

## Revision Notes

### 1) Basic eco problem

Limited eco resources (or factors of prod.): define land, labour, capital and enterprise. (Free gifts of nature, all human input, man-made aids to production The entrepreneur combines the other factors of production and takes risks) Unlimited wants. Opportunity cost (value of next best alternative given up)

Define the **division of labour** (breaking down prod. process into a large number of specialist tasks) Know the advantages (practice makes perfect, can concentrate on what you are best at, save on capital goods etc.) and disadvantages (boredom, standardized products, interdependence etc) Mobility of the factors of production (geographical and occupational) Linked to specialization in modern economies is the need for..

**Money** (anything generally acceptable as payment for goods and services) Functions of money (medium of exchange, store of value, measure of value, ) Features of money (limited in supply, divisible, portable, durable, identical) Without money we'd have to use barter (the direct exchange of one good for another) which is inefficient (unless there is a double coincidence of wants)

**Resource allocation** Is a v. important concept. (How scarce resources are distributed between competing users) **Economic systems** (market, planned, mixed, traditional) A mixed eco is one where there is private and public ownership of the means of production and where there is use of both the price mechanism and planning) Remember in a market or mixed eco the price mechanism is important in allocating resources (consumers want skate boards, demand for skate boards rises, price rises so producers switch resources into skate board production and away from something else) Key words for market economies: competition, choice, profit, decentralized decision making, efficiency, quality. But there are disadvantages too for market economies (and so to an extent mixed economies); missing markets, rise of monopolies and cartels, booms and slumps, lack of concern for social costs and benefits etc.

### 2) Nature and functions of organizations

**Public sector** comprises central government, local government and public corporations. **Private sector** comprises sole trader (one-person business) partnerships, private limited companies and public limited companies as well as co-operatives. Public limited companies (PLCs) are sometimes called joint-stock companies. Sole traders are easy and cheap to form and are very flexible but have unlimited liability (Personally responsible for company debts) they also find raising capital difficult. Partnerships popular for doctors, lawyers etc. Private limited cos. cannot sell shares to the general public. Public limited companies e.g. Shell can. Shell is in fact a multinational which produces goods in a number of countries. Each type of bus. org. has its own strengths and weaknesses which you should know. You may get question asking advantages of becoming a PLC

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**Trade unions** are organizations consisting of groups of workers who combine to protect their interests. Unions are concerned with: wage levels, job security, health and safety etc. There are different types of union (e.g. craft, industrial etc. Recent rise of white collar unions for teachers, civil servants etc.) Collective bargaining is where representatives of workers negotiate with the representatives of their employers. Unions are sometimes accused of creating unemployment by insisting on such high wages that employers cannot afford to employ many workers. Unions can raise wages by decreasing supply of workers or insisting on a minimum wage. (Be able to draw diagrams) A closed shop is where all workers in a firm must also join a particular union (scrapped by many governments following supply-side policies)

**Central bank** (Bank of England, Federal Reserve etc.); controls money supply, government's bank. Bank's bank, lender of last resort, manages national debt, international responsibilities (ex. rate etc), in charge of issue of notes and coins

**Commercial Banks:** loan and investment services, money transfer services and personal services (safe deposits)

**Stock Exchange.** A market place (arrangement) for buying and selling of shares, debentures and govt. securities. Often accused of being almost casinos but in fact firms needing capital would find it very difficult without Stock Markets.

### 3) The market.

**D & S.** Effective demand = demand backed by money. Any diagrams properly labelled (tons per week etc.) + title (D & S for Sugar in France etc) Equilibrium price where  $QD=QS$ . Increase in demand (more demanded at any price) caused by e.g. rise in consumer income, fall in price of substitutes, adverts, fashion etc. Note an increase in demand causes a movement along the supply curve (in this case extension in supply). Increases in supply caused by e.g. excellent weather conditions (for farm products), new technology, and fall in prod. Costs etc. An increase in supply causes an extension in demand. Rise in price of the good in question causes a contraction of demand. Substitutes (= goods in competitive demand) e.g. Pepsi and Coke. Complements (= goods in joint demand) e.g. camera and film. Goods in joint supply e.g. beef and leather. Goods in competitive supply e.g. milk and cheese.

**Elasticity** = responsiveness of  $QD/QS$  to change in price/income etc.

Price elasticity of demand: % change  $QD$  *divided by* % change  $P$

Price elasticity of supply: % change  $QS$  *divided by* % change  $P$

Income elasticity of demand: % change  $QD$  *divided by* % change income

Cross elasticity: % change  $QD$  Good  $X$  *divided by* % change  $P$  of Good  $Y$

If greater than 1 elastic. Goods likely to be more elastic in demand if there are a lot of substitutes, if the good is not habit-forming/ essential, represents a small proportion of total income e.g. matches. Goods likely to be elastic in supply if: length of production process is short, there are large stocks available etc.

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All normal goods have a positive income elasticity of demand. Inferior goods have a negative income elasticity of demand (as income rises demand falls) Substitutes have a positive cross elasticity of demand. Complements negative.

Remember the relationship between elasticity of demand and total revenue. If demand is inelastic, a rise in price will increase TR (e.g. price rises 10% demand falls by less than 10%). If the good is elastic in demand a price rise will cause TR to fall. Both government (for tax) and firms (profit-maximizing price) need to know this.

The purpose of **advertising** is to a) increase demand b) make demand more inelastic. Adverts can be informative and/or persuasive. In a market economy adverts are essential for firms to tell customers about their products. But many adverts are also misleading and hardly give any meaningful info to the consumer at all. Advertising creates jobs (in advertising) but it could be argued these resources could be better used in actually making goods and services. Adverts also provide subsidies for the arts and sports (but consumers pay in the form of higher product prices)

**Market structures** Features of perfect competition (identical goods, many buyers and sellers, free entry/exit, perfect information). Firms are price takers. This is the ideal market economists are thinking about when they talk about the free market economy. Monopoly = sole suppliers. A pure monopolist makes goods for which there are no close substitutes e.g. there must be barriers to entry (legal, cost, and marketing). Monopolies have disadvantages to society (higher prices than under competition, lower output, less quality etc). But there are some advantages especially in economies of scale which explain state monopolies in water, railways etc.

#### 4) The individual

Determination of **wages** Wage questions are D&S questions. The demand for labour is a derived demand i.e. it depends on; the demand for the product of the worker. But the demand for labour also depends on the price of capital (are machines cheaper? etc). Note that at lower wages more workers are demanded.

Supply of labour depends on e.g. number in the labour force, social factors (emancipation etc) amount of labor-saving technology in the household (washing machines etc.). More workers are supplied (willing to work longer hours etc) as wages rise. Wages are likely to be higher for workers with a high marginal revenue product, doing dangerous work, with scarce skills etc. The supply of brain surgeons is in the short term inelastic. There are also non-wage factors e.g. holidays, job security etc. Public sector jobs often have lower pay but better job security. Females still on average earn less than males - clearly due to discrimination but also due to the factor that many typically 'female' jobs (nurses, secretaries etc) are poorly paid. Different sectors of the eco (primary, secondary and tertiary). As machines are introduced into the workplace (combine harvesters on farms etc) this puts downward pressure on wages for unskilled workers in the agricultural sector. Same starting to apply to manufacturing. Remember as economies develop the relative size of the primary and then secondary sectors falls.

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Wages can be divided into transfer earnings (minimum payment to a factor needed to keep it in its present place of employment) and economic rent. Anything above transfer earnings is economic rent. Madonna's wage largely consists of economic rent

**Saving** = income not spent on goods and services. People save because a) the value of their savings will grow (interest) b) they are saving up to buy something e.g. a car c) they are saving up for the future e.g. pension plans. Concept of **spending** is basically common sense. Just remember as incomes rise, people tend to save more but also tend to spend proportionally less on essentials (and more on luxuries). So over time and as National Income in the UK has risen, expenditure on food fuel etc as a % of the total has fallen and spending on cars and housing as increased.

### 5) The firm

Main motivation: **profit maximization** (but other motives possible e.g. as a satisfice (make enough profits to keep shareholders satisfied but also try and satisfy workers , managers etc.) Also managers might want to maximize sales revenue (sales revenue = turnover) the demand for the different factors of production (labour capital etc) depends on the price of labour/capital compared to the marginal revenue product. So a film company may hire an expensive film star rather than an unknown because he/she generates a lot revenue for the film.

Fixed costs do not vary with output. So whatever costs exist at output zero must be fixed costs e.g. rent, depreciation (land, capital costs etc.) Labour more likely to be a variable cost (like raw materials, power etc.) Variable Costs often expressed in terms of so many \$ per unit produced

$FC+VC=TC$ .

$AC=TC$  divided by output

Average revenue = total revenue divided by output

$TR=Price$  (or average revenue) times output (or demand)

Marginal cost= the TC of, say, 10 goods minus the TC of 9 goods. MC is the amount by which TC rises as a result of producing one more good.

**Size of firms** While large firms make about 50% of output in most economies, most firms are small. Reason for existence of small firms (flexible, no diseconomies of scale, can share costs with other small firms, personal touch, size of market limited, wage costs for small firms likely to be low due to lack of union organization. Some entrepreneurs do not want to get big. More often small firms cannot get the finance they need to expand.

Why do firms grow? a) Prestige b) market motive and c) cost motive

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**Internal economies of scale** (advantages. of large-scale production). As inputs for a firm rise output rises more than proportionately. Put another way, AC falls. Types of econ of scale: technical, marketing, financial, administrative, risk-bearing (advantages of diversification).

**External economies** refer to the size of the whole industry and the cost advantages gained as the industry's output rises: pool of specialized labour, infrastructure (roads etc), specialist suppliers. Internal diseconomies of scale refer to a rise in AC as the individual firm gets bigger (e.g. as inputs rise 5%, outputs rise less than proportionately) Due to problem of managing all economic resources as the firm gets bigger.

**Diminishing marginal returns** refers to the fact that as successive equal amounts of a variable factor are put to work with a fixed amount of other factors, a point is reached when marginal output starts to fall.

**Integration** Merger, amalgamation or takeover= a situation where one company is joined to another company. A takeover usually refers to the situation where one firm buys another against the wishes of the managers of the second firm. Horizontal integration is a merger between two firms that produce similar goods, at the same stage of production (Pepsi and Coke.) Vertical is the merger of one firm with another that either supplies it with products or buys from it. Forward vertical integration is when a firm merges with another at a later stage of production. Conglomerate integration is a merger between 2 firms producing unrelated goods.

**Location of industry** Why do firms locate where they do (proximity to market, raw materials, labor supplies, external economies of scale, inertia, government incentives)

Firms will choose to be labor-intensive or capital-intensive depending on which is the cheapest.

**Sources of company finance:** retained profits, bank borrowing (loans and overdrafts), debentures, hire purchase, leasing, issuing new shares ('equities'), government grants (unlikely) Preference shares carry a fixed rate of dividend and are repaid in full before ordinary shares. Ordinary shares have a dividend which differs according to the size of profit. Dividends can be high or low etc.

## **6) Government.**

**Privatization:** sale of government-owned firms to the private sector.

Advantages of privatisation: more competition leads to more efficiency, quality, choice, responsiveness to consumer demand. An extra advantage for the government is that it is a (once-and-for-all source of revenue. **Nationalization** is hardly ever discussed now but there are still nationalized industries left. Reasons include Economies of scale, avoid exploitation of consumers by private monopolies, easier for government to control the economy. Some industries are probably natural monopolies, i.e. a single firm can produce the output of the market at lower average cost than a number of firms each producing a smaller quantity. *Examples* nuclear power, railways (in small economies etc.)

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**Control of monopoly** if there are private sector monopolies (or oligopolies) governments may pass regulations controlling their powers. Governments may to set prices, control profits, break-up monopolies into competing firms etc. Governments may also have laws preventing unfair trading practices: when different firms make agreements on price, output etc

Also government regional policy may be important (grants, subsidies, tax advantages for firms setting up plants in depressed areas) Governments may also instruct nationalized firms to hire workers in depressed areas.

**Objectives of government policies:** low inflation, high employment, high economic growth, satisfactory current account. Governments may also have policies on income distribution and the environment. Note that many of these objective conflict e.g. low unemployment and low inflation

### **Policy tools.**

**i) Fiscal policy** (G and/or T). Demand management is an attempt to control the economy by influencing aggregate demand. So to reduce unemployment the government might cut taxes and/or raise govt. expenditure.

**Government expenditure** may take place to supply a) public goods (lighthouse) (non-excludable, non-rivalrous) b) merit goods (under-provided by the market economy (education) c)increase equity (pensions, unemployment benefits etc) d)increase efficiency (natural monopolies)e)increase government control over the economy

**Taxation** Takes place to a)raise finance to pay for public expenditure b)re-distribute income, c)help control the economy (e.g. to fight inflation) d) affect economic behaviour (e.g. discourage smoking)

There are direct taxes such as income tax and indirect taxes like VAT (which is not 'directly related' to your income). Taxes can be progressive (% of income paid in tax rises as income rises) proportional (% stays the same) or regressive (% of income paid in tax falls as income rises).Remember to use a word like '%' in your definitions. Even with a progressive tax, the rich pay more dollars etc in tax than the poor do.

**Disposable income** = gross (or total) income minus taxes plus transfer payments (such as child allowance) Do not confuse disposable income with real income

**Incidence of taxation** When the government imposes a tax on a good who pays? Show the effect of such a tax by shifting the supply curve to the left (i.e. treat as a rise in production costs. The more inelastic demand, the more of a tax the consumer must pay.

If G is greater than T, the government must borrow the difference. This increases the budget deficit (or public sector borrowing requirement) and increases the size of the national debt and it is likely to raise interest rates (because the increase govt. borrowing increases the demand for loans which in turn discourages investment.) Do not confuse a budget deficit with a trade deficit

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ii) **Monetary policy.** Banks can create money by creating loans thru the money credit multiplier.

**Current accounts and savings accounts.** Remember cheques are not money but ways of transferring money. Money held in current accounts is more liquid than in savings accounts. Liquidity refers to the ease with which assets (or possessions) can be converted into cash. Paintings are not very liquid. To reduce the money supply the government can: raise interest rates, sell government bonds (open market operations) issue directives, call for special deposits, engage in funding. Reducing the money supply will raise interest rates (and discourage spending)

iii) **Supply side policies** Increase AS. Improve workings of the labour market (cut unemployment benefits, scrap minimum wages, set up training courses, cut income taxes etc) Improve the workings of the capital market (privatisation, reduce red tape, cut taxes on profits and savings etc.)

iv) **Trade policy** (see later)

v) **Exchange rate policy** (see later)

vi) **Influence of government on private producers** in a market eco: regulations (pollution etc) profit taxes, VAT (raises prices) tax incentives to invest, government as a purchaser of goods, subsidies

## 7) Main economic indicators

**Inflation** A sustained rise in the general price level. Measured by the retail price index. You must be able to calculate this ('basket of goods', base year, weights etc.). Take the price to be indexed and divide by the price in the base year. Multiply by the weight. Sum the weighted index and divide by the sum of the weights. With a price index you can convert nominal (or money) terms to real terms.

Real = Nominal \* 100 *divided by* the price index

When you convert real to nominal you are converting from current prices to constant prices. Weights best based on % of expenditure. So things like rents have a higher weight than newspapers.

**Costs of inflation:** loss of competitiveness (unless ex. rate falls) leading to job losses, unfair distribution of income (e.g. from savers to borrowers, from people on fixed incomes to those who can bargain for large pay rises etc).

**Causes:** cost-push, demand-pull, monetarist explanation.

**Costs of unemployment:** to government, to individual concerned and to those in work (higher taxes)

**Types of unemployment:** cyclical, structural, frictional, regional, voluntary, seasonal. Basic causes; demand side (not enough demand) and supply side (inefficient labour market -minimum wages etc.)

**Measurement of national income.** 3 methods of calculating national income: add up all income (wages, rents, interest and profits) add up all expenditure or add up the value of all output.

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**Gross Domestic Product**= the value of all goods and services produced per year within a country.

**Gross National Product**= the value of all goods and services produced per year by nationally-owned factors of production. This is the same as GDP + net property income from abroad. Net property income refers to flows of interest, profits, dividends and rent. National income is GNP minus depreciation (replacement of machines).

**Sources of income:** rent for land, wages for labour, interest for capital and profit for enterprise. Note that rent and interest (like labour) is determined by demand and supply.

Functions of profit: to finance investment, reward for risk taking, help resource allocation. Features of profit: fluctuates more than the other sources of income, can be negative, is a residual (what is left from TR after TC has been deducted).

The **circular flow of income theory** as developed by Keynes. The economy is in equilibrium when total leakages = total injections i.e. where  $S+T+IM=I+G+EX$ . If total leakages are greater than total injections, national income will fall. Keynes also talked about the expenditure multiplier: the theory that extra govt spending will lead to yet further increases in spending in the rest of the economy.

The **balance of payments:** is the record of all financial transactions by one country with all other countries (normally in one year) The current account consists of the visible balance (goods, 'balance of trade') plus the invisible balance (services). Exports involve inflows of money from abroad. The capital account refers to flows of money (capital) for purposes other than to buy or sell goods and services i.e. it records flows of investment, savings and borrowings. If a country's imports exceed exports there is a current account deficit which must be financed by borrowing etc (i.e. a capital surplus (net capital inflow)).

An **exchange rate** is the price at which one currency is bought and sold for another currency. Determined by demand and supply. Americans supply \$ because they want to buy foreign goods, buy foreign financial assets or invest abroad. An exchange rate is likely to fall if: a) there is a current account deficit b) if relative interest rates fall and c) if speculators think the value of the currency is going to fall in the future. Remember changes in exchange rate will have both good and bad effects. A depreciation/devaluation will boost exports and jobs, and reduce a trade deficit but they will also raise import prices and possibly stimulate inflation.

**Exchange rate systems:** Floating (determined by market forces) or fixed (determined by government) Governments can raise their exchange rate by a) buying their currency, b) raising interest rates, c) import restrictions d) deflation e) exchange control. Exchange rate mechanism ERM involves most EU economies.

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## **8) Developed and developing economies**

**Standard of living;** most commonly measured by real GNP per capita but other indicators too: literacy, number of households with inside toilet etc. Non-material factors important too (crime / suicide rate, lack of pollution etc).

**Population;** Birth rates (numbers born per 1000 of the population) Death rates. The natural rate of growth of the population refers to BR-DR. Immigration refers to numbers entering a country. Demographic transition: Stage 1 High BRs and high DRs Low pop growth. Stage 2 Falling DRs and constant BRs. Rapid population growth. Stage 3. Low BRs and low DRs. Stable population. The optimum population refers to that level of population which maximizes output (or income) per head. The working population (or labour force) refers to all those employed, self-employed and registered unemployed. Population pyramids. Most DCs have population pyramids that look like, well, pyramids! A country with an ageing population e.g. UK will find the dependency ratio rises as more old people depend on a smaller labour force. Generally an ageing population is likely to become less dynamic (less occupationally and geographically mobile). The pattern of demand will change too (more walking sticks, retirement homes etc)

Birth rates depend on social attitudes, availability of contraceptives etc. DRs depend on medical improvements, sanitation, nutrition etc.

**Features of DCs:** low income per person, low life expectancy, high pop growth, less educated workforce, shortage of capital, low productivity, poor housing, health etc. Poverty cycle - low income per head - low savings - low investment - low income etc. Not in the book but in the syllabus and useful in this context is the principle of diminishing marginal returns (as more units of a variable input (e.g. labour) are added to a fixed amount of other inputs (e.g. land), there will eventually come a time when marginal product begins to fall)

**Economic growth** caused by a) increase quantity of eco resources (bring more land into production etc, investment or b) improve quality of eco resources (education 'human capital', new technology etc). DCs grow in the same way but additional problem in that they don't have sufficient incomes to finance their own growth. So they have to borrow, rely on grants, or invite multinationals in. Loans are OK if used for productive purposes but they have to be repaid with interest. Many loans are 'tied' to the exports of the donor country. Multinationals have advts (provide their own capital, knowhow, infrastructure etc) but disadvts too (profits are likely to be sent back, any development generated may be highly localized and grind to a halt when the multinationals leave. DCs can also be helped by granting them access to our rich markets (which is not what usually happens e.g. the Common Agricultural Policy in the EU)

**Growth is not always good:** environmental factors (destruction of rain forest, global warming, species become extinct, break-down of cultural identity etc.)

## 9) International interdependence

**Comparative advantage** = when one producer can produce a good at a relatively cheaper cost in terms of other goods than another producer. This is more useful to explain the advantages of free trade than absolute advantage = where one producer is better at producing a product than another producer.

Best explained by a numerical example:

cost of production (man hours)	Italy	UK
one pair of shoes	10	20
one radio	30	40

Italy has an absolute advantage in both radios and shoes. It has a comparative advantage in shoes. The UK has a comparative advt. in radios (i.e. it is least inefficient at making radios).

A slightly different approach: France Germany

production from a given no. resources	France	Germany
kilos of cheese	25	15
number of sausages	12	11

France has the absolute advantage in both but a comparative advantage in cheese (Germany in sausages)

### **Terms of trade**

$$\frac{\text{Index of export prices}}{\text{Index of import prices}} \times 100$$

For many DCs the prices for their exports has fallen relative to the prices they must pay for their imports so their terms of trade have become less favorable. Free trade leads to more efficient resource allocation on a world scale. But barriers to trade do exist: tariffs (taxes on imports) quotas (physical limitations on the amount of goods imported, special regulations, embargoes, exchange control, subsidies etc. Reasons: protect infant industries, reduce trade deficits, and prevent unfair competition (dumping= selling goods at below cost price, strategic reasons, protect jobs, raise revenue for government (tariffs).

**Externalities** Social costs = all costs to society of the production of a good. This will be private costs + detrimental externalities such as pollution. Market economies are not good at dealing with detrimental externalities since it is hard to measure the 'price' of the ozone layer. Use of cost-benefit analysis to try to assess these environmental issues. E.g. loggers knocking down the rain forest do create incomes,

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jobs etc (at least while the forest remains) but there is damage too - in the short term (loss of tourist incomes etc) but in the long run too if the resource is exhausted.

The short run = that period of time in which there is at least one fixed factor e.g. a farmer might easily be able to adjust use of unskilled workers, raw materials etc but will find it hard to expand the area of his farm. In the long run all factors become variable (so in the long run he might be able to buy land from the farm next door or sell his land etc.)

**Private expenditure versus public expenditure** is really about the issue of nationalization and privatization.