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Content Guidance

Scarcity and choice

The basic economic problem

The basic economic problem exists because resources are scarce and wants are infinite. Economists are therefore tasked with making choices which efficiently allocate these scarce resources. The key insight from the basic economic problem is that we cannot have everything that we want — this is true on a household, firm and governmental level:

- Households have a scarce amount of income and have to make choices as to how to allocate this income, e.g. whether to buy a new car or go on holiday.
- Firms in the short run have a limited amount of resources and have to make choices as to how to allocate these resources, e.g. a clothes manufacturer has to decide whether to use its labour to produce t-shirts or jeans.
- Governments have insufficient tax revenue to meet the public service demands of the whole population and therefore have to make spending decisions, e.g. whether to build a new hospital or increase teachers' wages.

Allocation decisions are required for all economic goods. These represent the vast majority of goods in society. The exception is free goods, for which no allocation decision is required because there is no scarcity of the good.

All goods and services in the economy are produced by a combination of the four factors of production:

- Labour is the human input into the production process.
- Capital is any man-made aid to production.
- Enterprise is the risk taking involved in organising the other factors of production.
- Land is a natural resource — it includes the physical land itself and everything that occurs naturally on it.

Positive and normative statements

As economists, we need to be able to differentiate between positive and normative economic statements.

- Positive statements are objective statements that can be tested using evidence.
- Normative statements are subjective statements based on value judgements that cannot be proven.

Words such as 'should', 'right', 'wrong', 'best' and 'worst' often imply a value judgement is being made and therefore can help identify normative statements.

Exam tip

Do not confuse needs with wants in your definition of the basic economic problem. Needs are not infinite and in the developed world there are often sufficient resources to meet the population's needs.

Knowledge check 1

What are the rewards of each of the factors of production?

Opportunity cost

The economic problem results in there being an **opportunity cost** to most decisions taken — making a choice usually involves an element of sacrifice. A production possibility frontier (PPF) diagram can be used to illustrate the concept of opportunity cost (see Figure 1).

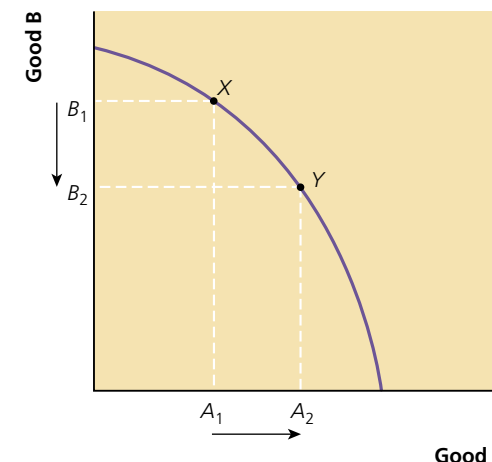


Figure 1 Production possibility frontier

Suppose the economy is initially at point X, producing B_1 units of good B and A_1 units of good A. To increase the production of good A, production can move along the PPF from X to Y. The result is that the production of A has increased from A_1 to A_2 . However, to achieve this, the production of some of B has to be sacrificed ($B_2 - B_1$).

Thus, the opportunity cost of producing $(A_2 - A_1)$ units of good A is the sacrifice of $(B_2 - B_1)$ units of good B. Because all resources are fully and efficiently employed when on the PPF, the only way to increase the output of one good is to reallocate resources and in doing so sacrifice some output of the other good.

In the long run, it is possible for the PPF to shift outwards as a result of an increase in the quality or quantity of factors of production. For example, technological advancement could increase the quality of capital, boosting the productive capacity of the economy and causing the PPF to shift to the right.

Specialisation and trade

Specialisation can take place on an individual, a firm and a national level. It can be seen as an important tool in addressing the problem of scarcity — specialisation is a route through which more output can be produced with a given set of inputs, which can increase the number of wants and needs that can be satisfied.

One form of specialisation is the division of labour. This takes place within a firm, where individual workers are responsible for performing specialised tasks. There are clear advantages to this — it is likely the tasks they are specialised in are those they are best at conducting (for example, an individual specialising as an economics teacher is likely to be more skilled teaching economics than drama because they have relevant

Opportunity cost

The sacrifice of the next best alternative foregone when a choice is made.

Exam tip

Be careful not to make the mistake of saying that point X or point Y is more efficient — remember, all points on the PPF are productively efficient. This means productive efficiency would still be achieved even if the economy was operating at either end of the PPF (i.e. when the output of either good A or good B was zero).

Knowledge check 2

Explain whether there is an opportunity cost to increasing output when an economy is operating inside its PPF.

A-level microeconomics Section B

Quantitative essay question

When the National Health Service (NHS) was launched in 1948, it had an annual budget of approximately £9 billion at today’s prices. The NHS budget now exceeds £115 billion, with the mainstream political parties all agreeing even further increases in the budget are needed to provide a good quality service.

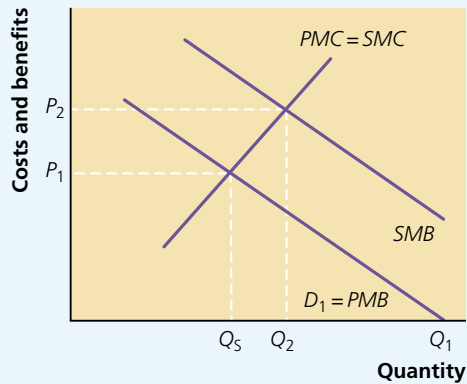
Evaluate, using an appropriate diagram(s), whether healthcare should be privatised.

(25 marks)

e A two-sided discussion is required here which considers the arguments both for and against healthcare being privatised. Diagrams should be used to support your analysis before you make a supported judgement that reaches a conclusion about which model of healthcare provision is the most desirable.

Student A

Healthcare should be privatised because government provision is simply too expensive and wasteful. When a good or service is provided for free (as it is currently), consumers who derive virtually no benefit from consuming healthcare services will consume the service because they are not charged anything for doing so. This is illustrated on the diagram below, where consumption takes place at the bottom of the demand curve at Q_1 .



This creates a situation of significant over-consumption – consumption is well above the social optimum of Q^* . a Evidence of this in the NHS can be seen at present, where people call for ambulances or visit A&E when their condition is not serious enough to warrant hospital treatment. b This is an inefficient use of scarce resources as too many resources are being allocated towards the provision of healthcare. When healthcare is privatised, this wastage will be eliminated as when people have to pay for a service they are less likely to abuse it and will only consume healthcare when the benefit they derive from doing so is at least equal to the cost, meaning consumption will reduce to Q_M . c Moreover, the profit incentive private firms have is likely to improve the efficiency of

provision, helping to reduce the cost of healthcare provision and in doing so improving productive and allocative efficiency in the market. d

However, there are a number of problems with privatisation. When healthcare is charged at a price of P_M , there will clearly be some individuals who are priced out of the market, unable to afford the cost of the service. Many would argue healthcare is a basic right in a developed country and that it is not acceptable for some individuals to potentially die because they are denied access to healthcare they cannot afford. Ensuring access to all citizens is therefore an important argument in favour of state provision and against privatisation. e

While there are ways around this problem in a private system by, for example, offering the poorest in society free access to private healthcare, fragmenting the system in this way can be extremely expensive and end up costing the government significantly more per capita than it would have done to provide it free for the whole population – a good example of this is the healthcare system in America, which is not run by the government and yet still incurs a huge cost to taxpayers. f

To conclude, healthcare is ultimately too important a service to privatise. While there might be some inefficiency involved in state provision, this is preferable to some individuals missing out on healthcare entirely because they cannot afford it, as would be the case in a fully privatised system. It may be that introducing elements of charging in the NHS may be the best solution to reduce the ever increasing cost of the service – for example, charging patients for missed doctors’ appointments may go some way to making individuals value the service closer to the cost of providing it. g

e 22/25 marks awarded. a There is strong technical analysis explaining how state provision of healthcare results in significant over-consumption, with good use of a diagram to support this. b This is well applied to healthcare and makes a strong argument for privatisation. c The analysis that privatisation will reduce consumption is solid, but the answer could be improved by some reference back to this consumption point at a later stage, recognising that this consumption point is below the socially optimum level. d A further strong argument in favour of privatisation is made in terms of the improved efficiency it brings.

e The arguments against privatisation are well made, with reference to the important equity vs. efficiency debate. f The explanation of the problems with a fragmented healthcare system using the example of America provides an excellent context to the answer. g A strong judgement is reached, which recognises that a solution that involves elements of market and state provision may be the most desirable. The arguments made throughout this essay are very strong, but it is unwise to have no mention of the merit good or positive externality elements of healthcare, as these are core underlying principles to this debate. The diagram implies knowledge of this, but there should be more explicit consideration within the essay.