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Economics Notes

Chapter 3
Economic Systems

All countries are faced with the problem of scarcity of resources. As a result they can't satisfy their unlimited wants. Thus, they must choose which wants to satisfy and how they are to do this. For example, if they choose to satisfy their want for power by producing electricity they must decide how to do this; do they build a coal fired powered powers station or a nuclear powered power station.

There are lots of different ways in choosing what to produce using scarce resources. Economists refer to this as the problem of resource allocation. That is deciding what to produce and how much land, labour and capital are to be employed. This refers to the uses that the factors of production are put to.

One problem facing people when there is a scarcity of resources is exactly what goods and services to produce. It also involves choosing which wants to satisfy. Every society, no matter what size, is faced with this problem. It may be the choice between food or shelter. In a more advanced country it may be the choice between producing more nuclear weapons or building more hospitals.

Once it has been decided what to produce there still remains the question of how to produce. What quantities of tools, land and labour will be required? In addition to this there is the fact that there are several different ways in which a good can be produced. For example, wheat; one method requires a lot of machinery and little labour to plough the land, sow the seeds and harvest the crop. Another method utilizes a large labour force and few machines.

After the questions of what and how to produce are answered it must be decided whom we are producing for. Due to scarcity not all wants can be satisfied so it must be decided whose wants are to be satisfied. In other words it has to be decided who receives these goods and services. This question must be answered by society as a whole. Economists cannot tell us the right answer because it is based on people's opinions i.e. it is a value judgement.

How a country answers the question of what, how and for whom to produce is known as an economic system. These systems are designed by people. Some people may be caring and wish to share their resources with everyone. Others may want to be rich and powerful, they may want to own all the resources for themselves. They may even exploit others. Economic systems are designed according to the behaviour of people. Without economic systems no decisions would be made and resources would be left idle.

A market is made up of all the producers and consumers of a certain product. A free market economy depends on the producers and consumers to make decisions on what, how and for whom to produce goods and services.

All the resources in a market economy are owned by private individuals. The firms and businesses aim to generate as much profit as possible. To remain profitable a firm must sell the goods and services demanded the most by their consumers.

In a market economy all firms aim to make as much profit by allocating their resources away from shrinking economies (where people buy fewer products) to expanding economies (where people buy more products).

What is produced in a market economy depends on what the consumer demands and what they are willing to pay. Firms will produce the most demanded products using the cheapest method possible so as to gain the maximum profit. The people who will benefit from these products are only those who can afford to buy them.

If a firm decides that a particular product is doing extremely well it can raise the price for it safely since it knows that its consumers will continue to purchase it and as a result generate more profit for the business.

A price rise acts like a signal to other firms; they now know what the consumer wants and what makes the most profits. As a result they are likely to stop producing what they are at present and allocate their scarce resources the expanding market. They have now entered a new market.

Similarly a fall in prices, since few buy that product, tells firms that they should allocate their resources to something more profitable. This is known as the price mechanism. The market force determine what, who and for whom to produce. In other words the changing consumer preferences and profit motive determine the allocation of resources.

Mixed Economy

Due to the various disadvantages of a free market economy many countries make use of a mixed economy.

A mixed economy combines government planning with the use of the free market. As in the market economy various firms and people (private sector) own scarce resources with the prime intention of making a profit. However, in a mixed economy the government or public sector owns some scarce resources. It uses them to produce goods and services that it thinks their country and its people need and want. The UK has mixed economy.

Advantages:

1. The problem with a free market economy is that it usually experiences high unemployment rates. As a result many people are left unemployed simply because it is not profitable to employ them. The government can help these people by employing them in their own offices and factories or helping the private sector create jobs for them.
2. No private firm can provide public goods like defence, law and order and street lighting since it would be impossible to force them to pay for them. In a mixed economy the government can provide such goods and services by placing taxes on people’s spending and income. In a addition the government

can provide merit goods such as education and healthcare that it believes that the people should have.

3. Some people may wish to consume harmful goods (drugs for example) and the firms in the market economy may find it profitable to manufacture and sell such products. The government can combat the consumption of such goods by making them illegal, hard drugs, or imposing heavy taxes, alcohol.
4. Firms in the market economy only take into account their own cists and benefits. For example, a firm dumping waste into a river would not worry about the damage done to the environment. The government can stop the pollution o the environment by imposing laws, heavy taxes or large fines.
5. The main problem with the free market economy is that it allocates more goods and services to the people who have money rather than those who can' afford to buy such expensive products. With the power of planning the government can give goods and even money to the people who deserve such support. In the UK free healthcare and unemployment benefits are given to those who can't afford them.

A mixed economy tries to overcome the disadvantages of a market economy by implementing government control or regulations on the different markets. Government ownership of some scarce resources allows it to produce some goods and services which it gives to the people who it thinks deserve them. To pay for the production of these things the government raises taxes from people and services. High taxes may discourage people from working hard as some of their income is taken away by the government.

Planned Economy

Countries such as Romania, Poland, Hungary and Russia (as part of the former USSR) had tried to plan what, how and for whom to produce for all goods and services. These countries made use of planned economies and it was often know as communism.

The government planners decided exactly what goods and services to produce. This involved issuing millions of instructions to hundreds of thousand of firms telling them what to produce and where people should work. In planned economies the aims of the firms were to make what the government wanted not what the people wanted.

The main problem with a planned economy was that the various firms produced what the government wanted not what the people required. There was usually a shortage of consumer goods or they were of limited quality. This was because there was no profit motive and, thus the firms did not do good job. This lead to the production of a limited range of poor quality goods. This is why many people living in countries still under the control of communist governments want change.

Because there are so many disadvantages concerning a planned economy many countries have changed to mixed economy. Even countries still controlled by communist governments are slowly moving away from planned economies – China and Cuba. Here firms that used to be governmentally owned are now privately owned. The advantage with the market economy is that it does not require the government to inform firms about what and how to produce the various products. Instead the changes in customer demand and spending act as a signal as to whether the firms are producing the right products in the correct manner by rewarding them with a loss or profit. However, in many of these countries there are still a lack of certain goods and services and many people in the old economies are witnessing, for the first time, an increase in price inflation and unemployment.

Chapter 4
Production

Goods and services (commodities) are produced to satisfy peoples' wants. Production refers to the making of the goods and services. Businesses and firms are producers; they use the resources of land, labour and capital (input) to make commodities (output).

The aim of production is to satisfy peoples' wants by providing commodities. However, the process is not over until the product reaches the end consumer. Warehouses and shops that sell goods and services as well as the people and machines that provided insurance, transportation for these commodities are all part of the production process.

Some countries (USA) produce a vide variety of commodities for there people to choose from. This has them very rich as a result. Economist value commodities according to how much people are willing to buy them for.

However, some things like washing the dishes or cleaning your room can't be valued in this way; as you are not paid a salary for these useful services. Similarly, the useful output of a gardener or DIY enthusiast can't be evaluated either.

Most private sector firms tend to sell commodities for a profit. Profit is the revenue received by the entrepreneur for taking the risk of setting up a business. The owner will not know in advance how much or how many of these commodities the customers will be willing to pay for. The owner must pay in advance for the capital, land and labour if the production of these commodities is to be carried out. In some cases there is often a large gap between the preliminary designing, production and testing of a new aircraft, for example, and it costs billions of pounds. This all happens before the manufacturer can start selling the aircraft to the various airlines.

If a firm intends to increase the amount of commodities it produces it should employ more resources. To do this quickly a firm could employ more labour or ask its current workforce to work overtime. However, it will take a long time to increase the quantity of capital goods (factories, machinery etc) and natural resources (coal, oil, wood etc) available to the firm.

There are three time periods:

1. Momentary Run: is the period of time when the firm will not be able to increase production levels.

2. Short Run: is when a firm increases production levels by increasing the amount of labour since no more land or labour can be obtained. In this case labour is a variable quantity whilst land and capital are fixed in supply.
3. Long Run: is when the firm will be able to employ more of all the factors of production.

We cannot say how long the short and long runs are since the time will differ between firms. For example, in a matter of weeks a nuclear power station and clothing factory can both employ more labour. However, it takes more time to train a nuclear scientist than a sewing machine operator. Also it takes a few weeks to make some sewing machines but it may take many years to manufacture a new nuclear reactor. It takes only one season to grow cotton plants and to gather wool for the clothing company (the raw materials). It may take many years to locate uranium and plutonium for use in a nuclear power station.

The Law of Diminishing Returns states that if one factor of production is in fixed supply (land and/or capital) and if units of another factor (labour) are constantly added on then the output gained from these factors will eventually decrease.

$$\textbf{Average Product} = \frac{\textbf{Total Product}}{\textbf{Number of Workers}}$$

$$\textbf{Marginal Product} = \frac{\textbf{Change in Total Product}}{\textbf{Change in Number of Workers}}$$

Just as consumers decide on what commodities to buy business owners must decide on what commodities to produce and how to do this. Whatever method of organisation they use the main aim is to maintain costs at the lowest level and make as much profit as possible.

Another concern is the size of the firm. Size is usually method by the level of output per month or year. A change in size affects costs. If more capital goods are employed to increase production then we say the scale of production has increased.

1. The plant or factory will be situated on a particular site. They will usually produce one goods or a range of goods. Some plants may be very large employing a lot of labour and capital goods.
2. The firm is the business unit that owns and controls one or more plants. BAE systems owns and controls 9 different plants that manufacture and assemble defence equipment.
3. The industry comprises of several firms involved in the production of similar products for a particular market.

Total Cost= Fixed Cost + Variable Cost

Total Revenue= Price per commodity * Amount of commodity sold

$$\textbf{Average Revenue} = \frac{\textbf{Total Revenue}}{\textbf{Amount of Commodity Sold}}$$

Profit or Loss= TR – TC

Break Even Point of Production is where TR=TC.

$$\textbf{Average Cost} = \frac{\textbf{Total Cost}}{\textbf{Amount of Commodity Produced}}$$

$$\textbf{Marginal Cost} = \frac{\textbf{Change in Total Cost}}{\textbf{Change in amount of commodity produced}}$$

Firms that are able to double their inputs but more than double their outputs are said to be experiencing increasing returns to scale. Those that double inputs but do not double their outputs experience diminishing returns to scale. Those that double outputs and inputs experience constant returns to scale.

Financial Economies:

1. Large firms can borrow money from a number of different sources to buy things like machinery etc. They can also raise money buy selling shares on the stock exchange.
2. Large firms have many assets such as deeds to factories, machinery etc which they can offer to lenders in the event they can't pay back loans. However, since this unlikely many financial institutions are willing to lend money to such firms.
3. Since these firms are low risk borrowers they are often charged lower interest rates.

Chapter 8
How prices are decided

Consumer's demand for goods and services play a key role in how scarce resources are used. Demand is the willingness of consumers to buy a specific commodity given a range of prices. Producers will only make these products if the consumers have the money to buy them.

Demand Curves: generally slope downwards and are graphs showing price against quantity demanded. Price is indirectly proportional to quantity demanded.

Extension of demand: or an increase in quantity demanded refers to the way in which demand changes as prices fall; considering that no other factor that could affect demand changes.

Contraction of Demand: or a decrease in demand refers to how demand is affected when prices rise, considering no other factor that could affect demand changes.

Consumer purchase goods and services to satisfy their wants. This also known as utility. We assume all consumers are rational i.e. they get as much utility out of a product as possible.

When a person purchases and consumes a product he/she enjoys its utility. For every extra unit they consume they utility they enjoy rises but not by the same amount.

The extra utility gained by the consumption of each extra unit of that product is the marginal utility. With most people the marginal utility decreases with each extra unit that is consumed.

The **LAW OF DIMINSIHING MARGINAL UTILITY** applies to most people: with each extra unit of a product that is consumed the utility that is gained from it reduces and so does the price the consumer is willing to pay for it.

When price as a factor is changed the result is to move along the demand curve i.e. a contraction or extension in demand occurs. However, when a factor other than price changes then the demand curve as a whole shift outwards or inwards.

An **increase in demand** is where consumers are demanding more for each and every price than they did before.

A **decrease in demand** is where consumer demand less for each and every price than they did before.

Factors that affect demand (other than price)

- An increase in incomes means people have more money to spend on buying the products they want. As a result the demand for these products rises and there is a outward shift of the demand curve. However, when people have more money to spend, they tend to buy more luxury oriented products and other basic items (food, clothing etc.) become classed as inferior. The demand for such products reduces and the demand curve shifts inwards.

- If the government wants to encourage consumer spending (in a time of recession, for example) they might cut taxes. The multiplier effect is that people will demand more products and firms will employ more people to produce these products. With more after tax-income people will buy more and demand will spike causing a shift of the curve outwards.

- With an increase in the total population there will be a greater need for food, clothing, homes etc. As a result the demand for these products will rise.

- Some of the products we purchase require other accessories e.g.: compact discs need CD players, cars need petrol and TV sets need electricity. These jointly demanded goods are known as complements or complementary goods.

  If the price of petrol rises then many people will be put off buying cars as it would be too expensive. The result is a decline in demand and shift inwards of the demand curve.

  Some goods can be used as a substitute for others. For some people margarine is a good substitute for butter. An increase in the price of butter may reduce the demand for it and increase the demand for margarine. Thus the demand curve for margarine shifts outwards.

- A well planned advertising campaign can generate consumer interest in a product and cause demand for it to rise.

- Changes in taste and fashion have an effect on the demands for products. Now-a-days people are demanding products that are kinder to the environment and animals, safer etc.

- Many other factors such as changes in weather; a very hot summer will increase demand for cold drinks, high interest rates may cause people to spend less and demand as a result falls.

Supply refers to the amount of a specific product producers or firms are willing to make and sell given a number of possible prices. It is measured as the quantity supplied over a period of time (per month, per week, per year etc.).

A firm will only produce a commodity if it can sell it at a price over and above their costs so as to make a profit. The higher the price of the product the higher the profit and the more firms are willing to produce it.

Supply curves are usually upward sloping and show that price is directly proportional to the quantity supplied.

Factors that affect supply

- A change in the price of commodities where one becomes more profitable to produce than the other. The producers are automatically attracted to the production of the more profitable commodity. As a result the supply curve moves outwards (profitable commodity) and the supply curve for the other commodity shifts inwards.
- An increase in wages payable to employees reduces profits and producers may be less willing to produce more of that commodity at each and every price.

  However, a fall in rents for example will boost profits and cause the producers to make more of that product at each and every price.

- Technical progress where the invention and use of more efficient machinery reduces costs allowing producers to make more profit.

- Other factors like weather determine the willingness to supply products like fruits. A bad harvest will result in a shift inwards of the supply curve and vice versa for a good harvest.

Chapter 10

See this ppt.
A market structure is influenced by the way in which firms behave. It represents the interconnected characteristics of price, supply, efficiency, competition and barriers tor trade.

Perfect competition suggests that resources are being made use of in the most efficient way possible. The resultant competition encourages firms to produce high quality products at the lowest cost possible. In this way they will be able to charge a lower price to consumers in order to attract custom. Thus, their profits and sales will rise.

The features of perfect competition include:

- Homogenous products: all firms produce the same product.
- Perfect Information: all buyers are aware of all available products and the prices charged to them. All sellers are aware of new production techniques.
- No Barriers: all firms may enter or exit the market at any time. There are no barriers to entry. Firms are able to steal the market and profit share of certain firms.
- Price takers: there are a large number of buyers and sellers. None can influence the price charged to a product to their advantage. Hence, they must accept any price that is charged.

Perfect competition is good because:

- Low prices: due to the amount of competition firms are forced to produce high quality goods at a low price in order to attract consumers and their custom.
- Consumer sovereignty: consumers get what they want i.e. cheap goods, high quality, good service etc.
- Efficiency: firms must make the best use of resources in order to produce quality products.

A monopoly is any enterprise or individual that has sufficient control over the market such that it can influence the prices charged and terms of access to the market.

A cartel is a small group of firms that agree to work together to keep their prices and profits high. They will agree to not compete with one another by using price methods of competition but instead they will use non-price methods of competition. This includes offers, advertising, free samples etc. This is done to attract consumers away from other firms.

Where a handful of companies have control over the supply of a particular item to the market is known as oligopolies. E.g.: banks, oil companies etc.

Natural barriers:

- Some industries require very expensive equipment and large amounts of capital. This puts off many firms from entering such industries (Nuclear).
- In some industries there are very large cost savings to be obtained from large scales of production. Not many firms may have the finance to attain such economies of scale.
- Where a few firms control the supply of a particular product to the market a monopoly exists.
- Some legal considerations must be taken into account; patents, trademarks, copyrights etc. These all prevent firms from producing certain protected products.

Artificial barriers:

- To prevent firms from entering a market monopolies may threathen suppliers by stating that they should not supply anything these new firms or risk losing their business. The supplier would conform to this and as it would not want to lose its biggest customer.

- Predatory pricing may be followed whereby prices are lowered when a new firm enters a market. The new firm would not be able to compete with such low prices as most consumers would be going to the monopolistic firm. Then when the new firm is pushed out of the market prices would be raised again.
- Exclusive dealing may be followed where a monopoly with a famous product tells businesses it supplies to that it should sell products from new firms that have penetrated the market. Such businesses would conform to this as they would lose an excellent fast moving product.

Chapter 16

Public expenditure i.e. the money spent by the government can be divided into types.

1. Current expenditure which is spent to provide pensions, unemployed benefits, pay public sector employees etc. This money is spent to cover the day-to-day expenses of the public sector.
2. Capital expenditure which is money spent by the government to build new roagds, schools, parks, weapons etc. It is money spent on the purchase of fixed assets.

Reasons for Government spending:

1. **Public goods:** certain goods and services cannot be provided by private sector firms profitably. However, these commodities are still very important to people (street lighting, defence, police etc.). For this reason the government provides these commodities even though no one is willing to pay for them.
2. **Merit goods:** the government spends money on the provision of commodities it believes people should have even if they can't afford it. Example; state healthcare and education.
3. **Social reasons:** it is considered unethical to leave the sick, old and unemployed to fend for themselves. Thus, money is spent on old age homes, unemployed benefits etc. to aid these people. Together these goods and services come to be part of a welfare state e.g. (England).
4. The government also spends money to control the economy. It can do this by changing its spending and taxation policies.
5. It also spends money on provision of financial aid for foreign countries that are suffering from the effects of war or natural disasters. This is foreign aid.

The public sector earns its revenue through:

- Borrowing of money.
- Sales of public sector assets and industries (privatisation).
- Interests received from money lent earlier.
- Sale of goods and services produced in government industries.
- Taxes levied on incomes, wealth and expenditure.
- Rent from government owned land and buildings.

Reasons for taxation:

1. Taxation is the same source of revenue for a government.
2. Taxes can be placed on harmful goods such as tobacco and alcohol to make the less attractive.

3. Taxes can be placed on foreign made commodities so as to make them more expensive. This encourages people to buy locally made commodities.
4. Taxation can be seen as a way to reduce the income gap between the rich and the poor.
5. If people spend too much at a time prices may rise. Taxes dissuade people from buying too much in one go. This keeps prices low.
6. Taxes can be used to protect the environment. High petrol taxes aim to dissuade people from using private transport but instead use public transport; buses, taxis, trains etc.

A good tax must be:

1. Fair i.e. if many people think it is unfair they will not pay for it.
2. Cheap to collect; the costs of collecting the tax should be lower than the amount collected.
3. Low enough so as to not discourage people from working.
4. Convenient i.e. easy to understand, calculate and pay.

All the taxes levied in a country are part of the tax system.

Taxation can be regressive, proportional or progressive.

Indirect taxes are levied on spending of individuals or organisations.
Direct taxes are levied on incomes of people and organisations.

Indirect taxes: VAT, Customs and Excise duties.
Direct Taxes: Corporation Tax, Income Tax, Capital Gains Tax etc.