more could be produced.

Making links

Economic, allocative and productive efficiency are used throughout the course. Productive efficiency can be shown on a graph using a production possibility curve (PPC) (see Chapter 3) and allocative efficiency can be shown on a supply and demand graph (see Chapter 8).

Exam skills

You should make sure that you can do each of the following to the required level.

| | Explain | Draw | Calculate | Evaluate |
|---|---------|------|-----------|----------|
| Incentives | | | | |
| Market, planned and mixed economic systems | | | | |
| Economic efficiency: productive and allocative efficiency | | | | |
| The effectiveness of incentives on the behaviour of economic agents and resource allocation | | | | |
| The allocation of resources in the different economic systems | | | | |

Exam practice

- 1 Explain, using an example, how an incentive might lead to an increase in the production of bicycles for a business. [3]
- 2 Explain two differences between a market and a planned economic system. [4]

Answers available online

3 Opportunity cost

What is opportunity cost?

Opportunity cost is a way of looking at a decision in terms of what you must give up.

- + Imagine you are given the choice between a chocolate bar and a packet of crisps. If you cannot have both then you must give up one of them.
- + Whatever choice you make there will be an opportunity cost. If you choose the chocolate bar, then the opportunity cost is the benefit you would have gained from the packet of crisps. Likewise, if you choose the crisps, the opportunity cost is the benefit you would have gained from the chocolate bar.
- + A rational person would choose the option that has the smallest opportunity cost — in other words, what you least mind losing out on.

Opportunity cost is an important element of economics because it helps us to understand how rational decisions are made. It also helps us to quantify (put into numbers) what we lose out on by making a decision.

Opportunity cost Cost of the next best alternative forgone (given up) when a decision is made.

Trade-offs

REVISED

A **trade-off** is the willingness of an economic agent to give up one thing for another.

- + For example, I am willing to trade my time for the money my employer pays me.
- + Losing my time has an opportunity cost (the benefit I would have had from using this time for leisure) but the payment I get from my employer is enough to compensate me for this loss.

Trade-off A sacrifice that is made in order to gain something.

Now test yourself

TESTED

- 1 For the following scenarios, explain the opportunity cost and the trade-off involved. The first one has been done for you.

| Scenario | Trade-off | Opportunity cost |
|--|-----------------------|--|
| A consumer purchases a car | The money for the car | The next best alternative use for the cash |
| A car manufacturer decides to produce more red cars | | |
| A government decides to decrease income taxation for poorer people | | |

Answers available online

Production possibility curves

A production possibility curve (PPC) is a way of showing the range of possibilities that exist for an economy or a firm.

Figure 3.1 shows a PPC for a firm that can choose to make a combination of Good A and Good B. The quantity of Good A is shown on the horizontal axis and the quantity of Good B is shown on the vertical axis.

- + The maximum combinations that the firm can make using all of its resources are represented by the PPC.

- + Any points on the PPC (like points X and Y) are productively efficient. This means all of the resources are being used to produce the maximum possible output.
- + Any point within the PPC is possible but productively inefficient. This means that there may be unused resources (which is a waste) or they are being used but don't produce the maximum possible.
- + Any point beyond the boundaries of the PPC is impossible.

Making links

PPCs are found in both microeconomics and macroeconomics (see Chapter 1). In microeconomics we are usually interested in decisions that individual firms make. In macroeconomics we are usually interested in decisions made by the entire economy. The axes for macroeconomic PPCs are usually labelled 'Capital goods' and 'Consumer goods' (see Figure 3.2).

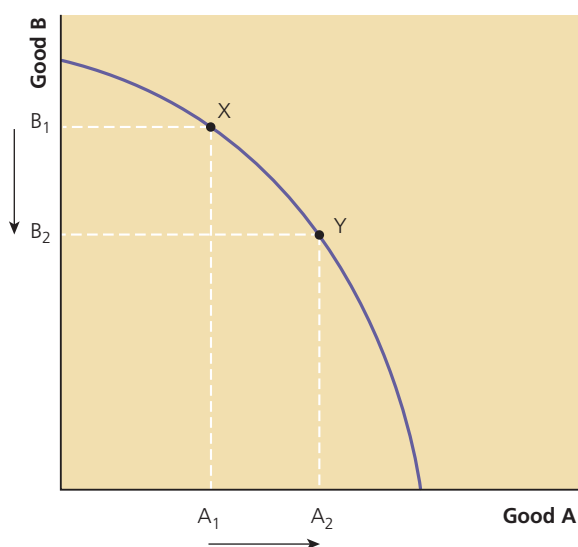


Figure 3.1 A production possibility curve (PPC)

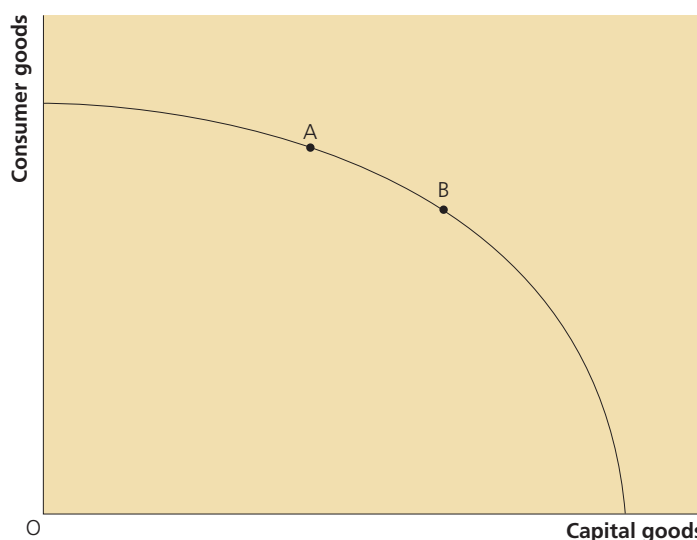


Figure 3.2 A production possibility curve (PPC) for a whole economy

Movements along a production possibility curve

REVISED

A PPC is very useful for showing the opportunity cost of a decision. In Figure 3.1, if the firm wants to increase production of Good A, then the increase (shown by the movement from A_1 to A_2) has an opportunity cost of a decrease in Good B (shown by the movement from B_1 to B_2).

Exam tip

Throughout your Economics A-Level you will encounter many graphs. They are one of the most effective ways of showing your understanding and how changes can have an effect on a market. When using graphs make sure that you:

- + correctly label every axis and line
- + bear in mind that your exam paper will be scanned in black and white (do not use colours or light pencil)
- + draw the graph big enough (no smaller than 1/8 of an A4 page)
- + label all the relevant points so that you can refer to them in your answer

Shifts of a production possibility curve

REVISED

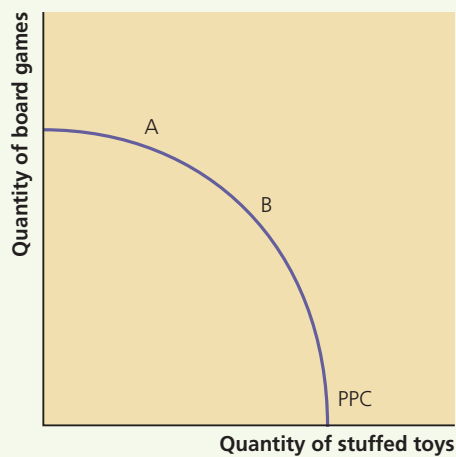
A PPC shows the maximum combination of goods and services that can be produced. Therefore, anything that affects what can be produced leads to a shift in the PPC. The PPC will shift outwards (increase) if:

- + there is an increase in the quantity or the quality of raw materials
- + there is an increase in the quantity or productivity of the labour available
- + there is an increase in the quantity or productivity of the capital available

Now test yourself

TESTED

2 A toy manufacturer would like to change its production from point A to point B. Fully label the graph and then explain the opportunity cost using your points.



3 Explain one reason why the PPC for the toy manufacturer might increase (shift outwards).

Answers available online

The usefulness of the concept of opportunity cost

REVISED

As discussed earlier, opportunity cost is a concept to aid decision-making. Here are some examples of the uses of opportunity cost:

- + Producers deciding whether to invest in a new piece of machinery or not.
- + Consumers deciding whether to purchase a new car or a luxury holiday.
- + Government deciding whether to spend on education or healthcare.

Exam skills

You should make sure that you can do each of the following to the required level.

| | Explain | Draw | Calculate | Evaluate |
|--|---------|------|-----------|----------|
| Opportunity cost and trade-off | | | | |
| Movements along a production possibility curve (PPC) | | | | |
| Shifts of a production possibility curve (PPC) | | | | |
| The usefulness of the concept of opportunity cost | | | | |

Exam practice

- 1

Explain what is meant by the term ‘opportunity cost’.

[2]
- 2

Explain, with the aid of a diagram, how a more productive piece of machinery may increase the production of goods for a business.

[4]
- 3

Identify one possible use of the concept of opportunity cost.

[1]

Answers available online

4 Specialisation and trade

Specialisation

Specialisation is an essential part of efficient resource allocation.

- Each of the factors of production can be specialised to make it more efficient.
- For example, a worker can be trained to be a specialist. By doing this the worker can do their job better, faster and with higher productivity. Likewise, some land is better used if it is specialised to produce what it is best at producing.

Specialisation Focusing on one activity (or part of an activity) to be able to produce more efficiently.

Making links

Specialisation is the basis for international trade, which is discussed further in Chapter 45.

Division of labour

REVISED

Many firms choose to specialise their workforce by dividing up complex tasks into smaller, easier tasks, a process known as the **division of labour**.

- For example, it would require a great deal of expertise for a worker, individually, to build a whole car.
- However, by dividing the process into easier, simpler steps, the worker can become an expert in the small step that they are responsible for or involved with.
- This is likely to make the process quicker and therefore more efficient.

Division of labour Splitting up a task into smaller activities to be able to produce more efficiently.

Evaluation of specialisation and the division of labour

REVISED

There are a number of advantages and disadvantages to specialisation and the division of labour (see Table 4.1).

Table 4.1 Advantages and disadvantages of specialisation and the division of labour

| Advantages | Disadvantages |
|---|---|
| Quicker production process | Can be demotivating for the workers to focus on one small task |
| Able to produce more goods and services | A single worker absent, or piece of capital equipment malfunctioning, can stop the whole production process |
| Lower average cost of production | May be a barrier to entering a market for smaller firms that cannot afford the investment |

Making links

The average cost savings a firm may gain from specialisation are linked to economies of scale, which are covered in Chapter 16.

The benefits a firm may gain from specialisation and the division of labour depend upon:

- **The nature of the good or service:** the process of cutting hair is unlikely to gain significant benefits from specialisation and/or the division of labour, whereas the production of a car is likely to benefit.
- **The importance of price to consumers:** consumers are often willing to pay more for goods and services that have been made by skilled labour as opposed to mass-produced products.
- **Changes in technology:** this may mean that firms cannot afford to buy specialist capital or to train workers because the processes change so often.

Now test yourself

TESTED 

- 1 Think about your school. How does it divide the labour between teachers? Are there specialist teachers? If so, why?
- 2 Secondary schools and sixth form colleges usually have more specialisation and division of labour than primary schools do. Why do you think this happens?

Answers available online

Trade

Barter system

REVISED 

Most of our markets are based on being able to exchange money for goods and services. If money is not used then a **barter system** can take their place. A barter system is when goods and services are exchanged for other goods and services.

- ✚ For example, a farmer growing carrots may exchange (or barter) their carrots for other goods, such as potatoes and meat.
- ✚ Barter systems came about so that producers could specialise and gain all the benefits of specialisation.
- ✚ The farmer who produces carrots may become an expert in carrots, but they cannot live on carrots alone.
- ✚ Therefore, by specialising, the farmer needs to barter to be able to have a variety of goods to consume.

Barter system System of exchanging one product for another without the use of money as a medium of exchange.

Money as a medium of exchange

REVISED 

One of the main problems with barter systems is that the person you are trading with must have what you want and want what you have (the double coincidence of wants). Often this is not the case and a medium of exchange is needed.

Money has become a medium of exchange in most economies by providing something that both the seller and the buyer can agree has value. As long as both sides agree on the value of the currency then a price can be negotiated and trade becomes easier.

Exam skills

You should make sure that you can do each of the following to the required level.

| | Explain | Draw | Calculate | Evaluate |
|---|---------|------|-----------|----------|
| Specialisation and the division of labour | | | | |
| Barter systems | | | | |
| Money as a medium of exchange | | | | |
| The role of specialisation and the division of labour in addressing the problem of scarcity | | | | |

Making links

Money is an important concept in both microeconomics and macroeconomics. In microeconomics we need to understand how money acts a medium of exchange, but in macroeconomics we start to look at what makes a good system of money and the characteristics of money, both of which are discussed in Chapter 47.

Exam practice

- 1 Explain what is meant by the term 'barter system'. [2]
- 2 Google employs more than 110,000 people around the world in jobs that include accountants, engineers, software specialists and program managers.
Evaluate how job specialisation in a business such as Google addresses the problem of scarcity. [20]

Answers available online

5 Demand

Demand is a key element of microeconomics. It encompasses the willingness and ability of consumers to purchase goods and services at a given price.

Exam tip

Mixing up demand and supply (see Chapter 6) is a very common mistake. You must make sure that you understand that demand relates to consumers whereas supply relates to producers.

Demand A consumer's desire and willingness to purchase goods and services at a specific price.

Individual and market demand

Individual demand is what one individual consumer would be willing and able to pay for a product or service. However, in economics we are more normally concerned with **market demand**. This is the total quantity demanded across all consumers in a market for a good or service.

Individual demand One consumer's willingness and ability to purchase a product or service at a given price.

Market demand The sum of all consumers' willingness and ability to purchase a product or service at a given set of prices.

The demand curve

The **demand curve** represents consumers' ability and willingness to purchase at different prices. In other words, it shows the relationship between the quantity that consumers wish to purchase and the price of the product. This means that the demand curve is almost always downward sloping, because there is an inverse relationship between price and quantity demanded.

Figure 5.1 demonstrates this relationship. At a price of £9 consumers demand a quantity of 3 units. As the price decreases, more consumers demand the product.

Demand curve

Relationship between the price of a product and the quantity demanded by the market.

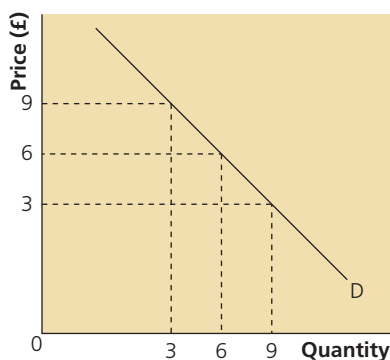


Figure 5.1 The demand curve

Making links

How consumers make decisions over what to buy and at what price is based on the consumers' marginal utility. This is discussed in Chapter 10.

Exam tip

You would be surprised how often candidates mix up supply and demand on a graph in an examination. If your graph is not correct, it can wipe out the marks you might have received.

Joint, competitive and composite demand

REVISED

Often we use the word 'demand' on its own. However, you need to be aware that there are several different types of demand.

- Joint demand** is when products are complements for one another. What happens to the price of one good can affect the quantity demanded of the other good. For example, the demand for cars is influenced by the price of petrol. The two products are, therefore, in joint demand.
- Competitive demand** is when products are substitutes for one another. The price of a substitute affects the demand for a good. For example, the price of a Samsung phone may affect the demand for a Sony phone.
- Composite demand** is when a product has multiple uses. The demand for what a product can do affects the demand for the product. For example, computers have multiple uses and as demand for streaming services has increased, so has demand for computers to fulfil this function.

Joint demand When products are demanded together. The products are complements.

Competitive demand When consumers demand one or the other product. The products are substitutes.

Composite demand When a product is demanded for multiple possible uses.

Now test yourself

TESTED

- For each of the following products suggest what else might be in joint demand, in competitive demand and what the alternative uses could be. The first one has been done for you.

| Product | Joint demand | Competitive demand | Alternative uses (composite demand) |
|-------------------|-------------------|--------------------|---------------------------------------|
| Netflix | A tablet computer | Amazon Prime | Entertainment Education Leisure |
| A pen | | | |
| A pair of glasses | | | |
| Cinema | | | |

Answers available online

Making links

Complements and substitutes can be identified using cross elasticity of demand. This is discussed in Chapter 9.

Movements along the demand curve

REVISED

When price changes there is a **movement along the demand curve**. These movements are known as extensions and contractions.

- A contraction of demand** is when there is an increase in price, which decreases the quantity demanded (see Figure 5.2, movement from A to B).
- An extension of demand** is when there is a fall in price, which increases the quantity demanded (see Figure 5.2, movement from A to C).

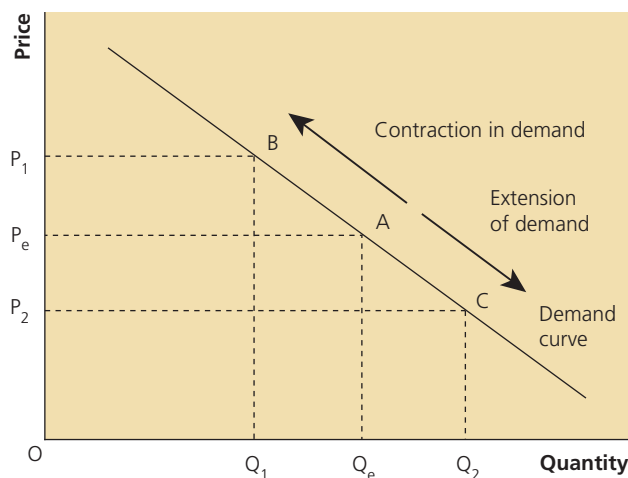


Figure 5.2 Movements along the demand curve

Movement along the demand curve Change in quantity demanded that results from a change in the price of a product.

Contraction of demand A decrease in the quantity demanded.

Extension of demand An increase in the quantity demanded.

Exam tip

A change in price does not lead to a change in demand — it can lead to a change in quantity demanded. A change in demand is usually associated with a shift, not a movement, of the curve.

Shifts of the demand curve

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When any factor other than price affects demand then a shift occurs. A simple shift shows that the quantity demanded has changed at every price level (see Figure 5.3).

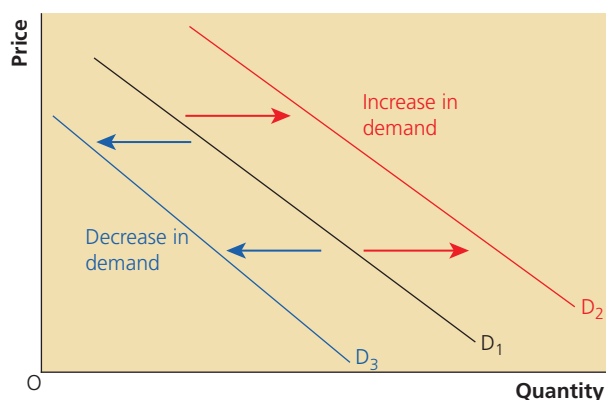


Figure 5.3 Shifts of the demand curve

- + An **increase in demand** is when the demand curve shifts outwards (from D_1 to D_2). This means that at every price there is an increased quantity demanded.
- + A **decrease in demand** is when the demand curve shifts inwards (from D_1 to D_3). This means that at every price there is a decreased quantity demanded.

Increase in demand

A shift outward of the demand curve so that there is an increase in quantity demanded at every price.

Decrease in demand

A shift inward of the demand curve so that there is a decrease in quantity demanded at every price.

Now test yourself

TESTED

- 2 For each of the following scenarios, tick whether there has been an extension, a contraction or a shift (inwards or outwards) in the demand for a film shown at the cinema.

| Scenario | Extension | Contraction | Shift inwards | Shift outwards |
|--|-----------|-------------|---------------|----------------|
| The ticket price increases by 10% | | | | |
| A successful advertising campaign increases consumer awareness of the film | | | | |
| There is a buy one get one free offer on cinema tickets | | | | |
| A more popular film is released on the same day | | | | |
| The price of popcorn at the cinema decreases significantly | | | | |

Answers available online

Factors that cause a shift of the demand curve

While changes in price can lead to a movement along the demand curve, other factors may lead to a shift of the demand curve. These factors are likely to be specific to the good or service and commonly include those shown in Table 5.1.

Table 5.1 Factors causing a shift of the demand curve

| Factor | Description |
|----------------------------------|---|
| Income | How much money a consumer has affects their willingness and ability to purchase goods or services at different prices. The demand for some goods increases as income increases (normal or luxury products), while the demand for other goods decreases as income increases (inferior products). |
| The price of complementary goods | When a good or service is in joint demand with another good or service (for example, petrol and cars), a price change in one is likely to lead to a shift in demand for the other. As the price of a complement increases, the demand for the original good decreases. |
| The price of substitute goods | When a good or service is in competitive demand with another good or service (for example, a Samsung phone and a Sony phone), a price change in one is likely to lead to a shift in demand for the other. As the price of a substitute increases, the demand for the original good increases. |
| Tastes and fashions | If people start to enjoy a good or service more or it becomes fashionable then demand is likely to increase. |
| Advertising and marketing | The aim of most marketing is to increase demand for a good or service. Advertising is usually aimed at persuading more people to purchase a good or service. |
| Size of population/target market | The number of people in a population, or in the target market, affects the demand for a good or service. For example, there is a growing number of pensioners, which leads to an increase in the demand for pensioner holidays. |

Now test yourselfTESTED 

- 3** Identify as many factors as you can that affect your demand for a car. Think about contextual factors such as where you live and what you do with your time.

Answer available online**Exam tip**

Many factors affect the demand for a product. In the examination, use the context given to help you to spot specific factors that affect the product in question.

Exam skills

You should make sure that you can do each of the following to the required level.

| | Explain | Draw | Calculate | Evaluate |
|--|---------|------|-----------|----------|
| The relationship between price and quantity demanded | | | | |
| Individual and market demand | | | | |
| Joint, competitive and composite demand | | | | |
| Movements along the demand curve (extension/contraction) | | | | |
| Shifts of the demand curve (increase/decrease) | | | | |

Exam practice

- 1 Explain what is meant by the term 'demand'. [2]
- 2 Explain, with the aid of a diagram, the relationship between price and the quantity demanded for a normal product. [4]
- 3 Explain, with the aid of a diagram, one factor that could cause an increase in the demand (shift) for the purchase of a house. [4]
- 4 Explain, with the aid of a diagram, what is meant by an extension of demand. [4]

Answers available online

6 Supply

Demand is only half of the picture in microeconomics. For a business transaction to take place there must be a supplier. **Supply**, therefore, is the ability and willingness of a business to sell products in the market at a given price.

Individual and market supply

Individual supply is what one individual business would be willing and able to sell at a given price. However, in economics we are more normally concerned with **market supply**. This is the combination of the decisions to supply at different price levels.

Supply Ability and willingness of a firm to sell products at a given price.

Individual supply One business's willingness and ability to sell a product at a given price.

Market supply Sum of all businesses' willingness and ability to sell a product at a given set of prices.

Supply curve Relationship between the price of a product and the quantity supplied by businesses.

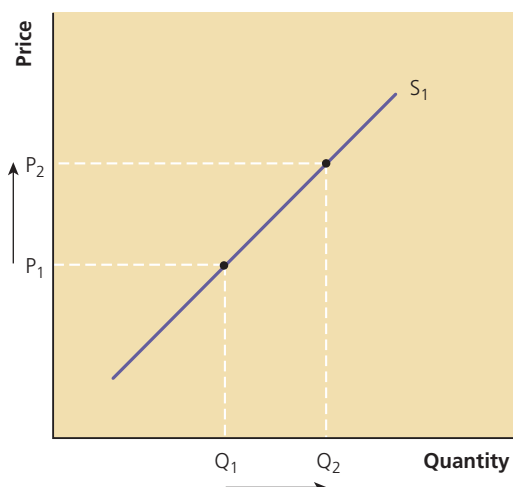
Making links

Supply is about the production of goods and services. It encompasses the decisions that firms make. Firms as an economic agent were covered in Chapter 1.

The supply curve

- ✚ The **supply curve** represents the amount supplied by firms and their willingness to sell at given prices over a certain period of time. In other words, it shows the relationship between the quantity that businesses supply and the price of the product.
- ✚ This means that the supply curve is almost always upwards sloping, because there is a positive relationship between price and quantity supplied.
- ✚ The higher the price, the greater the incentive for a business to supply products.

Figure 6.1 illustrates this relationship. As the price increases from P_1 to P_2 , businesses are attracted to supply more products and therefore quantity supplied increases from Q_1 to Q_2 .



Making links

It is important to understand the concept of supply but it starts to become more useful when linked to the concept of demand, as this shows the effect on price and quantity when supply changes. This interaction of supply and demand is covered in Chapter 8.

Exam tip

Not only do candidates mix up supply and demand but many forget to label their lines. A line without a label is useless and is likely to be ignored by the examiner.

Figure 6.1 The supply curve

Joint and competitive supply

REVISED

As with demand, supply is often used on its own. However, there are two other types of supply that you need to be aware of.

- ✚ **Joint supply** is when products are produced together. This may be because one product is a byproduct of another or simply because the production process leads to more than one product. For example, a cattle farmer may produce both beef and milk. Both products come from the rearing of cows.
- ✚ **Competitive supply** is when a producer has alternative uses for the factors of production and must decide which to produce. For example, a supermarket has a limited amount of space to display products. Each product takes up shelf space that could be used to sell something else.

Joint supply When products are supplied together, often as a byproduct.

Competitive supply When producers choose to supply one or the other product with given factors of production.

Now test yourself

TESTED

- 1 Identify as many services as you can that have joint supply with a bank account.
- 2 Identify as many products as you can that have competitive supply for a cereal farmer.

Answers available online

Movements along the supply curve

REVISED

When price changes there is a **movement along the supply curve**. These are known as extensions and contractions.

- ✚ An **extension of supply** is when there is an increase in price, which increases the quantity demanded (see Figure 6.2, movement from Q_1 to Q_2).
- ✚ A **contraction of supply** is when there is a decrease in price, which decreases the quantity supplied (from Q_1 to Q_3).

Exam tip

A change in price does not lead to a change in supply — it can lead to a change in quantity supplied. A change in supply is usually associated with a shift, not a movement, of the supply curve.

Shifts of the supply curve

REVISED

When any factor other than price affects supply then a shift occurs. A simple shift shows that the quantity supplied has changed at every price level (see Figure 6.3).

- ✚ An **increase in supply** is when the supply curve shifts outwards (from S_1 to S_2). This means that at every price there is an increased quantity supplied.
- ✚ A **decrease in supply** is when the supply curve shifts inwards (from S_1 to S_3). This means that at every price there is a decreased quantity supplied.

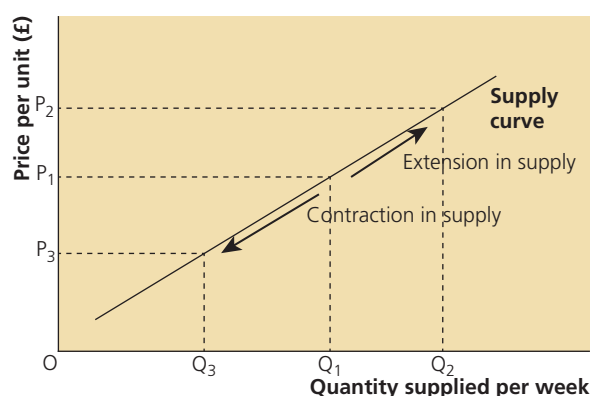


Figure 6.2 Movements along the supply curve

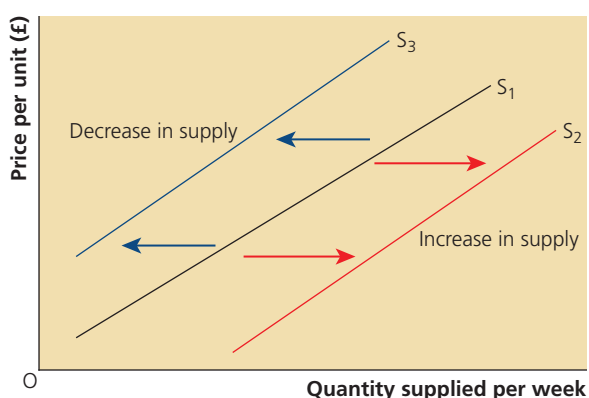


Figure 6.3 Shifts of the supply curve

Movement along the supply curve Change in quantity supplied that occurs from a change in the price of a product.

Extension of supply An increase in the quantity supplied.

Contraction of supply A decrease in the quantity supplied.

Increase in supply A shift outward of the supply curve so that there is an increase in quantity supplied at every price.

Decrease in supply A shift inward of the supply curve so that there is a decrease in quantity supplied at every price.

Factors that cause a shift of the supply curve

REVISED

While changes in price can lead to a movement along the supply curve, other factors may lead to a shift of the supply curve (see Table 6.1).

Making links

The factors affecting demand are covered in Chapter 5.

Table 6.1 Factors causing a shift of the supply curve

| Factor | Description |
|---|---|
| The cost of labour | Most firms need labour to produce products. If the cost of that labour changes then the overall cost of production will change. For example, if the minimum wage increases then the supply curve will shift to the left as the business finds it less profitable to produce. |
| The cost of capital | Businesses require capital to produce. This includes items such as machinery, vehicles and, of course, the cost of borrowing money. As the cost of capital increases, so the supply of a product will decrease (shift inwards) and vice versa. |
| The cost of land | Businesses need land and the raw materials that may come from the land. These need to be purchased or hired and as the cost changes so too does the firm's willingness and ability to supply products. |
| Technology | Many firms use technology in the production process and the hope is that this technology can increase the firm's productivity. As technology improves, a firm is likely to be able to produce more products for less money, so increasing supply. |
| Prices of jointly supplied products | If the price of a jointly supplied product increases, a firm is likely to make more profit from it and the supply of the original product also increases, e.g. if the price of beef increases then a farmer may be willing to increase the supply of milk as a byproduct, even if the price of milk stays the same. |
| Prices of competitively supplied products | If the price of a competitively supplied product increases then a firm is likely to switch production to that product (to gain higher profit), reducing supply of the original product. |
| Taxation | A cost of doing business is the need to pay taxation (tax). If taxes increase, there is less incentive to supply products and the supply decreases. |
| Subsidies | Governments sometimes pay firms a subsidy to encourage production of a product. This encourages firms to increase production, leading to an increase in supply. |

Exam skills

You should make sure that you can do each of the following to the required level.

| | Explain | Draw | Calculate | Evaluate |
|--|---------|------|-----------|----------|
| The relationship between price and quantity supplied | | | | |
| Individual and market supply | | | | |
| Joint and competitive supply | | | | |
| Movements along the supply curve (extension/contraction) | | | | |
| Shifts of the supply curve (increase/decrease) | | | | |

Exam tip

Candidates often mix up the factors that affect supply and demand. Remember — if it affects the consumer then it is a factor that affects demand. If it affects the business, it is likely to affect supply.

Exam practice

- 1 Explain what is meant by the term 'supply'. [2]
- 2 Explain, with the aid of a diagram, the relationship between price and the quantity supplied for a product. [4]
- 3 Explain, with the aid of a diagram, one factor that could cause a decrease in the supply (shift) of houses by a house builder. [4]
- 4 Explain, with the aid of a diagram, what is meant by a contraction of supply. [4]

Answers available online

Now test yourself

- 3 Identify as many factors as you can that affect the number of haircuts a hairdresser can supply. Think about contextual factors, such as the factors of production used in hairdressing.

Answers available online

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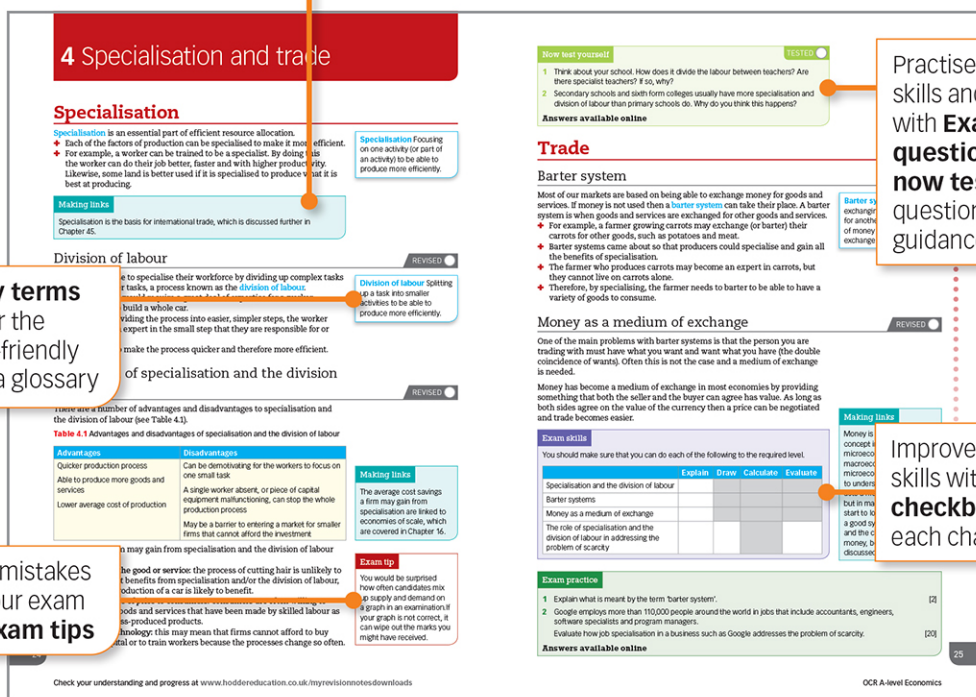
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