IGCSE Economics Subject Content 1

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May 26, 2019

Contents

Chapter 1

The Basic Economic Problem

Key points from this section:

1. Define the nature of the economic problem.
2. Define the factors of production.
3. Define opportunity cost and illustration of the concept.
4. Demonstrate how production possibility curves can be used to illustrate choice and resource allocation.
5. Evaluate the implications of particular courses of action in terms of opportunity cost.

1.1 The Nature of the Economic Problem

1.1.1 Finite resources and unlimited wants

- **The basic economic problem:** How to allocate scarce resources to satisfy unlimited needs and wants.
- **Scarcity:** Unlimited wants and not enough resources to fulfill the wants.
- **Unlimited wants:** The unlimited desires that people have.
- **Limited resources:** The limited factors of production (resources) that we have on Earth.
- **Needs:** Things which we require in order to survive.
- **Wants:** Things that we do not need but want for enjoyment or utility.
- **Basic economic questions:**

  1. What to product.
  2. How to produce it.
  3. For whom to produce it.

1.1.2 Economic and free goods

- **Goods:** Physical items, e.g. books, computers, and food.
- **Services:** Non-physical items, e.g. haircuts and internet access.
- **Economic goods:** Goods that are limited in supply, e.g. cars, paper, and oil.
- **Free goods:** Goods that are unlimited in suppy, e.g. air, sea, and public web pages.
- **Economic agents:** Individuals, firms, and the government.

1.2 The Factors of Production

1.2.1 Definitions of the factors of production and their rewards

- **Four factors of production (LLCE):**

  1. **Land:** The natural resources required in a production process, e.g. wood and oil.
  2. **Labor:** The human resources required in a production (physical or mental, skilled or unskilled), e.g. teacher and police.
  3. **Capital:** The manufactured resources required in a production, e.g. machinery and tools.
  4. **Enterprise:** The skills in a business person requires to manage the other three factors of production and the ability to undertake risks.

- **Four rewards to factors of production (RWIP):**

  1. **Rent:** Reward or payment for *land* resources.
  2. **Wage/Salary:** Reward or payment for *labor* resources.
  3. **Interest:** Reward or payment for *capital* resources.
  4. **Profit:** Reward or payment for *enterprise* resources.

1.2.2 Mobility of the factors of production

- **Geographical mobility:** The ability of factors of production (except land) to move around an area, region or country in order to work.
- **Horizontal mobility:** The ability of factors of production (mostly labor) to move from one occupation to another with the same social level.
- **Occupational mobility:** The ability of factors of production (mostly labor) to swtich career fields.

1.3 Opportunity Cost

1.3.1 Definition of opportunity cost

- **Opportunity cost:** The next best alternative given up when making a decision. (Doesn't have to be money)

  – The opportunity cost of taking economics course is the other subject you would be studying instead.
  – The opportunity cost of playing games is the other things that you could be instead like studying.
  – The opportunity cost of funding the military could be free or well-funded healthcare.

1.3.2 The influence of opportunity cost on decision making

- **Consumers:** Purchasing one good causes opportunity cost of the other good.
- **Producers:** Producing one good causes opportunity cost of the other good.
- **Government:** Passing one policy causes opportunity cost of the other policy.

1.4 Production Possibility Curve Diagrams (PPC)

1.4.1 Definition of PPC

- **Production possibility curve:** A graph illustrating the production of two goods, used to display opportunity cost.
- It is a graph with the number of production of two goods as the two axies, where the two goods share a certain factor of production to produce. Thus, resulting in a downward sloping curve.
- **Two types of PPC**

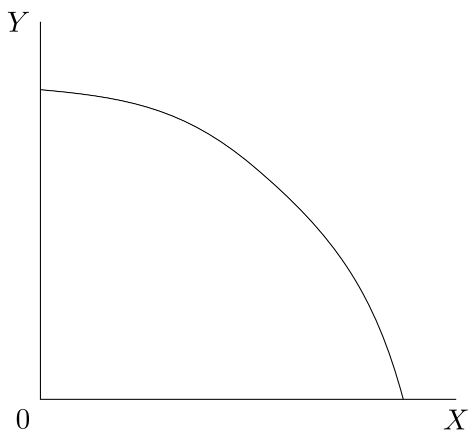

Figure 1.1: PPC with specialization

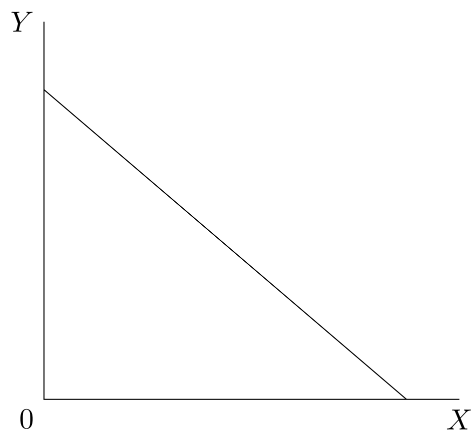

Figure 1.2: PPC without specialization

  - *Figure 1.1:* Increasing opportunity cost due to specialization. (Resources required are not the same)
  - *Figure 1.2:* Constant opportunity cost due to no specialization. (Resources required are identical)

1.4.2 Points under, on, and beyond a PPC

Keys:

- *Point A:* All resources dedicated to the production of good Y.
- *Point B:* All resources dedicated to the production of good X.
- *Point C:* X_1 amount of good X produced along with Y_1 amount of good Y.
- *Point D:* X_2 amount of good X produced along with Y_2 amount of good Y.
- *Point E:* Resources are not allocated at the maximum efficiency.
- *Point F:* This point of production is unattainable. (Not enough resources)

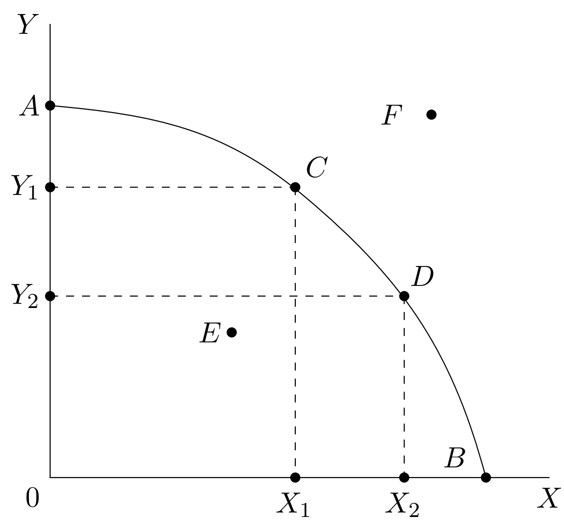

Figure 1.3: Generic PPC graph with points

1.4.3 Movements along a PPC

- **Movement along a PPC:** This happens when the producer alters its production.
- For example, originally a company was producing at *Point C*, which is X_1 amount of good X and Y_1 amount of good Y.(*Figure 1.4*) In this case the opportunity cost will be the amount of good Y that was not produced, which is OC_1 $(A - Y_1)$.
- After a while the company decides to change its production and produce at *Point D* (X_2, Y_2), this decision's opportunity cost would be OC_2 $(Y_1 - Y_2)$ as the amount given up by this specific decision is $Y_1 - Y_2$.
- This is a movement along the PPC from *Point C* to *Point D*.

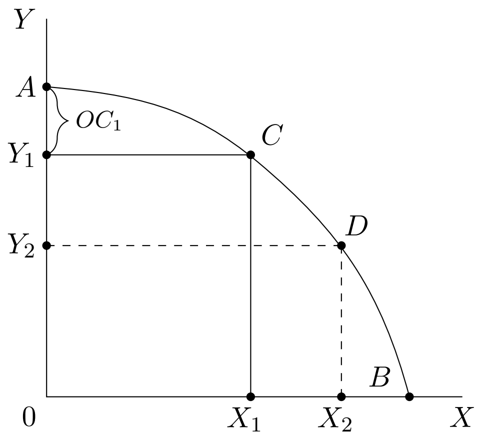

Figure 1.4: Before

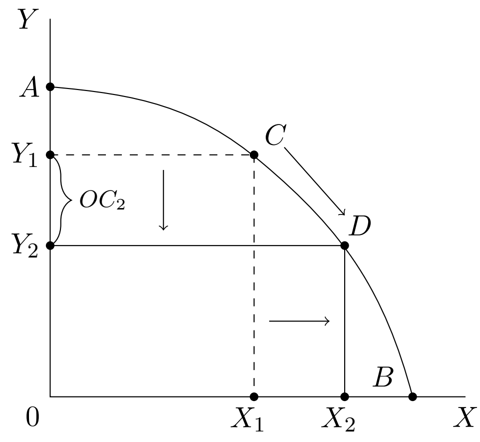

Figure 1.5: After

1.4.4 Shifts in a PPC

- **Change in productive capacity of both goods:** *Figure 1.6* shows the shifts in a PPC with change in both goods.

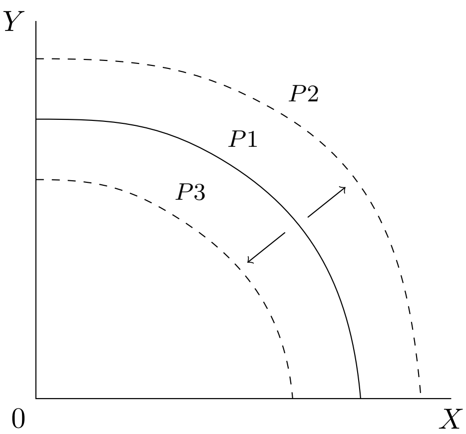

Figure 1.6: Change in both goods

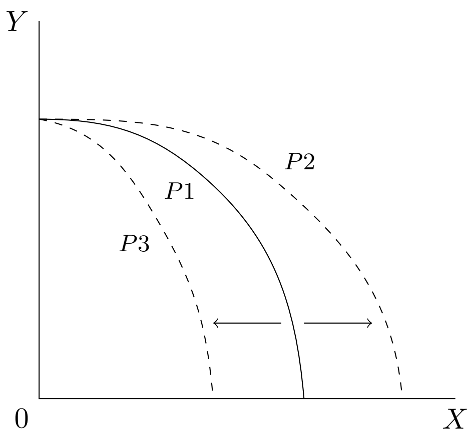

Figure 1.7: Change in good X

- **Change in productive capacity of one good:** *Figure 1.7* shows the shifts in a PPC with change in good X.
- Shifts from $P1$ to $P2$ is growth (increase in production) while shifts from $P1$ to $P3$ is recession (decrease in production).

- **Factors causing shifts in a PPC:**
  1. **The quantity of resources:** Increase, $P1$ to $P2$; decrease, $P1$ to $P3$.
  2. **Technology:** Improve, $P1$ to $P2$; worsen, $P1$ to $P3$.
  3. **The quantity of capital:** Increase, $P1$ to $P2$; decrease, $P1$ to $P3$.
  4. **War/Natural disaster:** Decrease, $P1$ to $P3$.
  5. **Economy:** Improve, $P1$ to $P2$; worsen, $P1$ to $P3$, etc.
- For any factor above, if the factor applies to both good X and good Y, it will cause a shift like *Figure 1.6*.
- For any factor above, if the factor only applies to one of the goods, it will cause a shift/change in slope like *Figure 1.7*.