STUDY AND REVISION GUIDE

Working for over 25 YEARS WITH Cambridge Assessment International Education

Cambridge IGCSE™ and O Level

Economics

Second edition

Paul Hoang

HODDER EDUCATION

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The author would like to dedicate this book to the wonderful students and staff of Sha Tin College, English Schools Foundation.

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ISBN: 978 1 5104 2129 5

First published in 2017
This edition published in 2019 by
Hodder Education,
An Hachette UK Company
Carmelite House
50 Victoria Embankment
London EC4Y 0DZ

www.hoddereducation.com

Impression number 10 9 8 7 6 5 4 3 2 1

Year 2023 2022 2021 2020 2019

Illustrations by Integra Software Services

Typeset by Integra Software Services Pvt. Ltd, Pondicherry, India.

Printed in India

A catalogue record for this title is available from the British Library.

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Contents

Introduction

Welcome to the *Cambridge IGCSE™ and O Level Economics Second Edition Study and Revision Guide*. This book has been written to help you revise everything you need to know for your Economics exam. Following the Economics syllabus, it covers all the key content as well as sample questions and answers and practice questions to help you learn how to answer questions and to check your understanding.

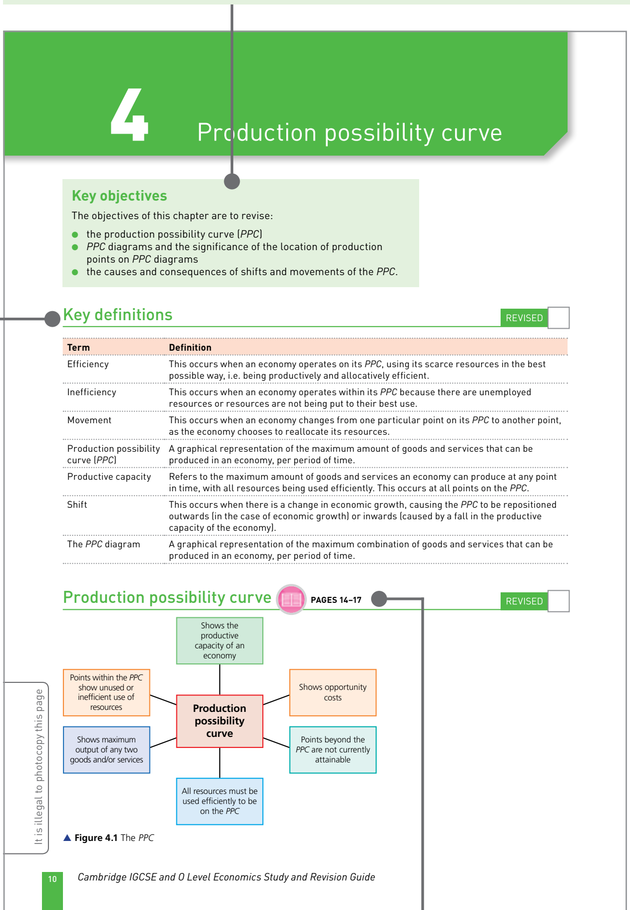
How to use this book

Key objectives

The key points covered in the chapter

Common errors

Mistakes that students often make, and how to avoid them.



4 Production possibility curve

Key objectives

The objectives of this chapter are to revise:

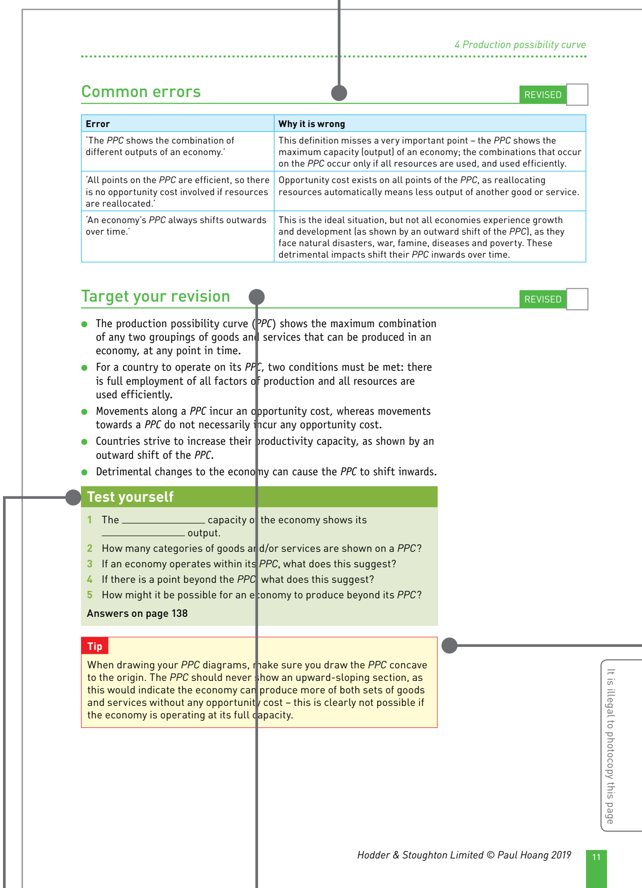
- the production possibility curve (*PPC*)
- *PPC* diagrams and the significance of the location of production points on *PPC* diagrams
- the causes and consequences of shifts and movements of the *PPC*.

Key definitions REVISED

Term	Definition
Efficiency	This occurs when an economy operates on its *PPC*, using its scarce resources in the best possible way, i.e. being productively and allocatively efficient.
Inefficiency	This occurs when an economy operates within its *PPC* because there are unemployed resources or resources are not being put to their best use.
Movement	This occurs when an economy changes from one particular point on its *PPC* to another point, as the economy chooses to reallocate its resources.
Production possibility curve (*PPC*)	A graphical representation of the maximum amount of goods and services that can be produced in an economy, per period of time.
Productive capacity	Refers to the maximum amount of goods and services an economy can produce at any point in time, with all resources being used efficiently. This occurs at all points on the *PPC*.
Shift	This occurs when there is a change in economic growth, causing the *PPC* to be repositioned outwards (in the case of economic growth) or inwards (caused by a fall in the productive capacity of the economy).
The *PPC* diagram	A graphical representation of the maximum combination of goods and services that can be produced in an economy, per period of time.

Production possibility curve PAGES 14–17 REVISED

▲ **Figure 4.1** The *PPC*



Common errors REVISED

Error	Why it is wrong
'The *PPC* shows the combination of different outputs of an economy.'	This definition misses a very important point – the *PPC* shows the maximum capacity (output) of an economy; the combinations that occur on the *PPC* occur only if all resources are used, and used efficiently.
'All points on the *PPC* are efficient, so there is no opportunity cost involved if resources are reallocated.'	Opportunity cost exists on all points of the *PPC*, as reallocating resources automatically means less output of another good or service.
'An economy's *PPC* always shifts outwards over time.'	This is the ideal situation, but not all economies experience growth and development (as shown by an outward shift of the *PPC*), as they face natural disasters, war, famine, diseases and poverty. These detrimental impacts shift their *PPC* inwards over time.

Target your revision REVISED

- The production possibility curve (*PPC*) shows the maximum combination of any two groupings of goods and services that can be produced in an economy, at any point in time.
- For a country to operate on its *PPC*, two conditions must be met: there is full employment of all factors of production and all resources are used efficiently.
- Movements along a *PPC* incur an opportunity cost, whereas movements towards a *PPC* do not necessarily incur any opportunity cost.
- Countries strive to increase their productivity capacity, as shown by an outward shift of the *PPC*.
- Detrimental changes to the economy can cause the *PPC* to shift inwards.

Test yourself

1 The ________________ capacity of the economy shows its ________________ output.
2 How many categories of goods and/or services are shown on a *PPC*?
3 If an economy operates within its *PPC*, what does this suggest?
4 If there is a point beyond the *PPC* what does this suggest?
5 How might it be possible for an economy to produce beyond its *PPC*?

Answers on page 138

Tip

When drawing your *PPC* diagrams, make sure you draw the *PPC* concave to the origin. The *PPC* should never show an upward-sloping section, as this would indicate the economy can produce more of both sets of goods and services without any opportunity cost – this is clearly not possible if the economy is operating at its full capacity.

Cross-references to the Student's Book are shown by this icon

Key definitions

Definitions of the key terms you need to know.

Target your revision

- Checklist of the key concepts and topics covered in the chapter.

Test yourself

Questions for you to check your understanding and progress.

Tip

Advice to help you give the perfect answer.

Sample questions and answers

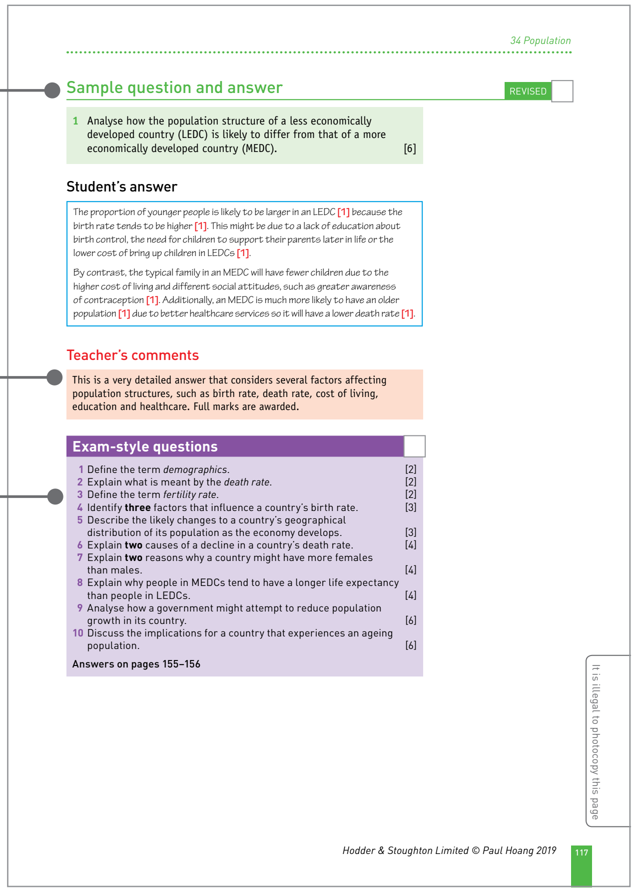
- Exam-style questions for you to think about
- Model student answers to see how the question might be answered
- Please note that, in line with Cambridge mark schemes for IGCSE Economics, the marks for some of the answers add up to more than the maximum available marks for the question. The purpose is to show candidates how marks can be awarded, and that alternative approaches can be taken and rewarded accordingly.

Teacher's comments

Feedback from a teacher showing what was good, and what could be improved in the student answers.

Exam-style questions

These questions are designed to show you the types of questions you may get in examinations, for you to check what you have learned. Note that they are only part questions, as they are intended to consolidate your understanding of the specific chapter being reviewed.



34 Population

Sample question and answer

REVISED

1 Analyse how the population structure of a less economically developed country (LEDC) is likely to differ from that of a more economically developed country (MEDC). [6]

Student's answer

The proportion of younger people is likely to be larger in an LEDC [1] because the birth rate tends to be higher [1]. This might be due to a lack of education about birth control, the need for children to support their parents later in life or the lower cost of bring up children in LEDCs [1].

By contrast, the typical family in an MEDC will have fewer children due to the higher cost of living and different social attitudes, such as greater awareness of contraception [1]. Additionally, an MEDC is much more likely to have an older population [1] due to better healthcare services so it will have a lower death rate [1].

Teacher's comments

This is a very detailed answer that considers several factors affecting population structures, such as birth rate, death rate, cost of living, education and healthcare. Full marks are awarded.

Exam-style questions

1 Define the term *demographics*. [2]
2 Explain what is meant by the *death rate*. [2]
3 Define the term *fertility rate*. [2]
4 Identify **three** factors that influence a country's birth rate. [3]
5 Describe the likely changes to a country's geographical distribution of its population as the economy develops. [3]
6 Explain **two** causes of a decline in a country's death rate. [4]
7 Explain **two** reasons why a country might have more females than males. [4]
8 Explain why people in MEDCs tend to have a longer life expectancy than people in LEDCs. [4]
9 Analyse how a government might attempt to reduce population growth in its country. [6]
10 Discuss the implications for a country that experiences an ageing population. [6]

Answers on pages 155–156

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Answers

Outline answers to the Test yourself questions and the Exam-style questions from page 137.

1 The nature of the economic problem

Key objectives

The objectives of this chapter are to revise:

- the nature of the economic problem
- finite resources and unlimited wants
- economic and free goods.

Key definitions

REVISED

Term	Definition
Basic economic problem	The issue of what, how and for whom production should take place (i.e. how best to allocate scarce resources) due to unlimited wants with limited resources.
Economic agents	Households (private individuals in society), firms (businesses operating in the private sector) and the government (the public sector of an economy).
Economic goods	Resources and products that are limited in supply. The vast majority of goods are economic goods.
Free goods	Resources and products that are unlimited in supply, e.g. sand, air and seawater.
Goods	Physical items made in the production process, e.g. tables, cars, toothpaste and pencils.
Needs	Goods and services that are essential for survival, e.g. food, water, clothing and shelter.
Private sector	Part of the economy where private firms and individuals produce goods and services.
Public sector	Part of the economy where the government produces goods and services, e.g. education and healthcare services for the general public.
Services	Non-physical products, e.g. haircuts, bus journeys, telephone calls and internet access.
Wants	Goods and services that are not necessary for survival but are desired by economic agents.

The nature of the economic problem

PAGES 2–5

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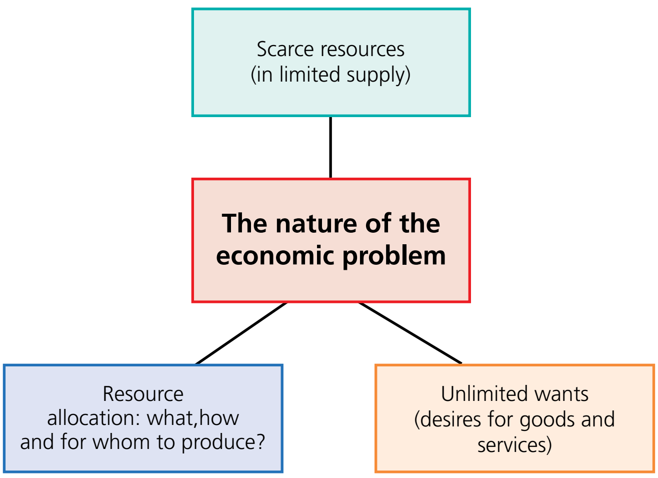
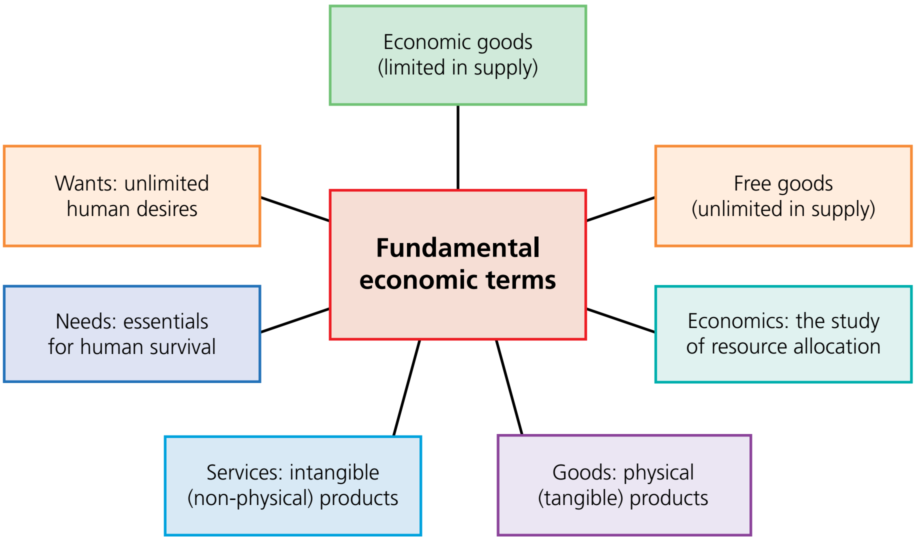


▲ **Figure 1.1** The nature of the economic problem



▲ **Figure 1.2** Fundamental economic terminology

Common errors

REVISED

Error	Why it is wrong
'Economics is about how a country makes money.'	Economics is about the allocation of scarce resources and making rational choices in order to meet people's infinite needs and wants.
'Free goods are those provided by the government, such as public roads and education.'	Free goods are those that do not have an opportunity cost. Both public roads and education are examples of economic goods – even if the government provides these, there is an associated opportunity cost involved.
'Economic goods are goods or services that consumers must pay a price to purchase.'	Not all economic goods have a market price (e.g. government provision of healthcare), but all such goods can only be provided with an opportunity cost (e.g. the provision of other public sector services).

Target your revision

REVISED

- Economics is the study of how resources are allocated to satisfy the needs and wants of individuals, governments and firms.
- The basic economic problem involves decisions about what, how and for whom production should take place, i.e. how best to allocate scarce resources in the economy.
- Needs are the items that we must have in order to survive. Wants are our desires, i.e. things we would like to have.
- Opportunity cost exists because the economy's resources are scarce, yet wants (desires) are unlimited, so choices have to be made.

Test yourself

1. State **three** wants and **three** needs.
2. Give **one** example of opportunity cost for a student who chooses to study IGCSE Economics.
3. Give **two** examples of products provided in the public sector.
4. Give **three** examples of different services provided in the private sector.
5. State **two** examples of free goods (which do not have an opportunity cost).

Answers on page 137

Tip

When writing your answers to definition questions, try to include one of the three Es: provide a brief *explanation*, give an *example* to clarify your definition, or provide the *equation* (formula) if it exists.

Sample questions and answers

REVISED

1 Describe why free goods do not have an opportunity cost. [2]

Student's answer

Free goods, such as seawater, are unlimited in supply [1]. They do not have an opportunity cost as the decision to consume a free good does not have to come at the expense (opportunity cost) of other goods or services [1].

Teacher's comments

This is a very good response. The student shows clear understanding of the demands of the question, stating what is meant by free goods, and providing a suitable example and using relevant economic terminology.

2 Describe how the objectives of private sector firms differ from those operating in the public sector. [2]

Student's answer

Private sector firms tend to operate in order to earn profit, i.e. personal gain [1]. By contrast, the public sector operates in order to provide a service to society such as state education and healthcare [1].

Teacher's comments

This is a very precise answer with good examples given to add clarity. Full marks are awarded.

Exam-style questions

1. Explain what is meant by the 'economic problem'. [2]
2. Explain why choices have to be made about how resources are allocated in an economy. [2]
3. Explain the difference between economic activity in the private and public sectors of the economy. [4]

Answers on page 137

2 The factors of production

Key objectives

The objectives of this chapter are to revise:

- examples of the factors of production
- the rewards for the factors of production
- the influences on the mobility of factors of production
- the causes of changes in the quantity and quality of factors of production.

Key definitions

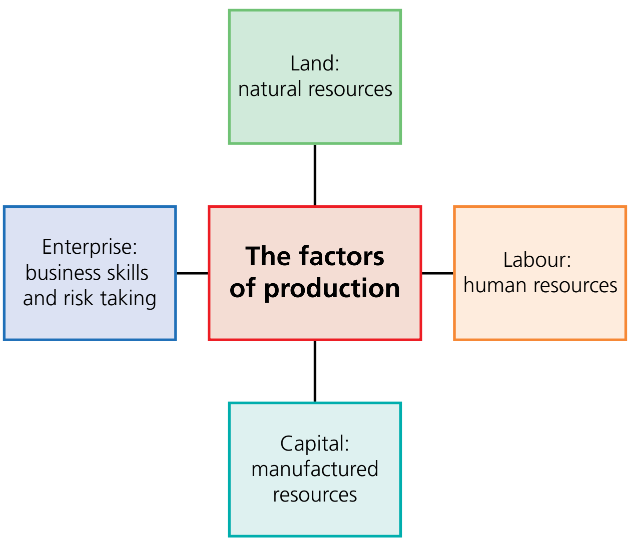
REVISED

Term	Definition
Capital	The manufactured resources required in the production process, e.g. machinery, tools, equipment and vehicles.
Ceteris paribus	Latin phrase commonly used in Economics, which means 'all other things remaining equal'.
Enterprise	The skills a business person requires to successfully combine and manage the other three factors of production.
Factors of production	The resources required to produce a good or service, i.e. land, labour, capital and enterprise.
Geographical mobility	The extent to which labour is willing and able to move to different locations for employment purposes.
Labour	The human resources required in the production process, e.g. skilled and unskilled labour.
Land	The natural resources required in the production process, e.g. oil, coal, water, wood, metal ores and agricultural products.
Occupational mobility	The extent to which labour is able to move between jobs. Retraining and upskilling workers helps to improve occupational mobility.

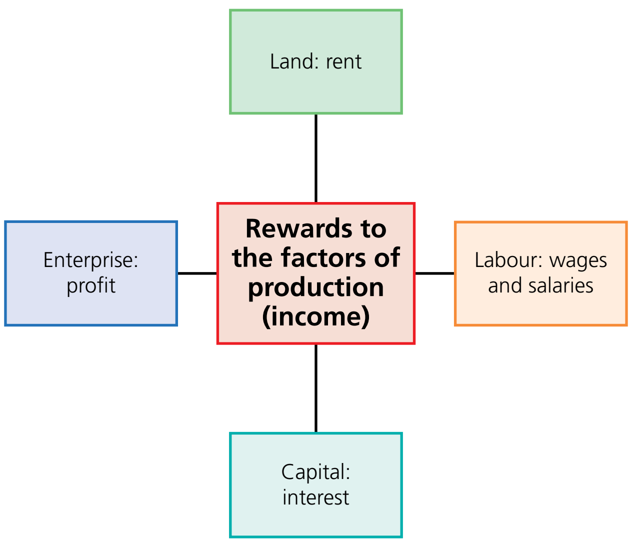
The factors of production

PAGES 6–10

REVISED



▲ **Figure 2.1** Factors of production



▲ **Figure 2.2** Rewards to the factors of production

Common errors

REVISED

Error	Why it is wrong
'Land refers to the physical land used in the production process, such as farm or office land space.'	In economics, land refers to natural resources in the production process, e.g. sugar, water and caffeine are some of the ingredients used to make Coca-Cola.
'Labour refers to the number of workers used in the production process.'	Labour refers to both the physical and mental human resources used in the production process, so it is more than just the physical number of workers.
'Capital is the amount of money used in the production process.'	Capital refers to all non-natural (human-made) resources used in the production process, e.g. machinery, tools, buildings and vehicles.
'Income refers to the money that labour receives for work.'	The reward for labour services is called 'wages' (although it can include 'salaries'). The term 'income' refers to the collective rewards for the factors of production, i.e. rent, interest, profit and wages.

Target your revision

REVISED

- The factors of production (land, labour, capital and enterprise) are the resources needed to produce a good or service.
- The return on the four factors of production are collectively called **income**, and comprise: rent (land), wages and salaries (labour), interest (capital) and profit (enterprise).
- Geographical mobility measures the willingness and ability of a person to relocate from one area to another for a job.
- Occupational mobility measures the extent to which a person is able to switch between jobs (occupations).
- The quantity and quality of factors of production will change if there is a change in the demand for and/or supply of land, labour, capital or enterprise.

Test yourself

1 Name the four factors of production.
2 State the different rewards for the four factors of production.
3 Name the two types of labour mobility.
4 State **four** factors that affect the level of labour mobility.
5 State **four** factors that change the quantity and quality of factors of production.

Answers on page 137

Tip

The four factors of production can be remembered using the acronym CELL: **C**apital, **E**nterprise, **L**and and **L**abour.

Sample questions and answers

REVISED

1 State **two** functions of an entrepreneur. [2]

Student's answer

An entrepreneur is someone who bears the uninsurable risks of running a business [1]. *He or she is responsible for organising the other three factors of production* [1] *and for making key decisions in the business.*

Teacher's comments

Although this answer scores the full 2 marks, the student has ignored the command term ('State') so has written far more than needed. In fact, the candidate has provided three functions of entrepreneurs by mentioning that they make the key decisions in a business.

2 Explain **two** reasons why there is a shortage of teachers and doctors in some countries. [4]

Student's answer

Doctors and teachers are very limited in supply because of the high level of qualifications needed to enter these professions [1]. *For example, to become a doctor or teacher requires many years of university education, so it is time consuming and limits the labour supply* [1].

Teacher's comments

While this is a very good explanation of why there may be a shortage of doctors and teachers, only *one* reason is provided. It is important to read the question very carefully; in this case, the candidate must provide two distinct reasons, e.g. the high level of qualifications *and* negative aspects of these careers (such as long working hours and the huge pressures placed on health professionals and educators). As only one reason is explained, only 2 marks have been awarded.

Exam-style questions

1 Define the term *factors of production*. [2]
2 Define the term *resources*. [2]
3 Explain the meaning of *capital goods*. [2]
4 Using machinery as an example, explain the mobility of capital as a factor of production. [2]
5 Explain **two** factors that firms consider when choosing which factors of production to use. [4]

Answers on page 137

3 Opportunity cost

Key objectives

The objectives of this chapter are to revise:

- examples of opportunity cost
- the influence of opportunity cost on decision making.

Key definitions

REVISED

Term	Definition
Consumers	Often referred to as 'households', consumers are the private individuals in society who purchase goods and services for their personal use.
Decision makers	Individuals or organisations that make economic choices, i.e. consumers, workers, producers and governments.
Firms	Businesses that produce or supply goods and services to their customers.
Government	The central authority of a country, responsible for the social, political and economic wellbeing of its people.
Opportunity cost	The cost of the next best option (opportunity) forgone when making an economic decision (or choice).

Opportunity cost

PAGES 11–13

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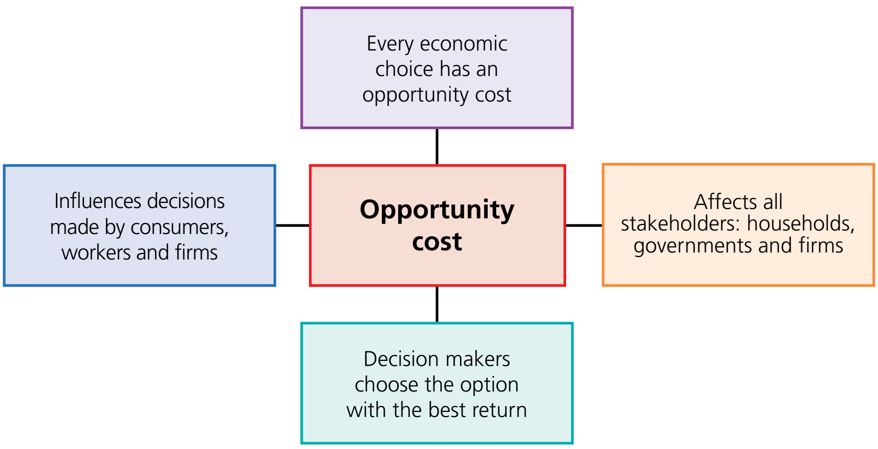

▲ **Figure 3.1** The concept of opportunity cost

Common errors

REVISED

Error	Why it is wrong
'Opportunity cost is the second best alternative forgone when decisions are made.'	Opportunity cost is the *next* best alternative (the 'second best alternative' would mean the third best choice when making a decision).
'Firms only face opportunity costs of production decisions.'	Firms (and governments) are also customers of other businesses, i.e. they make purchases too. Hence, firms (and governments) also face opportunity costs of purchasing decisions.
'Very wealthy individuals and households do not face opportunity costs.'	All decision makers face opportunity costs because of finite resources – even multi-billionaires have financial limits, so cannot afford to buy 'everything'.

Target your revision

REVISED

- Opportunity cost is the cost of the next best opportunity forgone (given up) when making a decision.
- Opportunity cost is a central concept in the study of Economics as all economic decisions have an opportunity cost.
- Opportunity cost affects the decision making of every economic agent: consumers, workers, producers and governments.
- Opportunity cost arises because decision makers have to make competing choices due to finite resources but unlimited wants.
- Thus, there is always an opportunity cost when allocating scarce resources in an economy.

Test yourself

1 Complete the following sentence: Opportunity cost refers to the next best opportunity ______________ when making an economic ______________.

2 Give an example of an opportunity cost of your choosing to study IGCSE Economics.

3 Give an example of an opportunity cost of a household choosing to buy a new Honda Civic motor car.

4 Give an example of an opportunity cost if the government spends $3 billion to build a new airport terminal.

5 Suggest how the concept of opportunity cost might influence the decisions of workers.

Answers on pages 137–38

Tip

Opportunity cost is a central concept that applies to all topics in economics. Therefore, make sure you can define the term, and provide appropriate examples of your own.

Sample questions and answers

REVISED

1 The opportunity costs for a farmer in terms of growing apples and oranges are shown in the table below.

Apples (kilos)		Oranges (kilos)
650	plus	300
550	plus	350

Calculate the opportunity cost for the farmer of producing 1 kilo of oranges. [2]

Student's answer

By producing an extra 50 kilos of oranges, the farmer gives up 100 kilos of apples. Hence the ratio is 50:100 or 1:2 [1], i.e. the opportunity cost of producing 1 kilo of oranges is 2 kilos of apples [1].

Teacher's comments

The student demonstrates a clear understanding of the demands of the question, showing the ratio of producing oranges in terms of sacrificing the production of apples. The working out and calculations are correct, so full marks are awarded.

2 Describe **one** opportunity cost of studying at university. [2]

Student's answer

Opportunity cost is measured in terms of the best alternative sacrificed when an economic decision is made [1]. *For example, if a student chooses to go to university, the opportunity cost is likely to be the wages lost had the student gone to work instead* [1].

Teacher's comments

This is a very precise answer that gives a good definition and a good example. Full marks are awarded.

Exam-style questions

1. Define the term *scarcity*. [2]
2. Explain why choices have to be made about how resources are allocated in an economy. [2]
3. Explain why scarcity creates an opportunity cost. [4]

Answers on page 138

4 Production possibility curve

Key objectives

The objectives of this chapter are to revise:

- the production possibility curve (*PPC*)
- *PPC* diagrams and the significance of the location of production points on *PPC* diagrams
- the causes and consequences of shifts and movements of the *PPC*.

Key definitions

REVISED

Term	Definition
Efficiency	This occurs when an economy operates on its *PPC*, using its scarce resources in the best possible way, i.e. being productively and allocatively efficient.
Inefficiency	This occurs when an economy operates within its *PPC* because there are unemployed resources or resources are not being put to their best use.
Movement	This occurs when an economy changes from one particular point on its *PPC* to another point, as the economy chooses to reallocate its resources.
Production possibility curve (*PPC*)	A graphical representation of the maximum amount of goods and services that can be produced in an economy, per period of time.
Productive capacity	Refers to the maximum amount of goods and services an economy can produce at any point in time, with all resources being used efficiently. This occurs at all points on the *PPC*.
Shift	This occurs when there is a change in economic growth, causing the *PPC* to be repositioned outwards (in the case of economic growth) or inwards (caused by a fall in the productive capacity of the economy).
The *PPC* diagram	A graphical representation of the maximum combination of goods and services that can be produced in an economy, per period of time.

Production possibility curve

PAGES 14–17

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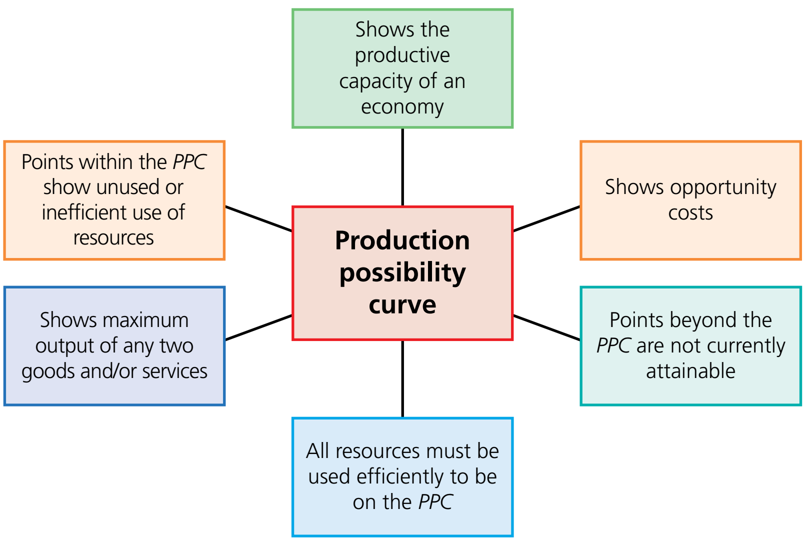


▲ **Figure 4.1** The *PPC*

Common errors

REVISED

Error	Why it is wrong
'The *PPC* shows the combination of different outputs of an economy.'	This definition misses a very important point – the *PPC* shows the maximum capacity (output) of an economy; the combinations that occur on the *PPC* occur only if all resources are used, and used efficiently.
'All points on the *PPC* are efficient, so there is no opportunity cost involved if resources are reallocated.'	Opportunity cost exists on all points of the *PPC*, as reallocating resources automatically means less output of another good or service.
'An economy's *PPC* always shifts outwards over time.'	This is the ideal situation, but not all economies experience growth and development (as shown by an outward shift of the *PPC*), as they face natural disasters, war, famine, diseases and poverty. These detrimental impacts shift their *PPC* inwards over time.

Target your revision

REVISED

- The production possibility curve (*PPC*) shows the maximum combination of any two groupings of goods and services that can be produced in an economy, at any point in time.
- For a country to operate on its *PPC*, two conditions must be met: there is full employment of all factors of production and all resources are used efficiently.
- Movements along a *PPC* incur an opportunity cost, whereas movements towards a *PPC* do not necessarily incur any opportunity cost.
- Countries strive to increase their productivity capacity, as shown by an outward shift of the *PPC*.
- Detrimental changes to the economy can cause the *PPC* to shift inwards.

Test yourself

1 The ________________ capacity of the economy shows its ________________ output.
2 How many categories of goods and/or services are shown on a *PPC*?
3 If an economy operates within its *PPC*, what does this suggest?
4 If there is a point beyond the *PPC*, what does this suggest?
5 How might it be possible for an economy to produce beyond its *PPC*?

Answers on page 138

Tip

When drawing your *PPC* diagrams, make sure you draw the *PPC* concave to the origin. The *PPC* should never show an upward-sloping section, as this would indicate the economy can produce more of both sets of goods and services without any opportunity cost – this is clearly not possible if the economy is operating at its full capacity.

Sample questions and answers

REVISED

1 Explain what is meant by the productive capacity of an economy. [2]

Student's answer

This means how much the economy can produce given the amount of factors of production it has [1].

Teacher's comments

The answer shows some understanding of the term 'productive capacity' but is imprecise. The productive capacity of the economy shows the *maximum* amount of output, if *all* factors of production are used *efficiently*. Productive capacity is shown by any point of the economy's *PPC*.

2 State which **two** conditions must hold for an economy to be operating on its *PPC*. [2]

Student's answer

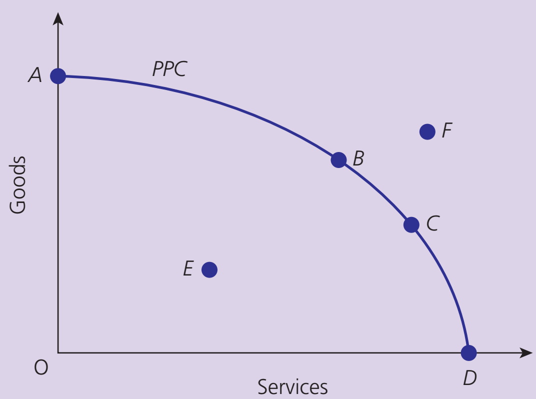
Full employment of all resources, i.e. factors of production [1], and efficient use of these resources [1].

Teacher's comments

This is a very precise answer with both conditions clearly stated (there is no need for an explanation). Both marks are awarded.

Exam-style questions

1 State **two** possible causes of an inward shift of the *PPC*. [2]
2 Give **two** general reasons for an outwards shift of the *PPC*. [2]
3 Explain how the *PPC* diagram demonstrates the concept of opportunity cost. [2]
4 Study the *PPC* diagram below and answer the questions that follow.



Identify the correct point in each case:

a All resources dedicated to the production of goods
b Unemployed resources
c Efficient output
d Unattainable production. [4]

Answers on page 138

5 Microeconomics and macroeconomics

Key objectives

The objectives of this chapter are to revise:

- the difference between microeconomics and macroeconomics
- the decision makers involved in microeconomics and macroeconomics.

Key definitions

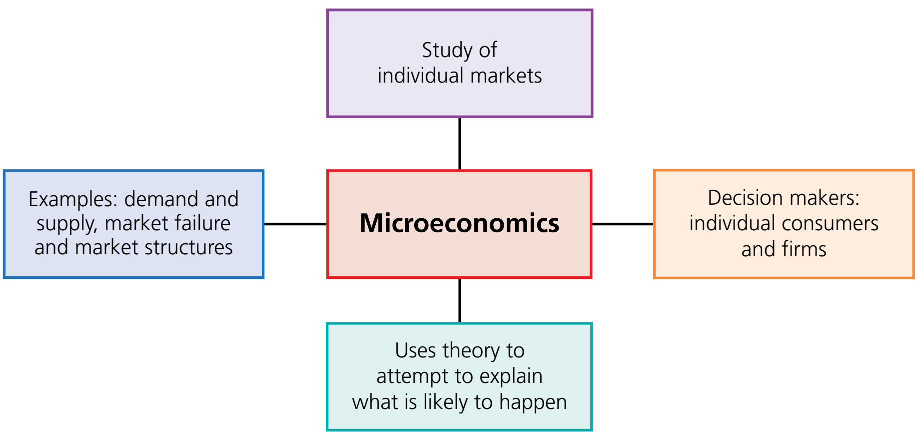
REVISED

Term	Definition
Consumers	Individual stakeholders who purchase goods and services for private consumption.
Households	Families who are affected by both microeconomics (e.g. what to buy) and macroeconomics (e.g. the general level of prices in the economy).
Microeconomics	The study of particular markets and sections of the economy, rather than the economy as a whole.
Macroeconomics	The study of economic behaviour and decision making of the whole economy, rather than individual markets.

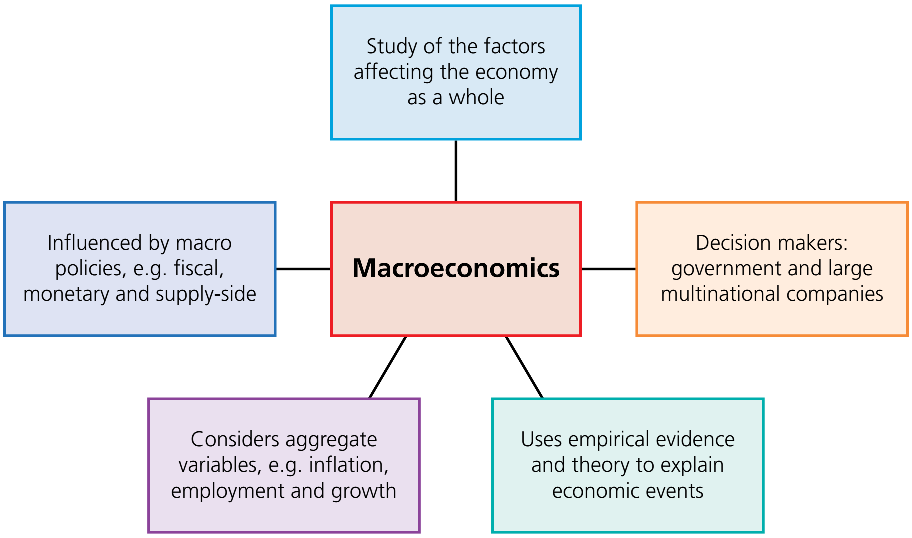
Microeconomics and macroeconomics

PAGES 20–23

REVISED



▲ **Figure 5.1** Microeconomics



▲ **Figure 5.2** Macroeconomics

Common errors

REVISED

Error	Why it is wrong
'Labour markets are an example of macroeconomics.'	As this refers to individual markets for labour services (e.g. in teaching, healthcare or retail), this is a microeconomics topic. Unemployment would be a macroeconomics topic as it has impacts on the whole economy.
'Poverty only affects a small number of people in a rich country, so it is a microeconomic problem.'	Poverty is a macroeconomic issue because it is widespread, even in high-income countries. It has large impacts on the level of consumption, employment and wealth distribution in the economy.

Target your revision

REVISED

- Microeconomics is the study of particular and individual markets within the economy, rather than the economy as a whole.
- Microeconomics tends to rely on theory and economic models, rather than empirical evidence, to explain changes in individual markets and industries.
- Microeconomics is concerned with decision making by individual consumers and firms.
- Macroeconomics is the study of economic behaviour and decision making of the whole economy, rather than individual markets.
- Macroeconomics tends to use empirical data and evidence to explain changes in the economy, such as an economic boom or recession.

Test yourself

1 Complete the following sentences: ______________________ is the study of the economic behaviour of individuals and firms. ______________________ is the study of economic behaviour and decision making of the economy as a whole.
2 Provide **four** examples of macroeconomic issues or topics.
3 Provide **four** examples of microeconomic issues or topics.
4 Who are the main decision makers in microeconomics?
5 Who are the main decision makers in macroeconomics?

Answers on page 138

Tip

Topics related to the individual (firms and consumers) are components of microeconomics, e.g. the nature of the economic problem (Chapter 1), price determination (Chapter 9) and market structure (Chapter 23). Topics related to the operations of the economy as a whole are aspects of macroeconomics, e.g. the role of government (Chapter 24) and supply-side policy (Chapter 28).

Sample questions and answers

REVISED

1 Define the term *macroeconomics*. [2]

Student's answer

Macroeconomics is the study of resource allocation and decision making of the economy as a whole [1], e.g. the causes and consequences of unemployment [1].

Teacher's comments

The definition is very succinct. The example is appropriate and clarifies the definition. Full marks are awarded.

2 Briefly explain the main decision makers in microeconomics and how they are different from the decision makers in macroeconomics. [2]

Student's answer

Households and individual firms make decisions in microeconomics [1]. By contrast, the government, large non-governmental organisations and large multinational companies make decisions with macroeconomic impacts [1].

Teacher's comments

This is a very precise answer with appropriate examples of decision makers at both the microeconomic and macroeconomic levels. Full marks are awarded.

Exam-style questions

1 Define the term *microeconomics*. [2]
2 Explain how **two** different stakeholder groups are affected by macroeconomic decisions. [4]

Answers on page 138

6 The role of markets in allocating resources

Key objectives

The objectives of this chapter are to revise:

- the meaning of the market system
- the key questions about resource allocation in a market system
- how the price mechanism allocates resources.

Key definitions

REVISED

Term	Definition
Market disequilibrium	This occurs when the market price is either above or below the equilibrium price, resulting in excess supply or excess demand.
Market equilibrium	This occurs when the demand for a product equals its supply. At this position, the market is cleared of any shortages of surpluses.
Market system	The economic system of relying on demand and supply (market forces) to allocate scarce resources.
Price mechanism	The method by which scarce resources are allocated, namely through the market forces of demand and supply.

The role of markets in allocating resources

PAGES 24–27

REVISED

▲ **Figure 6.1** The role of markets in allocating resources

Common errors

REVISED

Error	Why it is wrong
'The market system relies on both the government and private sector economic activity.'	This defines the mixed economic system. The (free) market system relies on the market forces of demand and supply to allocate scarce resources.
'The price mechanism allocates resources by charging customers a suitable price.'	This is not entirely incorrect, but price is determined in a market system by both demand (how much customers are willing and able to pay at a given price) and supply (how much firms are willing and able to provide at a given price). These opposing forces must be in equilibrium for the price mechanism to work effectively.

Target your revision

REVISED

- In a market system, the decision about what, how and for whom production should take place is determined by the forces of demand (buyers) and supply (sellers).
- In an economic system such as the market system, production takes place to fulfil people's needs and wants in a market economy.
- Market equilibrium is established where the demand for a product is equal to the supply of the product at a given price level.
- Market disequilibrium occurs when the market price is either above (creating surpluses) or below (creating shortages) the equilibrium price.
- Features of the price mechanism include: no government interference in economic activity, resources are allocated based on price and financial incentives, and competition creates choice and opportunities for firms and private individuals.

Test yourself

1. What are the **three** key economic questions that all economic systems need to ask about resource allocation?
2. Complete the following sentences: When the market price is above the market equilibrium price, a ________________ is created. By contrast, if the market price is below the market equilibrium price, a ________________ occurs.
3. In a market system, ________________ prices encourage more supply, whereas ________________ prices encourage consumer spending.
4. State **three** key features of the market system.

Answers on page 138

Tip

Revise the topics of demand (Chapter 7), supply (Chapter 8) and price determination (Chapter 9) to better understand the role of markets in allocating scarce resources.

Sample questions and answers

REVISED

1 Explain how prices are determined in a market system. [2]

Student's answer

Prices are determined by the interacting forces of demand and supply [1], i.e. when the demand for and supply of a product are equal (in equilibrium) [1].

Teacher's comments

This is a concise answer, with the student stating the condition that must hold (i.e. $D = S$), and providing clarification using relevant economic terminology. Full marks are awarded.

2 Explain how disequilibrium can occur in a market system. [2]

Student's answer

Disequilibrium occurs when the demand for a product is not equal to its supply [1].

Teacher's comments

This is too brief for full marks. Market disequilibrium arises when prices are either above the market price (too high) or below the market price (too low); neither of these conditions has been acknowledged or explained.

Exam-style questions

1 Define the term *price mechanism*. [2]
2 Explain **two** advantages of the market system in allocating resources. [4]
3 Explain how the price mechanism allocates resources. [4]

Answers on pages 138–39

7 Demand

Key objectives

The objectives of this chapter are to revise:

- the meaning of demand
- demand diagrams
- movements (contractions and expansions) along a demand curve
- the link between individual and market demand
- the causes of shifts in a demand curve.

Key definitions

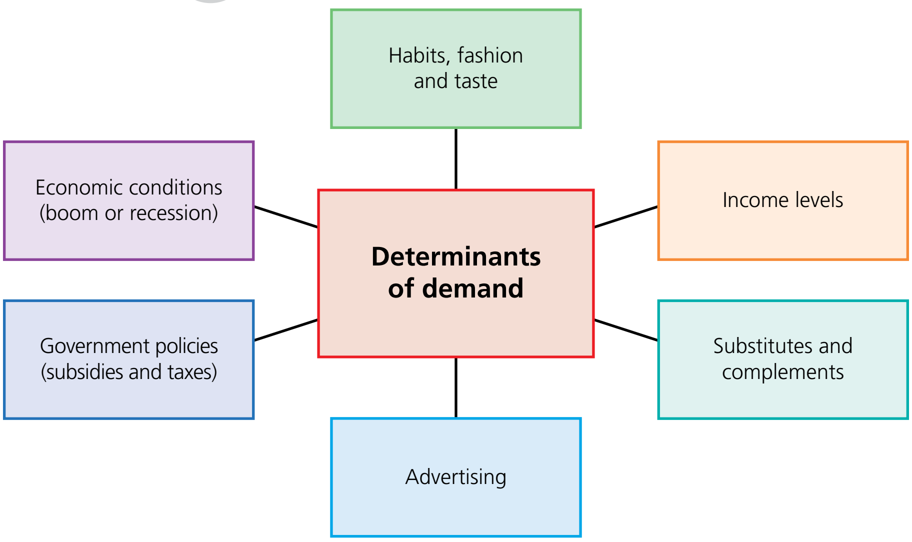
REVISED

Term	Definition
Complements	Products that are jointly demanded, e.g. cinema tickets, popcorn and drinks.
Contraction in demand	This occurs when there is a fall in the quantity demanded for a product following an increase in its price.
Decrease in demand	A leftward shift of the demand curve caused by unfavourable changes in non-price factors.
Demand	The willingness and the ability of customers to pay a given price to purchase a good or service. The lower the price of a product, the higher its demand tends to be.
Extension in demand	This occurs when there is an increase in the quantity demanded for a product following a fall in its price.
Increase in demand	A rightward shift of the demand curve caused by favourable changes in non-price factors.
Law of demand	The inverse relationship between the price of a good or service and its price, i.e. the quantity demanded falls as the price rises, while the quantity demanded rises if the price falls.
Market demand	The sum of all individual demand for a particular product at each price level. It is found by adding up all individual demand at separate price levels.
Quantity demanded	The amount of a good or service that customers are willing and able to purchase at each price level. The higher the price, the lower the quantity demanded, ceteris paribus.
Substitutes	Products that are in competitive demand because they can be used in place of each other, e.g. tea and coffee, Honda and Toyota cars, or Pepsi Cola and Coca-Cola.

Demand

PAGES 28–33

REVISED



▲ **Figure 7.1** Determinants of demand (HIS AGE)

Common errors

REVISED

Error	Why it is wrong
'When the price falls, people have higher real income so there is greater demand for a product.'	This statement suggests a *shift* in demand caused by changes in non-price factors.
'A fall in price causes demand to rise.'	Again, this statement suggests a *shift* in demand. A fall in price will cause an extension (movement) along the demand curve, ceteris paribus, rather than a rise in demand.
'Demand is the amount of a good or service that customers want to buy at each price level.'	Demand refers to both the willingness (want or desire) *and* the ability of customers to pay a given price to buy a good or service.
'The market demand refers to demand for a particular good or service in a particular market.'	This is a very imprecise definition. The market demand refers to the sum of all individual demand for a particular product at each price level.

Target your revision

REVISED

- Demand refers to the *willingness* and *ability* of customers to pay a given price to purchase a good or service.
- The amount of a good or service demanded at each price level is called the *quantity demanded*.
- The *law of demand* states there is an inverse relationship between the price of a product and its price.
- The determinants of demand can be remembered by HIS AGE: **H**abits, tastes and fashions; **I**ncome levels; **S**ubstitutes and complements (price and availability); **A**dvertising; **G**overnment policies (e.g. taxes, regulations and subsidies); and the state of the **E**conomy (boom or recession).
- The demand curve is drawn as downward sloping from left to right, showing the inverse relationship between price and quantity demanded.
- A change in the price of a good or service causes a *movement along* the demand curve.
- A price rise causes a *contraction* in demand whereas a reduction in price causes an *extension* in demand for the product.
- A change in all other (non-price) factors that affect demand will cause a *shift* in demand.
- The *market demand* refers to the sum of all individual demand for a product at each price level.

Tip

When providing examples of complementary goods, remember that it is possible to have more than just two products that are jointly demanded. For example, when purchasing tickets for the cinema or a theatre show, it is quite common for customers also to purchase: popcorn, sweets (confectionery), drinks and other snacks.

Test yourself

1 Complete the following sentence: Demand refers to both the ________________ and the ________________ of customers to pay a certain price in order to purchase a good or service.

2 A fall in quantity demanded is caused by changes in ________________ whereas a fall in demand is caused by changes in ________________ factors.

3 What is the difference between individual demand and market demand?

4 How would a decrease in demand be shown on a diagram?

5 What does a fall in the price of a product cause along the demand curve?

Answers on page 139

Sample questions and answers

REVISED

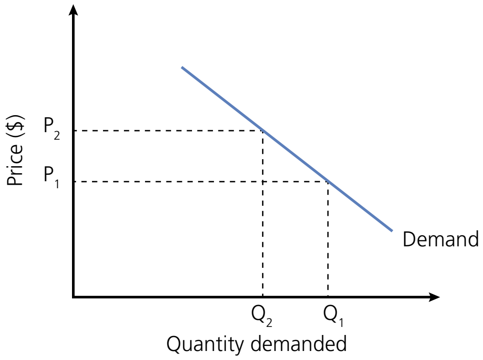
1 Using an appropriate demand diagram, explain the impact on the demand for Coca-Cola soft drinks in the following cases.

a) An increase in the price Coca-Cola. [4]

b) A fall in the price Pepsi Cola. [4]

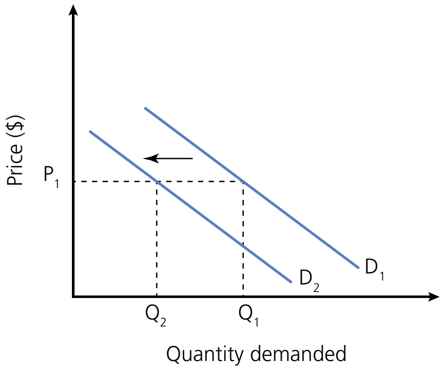
Student's answer

a) *There is a fall in demand for Coca-Cola because the increase in price causes less demand for Coca-Cola. As the price of Coca-Cola rises from P_1 to P_2, the demand falls from Q_1 to Q_2.*



[2]

b) *The demand curve for Coca-Cola should fall, as customers switch to Pepsi Cola. So the demand curve for Coca-Cola should shift to the left from D_1 to D_2, with less Coca-Cola demanded at each price level, ceteris paribus* [2].



[2]

Teacher's comments

a) The diagram is correct but the explanation is not quite correct. 'A fall in demand for Coca-Cola' means there has been a leftward shift in demand, rather than a 'fall in the quantity demanded', i.e. a contraction in demand due to the higher prices. 2 marks are awarded.

b) The diagram is correct and the explanation is accurate. There is appropriate reference to 'ceteris paribus' as the assumption is that customers will switch to buying Pepsi Cola because of its lower price. Hence, fewer customers will buy Coca-Cola, ceteris paribus. 2 marks are awarded for the explanation and 2 marks for a fully labelled and accurately drawn diagram, making a total of 4 marks.

2 Using an example, explain how population demographics can affect the level of demand for a good or service. [2]

Student's answer

Population demographics, such as age, gender, ethnicity or religious beliefs [1], *can affect the level of demand for goods and services. For example, adults and children or men and women have different buying habits for different goods and services* [1]. *Adults might buy alcohol and airline tickets, whereas children might have demand for toys and educational books* [1].

Teacher's comments

This is a very thorough answer – perhaps too much content for just 2 marks. Nevertheless, good examples have been used to show how demographics can affect the demand for goods and services. 2 marks are awarded.

Exam-style questions

1. Define the term *demand*. [2]
2. Explain why there is a negative correlation between the demand for a product and its price. [2]
3. Describe the difference between a *shift* and a *movement along* when referring to demand curves. [2]
4. Explain **two** factors that affect the level of demand for rice. [4]

Answers on page 139

8 Supply

Key objectives

The objectives of this chapter are to revise:

- the meaning of supply
- supply diagrams
- movements (contractions and extensions) along a supply curve
- the link between individual and market supply
- the causes of shifts in a supply curve.

Key definitions

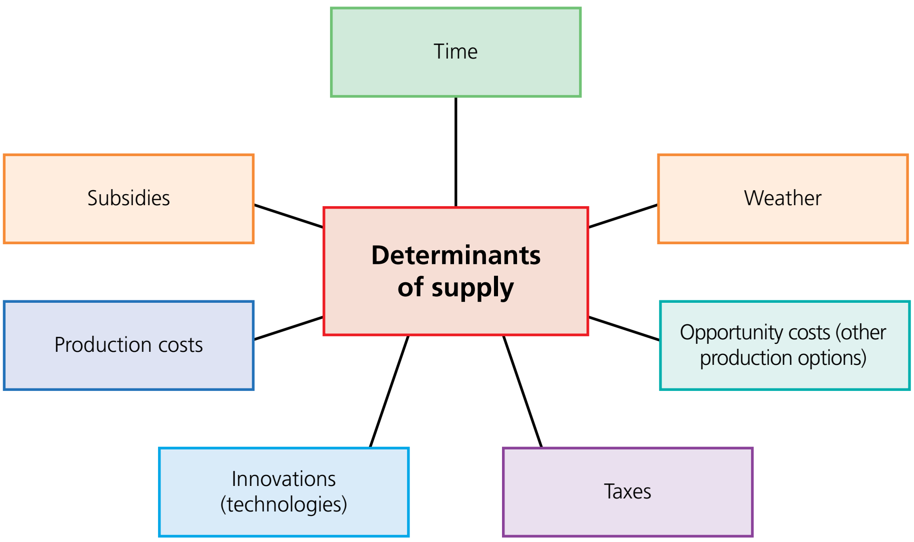
REVISED

Term	Definition
Contraction in supply	This occurs when there is a fall in the quantity supplied of a product following a decrease in its price.
Decrease in supply	A leftward shift of the supply curve caused by unfavourable changes in non-price factors.
Extension in supply	This occurs when there is an increase in the quantity supplied of a product following an increase in its price.
Increase in supply	A rightward shift of the supply curve caused by favourable changes in non-price factors.
Law of supply	The positive relationship between the price of a good or service and the price: in general, the quantity supplied rises as the price rises, while the quantity supplied falls if the price falls.
Market supply	The sum of all supply curves in the market at each given price level.
Quantity supplied	The amount of a good or service that firms are willing and able to supply at each price level. The higher the price, the higher the quantity supplied, ceteris paribus.
Supply	The willingness *and* the ability of firms to provide a good or service at given prices. The higher the price of a product, the higher its supply tends to be.

Supply

PAGES 34–38

REVISED



▲ **Figure 8.1** Determinants of supply (TWO TIPS)

Common errors

REVISED

Error	Why it is wrong
'A rise in price causes supply to rise.'	This statement refers to a *shift* in supply. A rise in price will cause an extension (movement) along the supply curve, ceteris paribus, rather than a rise in supply.
'When prices rise, demand falls so firms supply less.'	Supply expands when prices rise because firms are more willing and able to supply due to higher profit margins.
'The market supply refers to the amount of goods or services a firm supplies in a particular market.'	This is an imprecise definition. The market supply refers to the sum of all individual supply for a particular good or service at different prices.

Target your revision

REVISED

- Supply refers to the *ability* and *willingness* of firms to provide goods and services at given price levels.
- The determinants of supply can be remembered by the acronym TWO TIPS: **T**ime, **W**eather, **O**pportunity cost (i.e. other production options), **T**axes, **I**nnovations, **P**roduction costs and **S**ubsidies.
- The law of supply states that there is a positive relationship between price and the quantity supplied of a product.
- A movement along a supply curve is caused by a change in price.
- A contraction in supply means a lower quantity supplied due to a lower price.
- An extension in supply means a higher quantity supplied due to a higher price.
- A change in non-price factors affecting the supply of a good or service will cause a shift in the supply curve.
- The market supply curve is the sum of all supply curves at each price level.

Test yourself

1 Complete the following sentence: Supply is the ______________ and ______________ of firms to provide goods and services at given price levels.
2 Firms have more of an incentive to supply their products at ______________ prices. A change in the quantity supplied is caused by a change in ______________ only.
3 What is the difference between the impact of taxes and subsidies on supply?
4 State **three** factors that affect the supply of a good or service.

Answers on page 139

Tip

Taxes affect both the supply and demand of a product. However, in microeconomics, taxes usually refer to indirect taxes (such as VAT), which impact on the supply of a good or service. However, direct taxes (e.g. income tax) affect the disposable income of consumers, i.e. a rise or fall in income tax shifts the demand curve for a particular good or service.

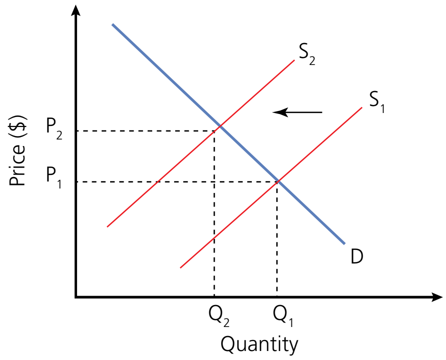
Sample question and answer

REVISED

1 Using an appropriate demand diagram, explain the impact on the supply of Coca-Cola soft drinks in the following cases.
 a) An increase in the wages of workers at Coca-Cola. [4]
 b) A fall in the price Coca-Cola. [4]

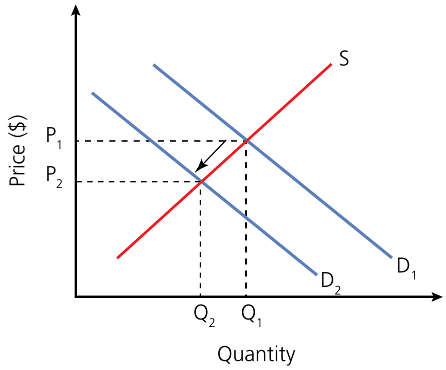
Student's answer

a) An increase in the wages paid to Coca-Cola workers causes the firm to have higher production costs [1]. Hence, the supply curve shifts leftwards [1], from S_1 to S_2, causing the equilibrium price to increase from P_1 to P_2 and quantity traded to fall from Q_1 to Q_2 [1].



[2]

b) A fall in the price of Coca-Cola, perhaps due to lower demand for the product, causes a contraction in demand [1], reducing the equilibrium position from P_1 and Q_1 to P_2 and Q_2 [1]. This is because price changes only cause a movement along the supply curve [1].



[2]

Teacher's comments

a) The diagram is correct and complements the explanation. 2 marks are awarded for the explanation and 2 marks for the diagram, making a total of 4 marks.

b) The diagram is correct, although there is no need to show *why* the price fell. The student has clearly shown they understand the idea of equilibrium price and quantity, and that changes in price cause a movement along the supply curve. 2 marks are awarded for the explanation and 2 marks for the diagram, making a total of 4 marks.

Exam-style questions

1. Define the term *supply*. [2]
2. Explain why there is a positive correlation between the supply of a product and its price. [4]
3. Explain **two** factors that affect the level of supply of rice. [4]
4. Explain the difference between a *shift* and a *movement along* when referring to supply curves. [4]

Answers on page 139

9 Price determination

Key objectives

The objectives of this chapter are to revise:

- market equilibrium
- demand and supply schedules and curves to establish equilibrium
- market disequilibrium
- diagrams to show shortages (excess demand) and surpluses (excess supply).

Key definitions

REVISED

Term	Definition
Equilibrium price	The price at which the demand curve for a product intersects the supply curve for the product. The market is therefore cleared of any excess demand or supply.
Excess demand	Occurs when the supply of a product exceeds its demand at certain price levels. This happens when the price is set above the equilibrium price, resulting in surpluses.
Excess supply	Occurs when the demand for a product exceeds its supply at certain price levels. This happens when the price is set below the equilibrium price, resulting in shortages.
Market disequilibrium	Occurs when the quantity demanded for a product is either higher or lower than the quantity supplied.
Market equilibrium	Occurs when the quantity demanded for a product is equal to the quantity supplied, i.e. there are no shortages or surpluses.
Shortages	The result of excess demand in the market economic system.
Surpluses	The result of excess supply in the market economic system.

Price determination

PAGES 39–41

REVISED

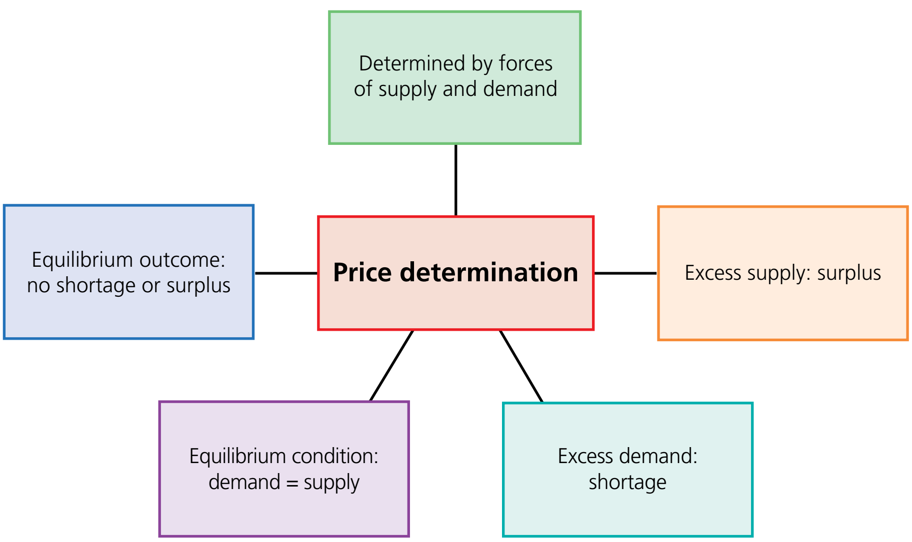


Figure 9.1 Price determination

Common errors

REVISED

Error	Why it is wrong
'Firms have a surplus when they have excess stock due to producing too much.'	While there is some truth in this statement, the reason for there being excess stock is that the price is too high, i.e. above the market equilibrium, which results in supply exceeding demand.
'Government intervention is needed to restore equilibrium if there is excess demand or excess supply.'	The market system tends to restore equilibrium due to the price mechanism (see tip below).

Target your revision

REVISED

- Price is determined by the market forces of demand and supply creating market equilibrium, i.e. the position where the demand for a product is equal to the supply of the product.
- At the equilibrium price, there is neither excess quantity demanded nor excess quantity supplied.
- Market disequilibrium occurs when the quantity demanded for a product is either higher or lower than the quantity supplied.
- Excess demand refers to a situation where the market price is below the equilibrium price, thus creating a shortage in the market.
- Excess supply refers to a situation where the market price is above the equilibrium price, thus creating a surplus in the market.

Test yourself

1 Complete the following sentence: If the price of a product is below the market equilibrium price, then ________________ will exceed the ________________.

2 A shortage in the market is caused by excess ________________ whereas a surplus is caused by excess ________________.

3 Why is disequilibrium inefficient?

4 What situation exists if demand is 1000 units while supply is 1200 units at the same price level?

5 What situation exists if demand is 7000 units while supply is 6200 units at the same price level?

Answers on page 139

Tip

The market system will tend to restore equilibrium due to the market forces of demand and supply. In a situation of excess demand (shortage), the price will rise, thereby reducing the quantity demanded and increasing the quantity supplied. The opposite occurs if there is excess supply (surplus).

Sample questions and answers

REVISED

1 Define the term *shortage*. [2]

Student's answer

A shortage occurs because suppliers run out of stock of goods to sell [1].

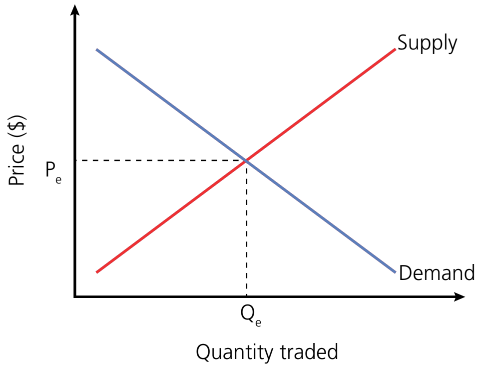
Teacher's comments

While the answer shows some understanding, it is imprecise. A shortage occurs due to excess demand, caused by price being lower than the market-clearing price rather than because of insufficient supply. 1 mark is awarded.

2 With the use of a suitable diagram, explain how an equilibrium price is determined in the market economy. [4]

Student's answer

An equilibrium price is determined where the demand for a product is equal to the supply of the product at a particular price level [1]. *This means the market clears itself of any excess quantity demanded or excess quantity supplied* [1] *as in the diagram below.*



[1]

Teacher's comments

The definition of equilibrium is clear and there is appropriate use of terminology, such as the market being cleared of any excess demand or supply at the equilibrium price. The diagram is correct but not fully explained – P_e and Q_e are not referred to in the explanation. It would also have been useful if the candidate had used an example (such as stating what market the diagram represents). 3 marks are awarded.

Exam-style questions

1. Explain when surpluses occur. [2]
2. Explain when shortages occur. [2]
3. Define the term *equilibrium price*. [2]
4. Use a suitable diagram to describe the impact on the equilibrium price and quantity following the imposition of a sales tax on a particular good. [4]
5. Explain why price tends to move towards its equilibrium over time. [4]

Answers on pages 139–40

10 Price changes

Key objectives

The objectives of this chapter are to revise:

- the causes of price changes
- the consequences of price changes.

Key definitions

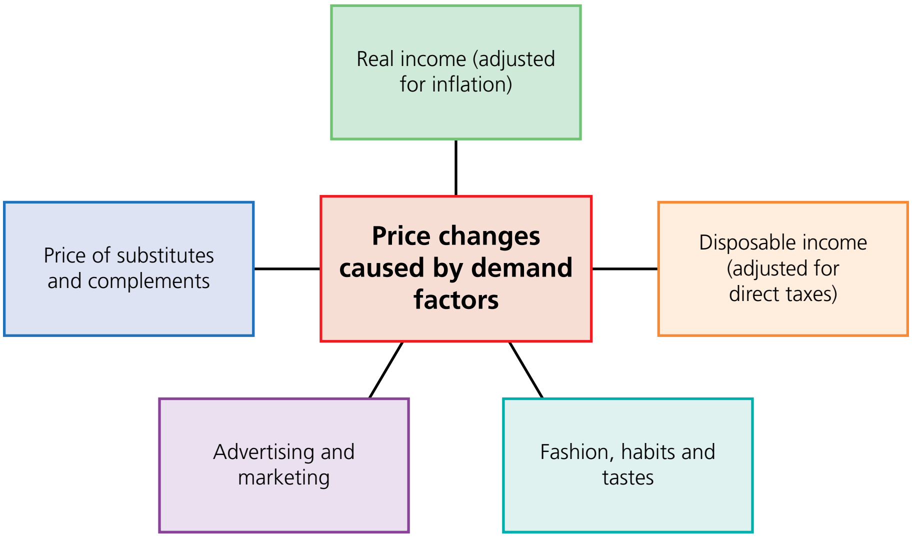
REVISED

Term	Definition
Decrease in demand	A leftward shift of the whole demand curve due to an unfavourable change in a non-price factor that affects demand, e.g. lower disposable income.
Decrease in supply	A leftward shift of the whole supply curve due to an unfavourable change in a non-price factor that affects supply, e.g. imposition of a sales tax.
Increase in demand	A rightward shift of the whole demand curve due to a favourable change in a non-price factor that affects demand, e.g. effective marketing and advertising campaigns.
Increase in supply	A rightward shift of the whole supply curve due to a favourable change in a non-price factor that affects supply, e.g. a government subsidy which reduces production costs.
Non-price factors	Any factors other than price that affect the level of demand or supply for a product, e.g. changes in the weather can affect both the supply and demand for certain products.
Sales tax	Indirect tax imposed on the purchase of goods and services, shown by a leftward shift of the supply curve.
Subsidy	Financial payment from the government to help reduce production costs for a firm or strategic industry, in order to encourage supply (output).

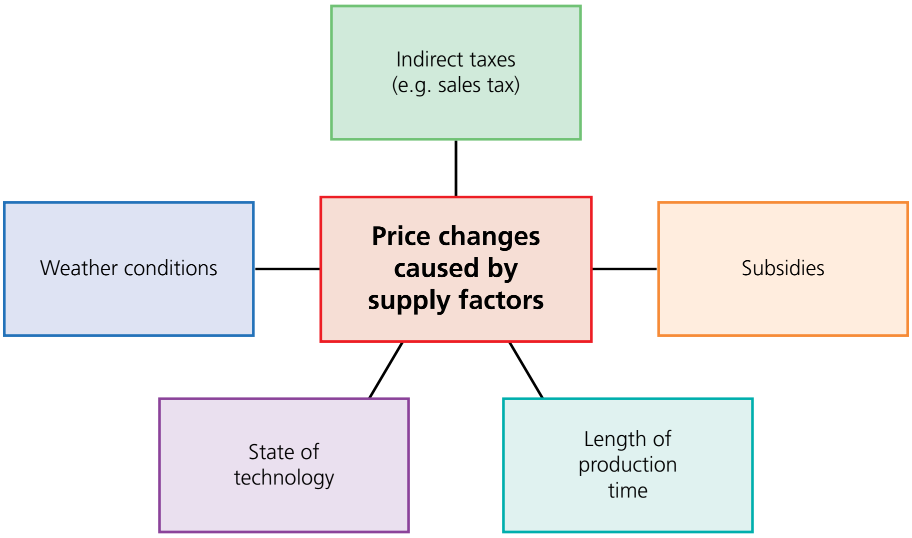
Price changes

PAGES 42–45

REVISED



▲ **Figure 10.1** Price changes caused by changes in demand factors



▲ **Figure 10.2** Price changes caused by changes in supply factors

Common errors

REVISED

Error	Why it is wrong
'When the price falls, people have greater ability to buy, so there is greater demand for a product.'	This statement suggests a *shift* in demand caused by changes in non-price factors. A fall in price will cause an extension (movement) along the demand curve, ceteris paribus.
'A rise in the price leads to a decrease in demand, but causes supply to increase.'	This describes a *shift* in demand (a decrease in demand) rather than a fall in the quantity demanded (a movement along the demand curve due to higher prices). Similarly, price changes will cause a movement along a supply curve, rather than a shift of the whole supply curve.

Target your revision

REVISED

- Changes in non-price factors that affect demand or supply will cause a change in the equilibrium price and quantity.
- Price can change due to a shift in supply, caused by a change in costs of production for example, or a shift in demand, caused by a change in consumer income for example.
- Lower supply causes the equilibrium quantity to fall and the equilibrium price to increase. An increase in supply causes the equilibrium quantity to rise and the equilibrium price to fall.
- Lower demand causes both the equilibrium quantity and the equilibrium price to fall. By contrast, higher demand causes both the equilibrium price and the equilibrium quantity to rise.

Tip

Sales taxes increase production costs while subsidies reduce costs of production. Both these forms of government intervention affect the supply curve (as they change the firm's production costs). Demand is affected, but only via the resulting change in price caused by a shift in the supply curve.

Test yourself

1 Complete the following sentence: Changes in ______________ factors that affect demand or supply will cause a change in the ______________ price and quantity traded.
2 A government subsidy paid to farmers will shift the ______________ curve of agricultural output to the ______________.
3 State **three** factors that might shift the demand curve for coffee outwards to the right.
4 State **three** factors that might affect the supply of bananas.

Answers on page 140

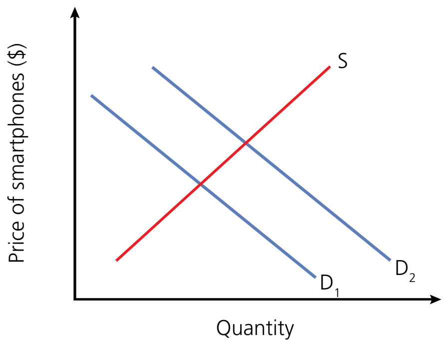
Sample question and answer

REVISED

1 Using an appropriate demand diagram, explain how lower income taxes are likely to affect the market for smartphones. [4]

Student's answer

Lower income taxes give people more disposable income [1], *so they are more likely to buy goods such as smartphones. This is shown by the demand curve shifting outwards from D_1 to D_2* [1].



[2]

Teacher's comments

The diagram is correct and the explanation is accurate, with good use of economics terminology, such as disposable income. 2 marks are awarded for the explanation and 2 marks for the diagram, making a total of 4 marks.

Exam-style questions

1 Explain two factors that might shift the demand curve for laptop computers to the left. [4]
2 Explain the likely impact on the market for Nike sports shoes if Adidas reduces its prices. [4]
3 Use a suitable diagram to explain the impact on the equilibrium price and quantity of a particular good following the imposition of a sales tax. [4]

Answers on page 140

11 Price elasticity of demand

Key objectives

The objectives of this chapter are to revise:

- the definition and calculation of price elasticity of demand (PED)
- drawing and interpreting demand curve diagrams to show different values of PED
- the determinants of PED
- the relationship between PED and total revenue
- the significance of PED for decision makers.

Key definitions

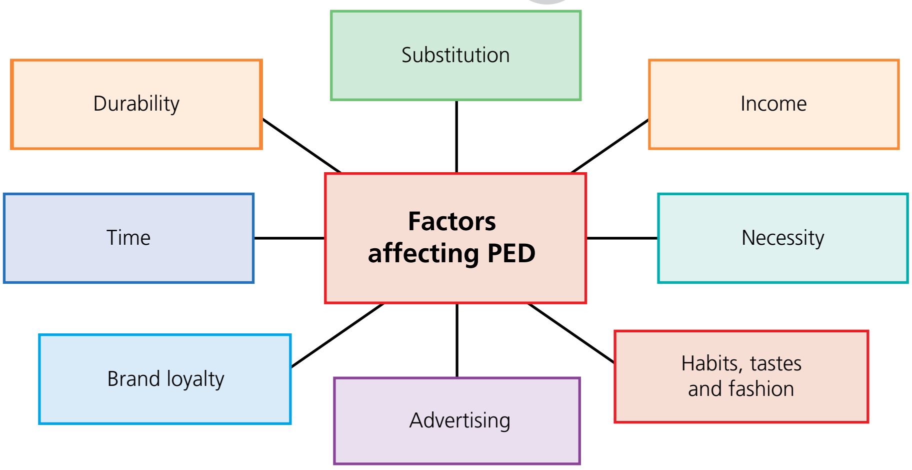
REVISED

Term	Definition
Perfectly price elastic	An extreme value of PED where a given percentage change in price leads to zero quantity demanded, i.e. $PED = \infty$.
Perfectly price inelastic	An extreme value of PED where a given percentage change in price has no impact on the quantity demanded, i.e. $PED = 0$.
Price discrimination	The ability or strategy of firms to charge different customers different prices for essentially the same product, due to differences in their PED.
Price elastic demand	Describes demand for a product that is highly responsive to changes in price, usually due to substitutes being widely available.
Price elasticity of demand (PED)	Measures the extent to which the demand for a product changes due to a change in its price.
Price inelastic demand	Describes demand for a product that is relatively unresponsive to changes in price, mainly due to the lack of substitutes available.
Profit	The difference between a firm's total revenues and its total costs. It is calculated using the formula: $TR - TC$.
Sales revenue	The sum of money received from the sale of a good or service. It is calculated by the formula: $P \times Q$.
Unitary price elasticity of demand	Describes a PED value = 1, i.e. when the percentage change in the quantity demanded is proportional to the percentage change in the price, so there is no change in the sales revenue.

Price elasticity of demand

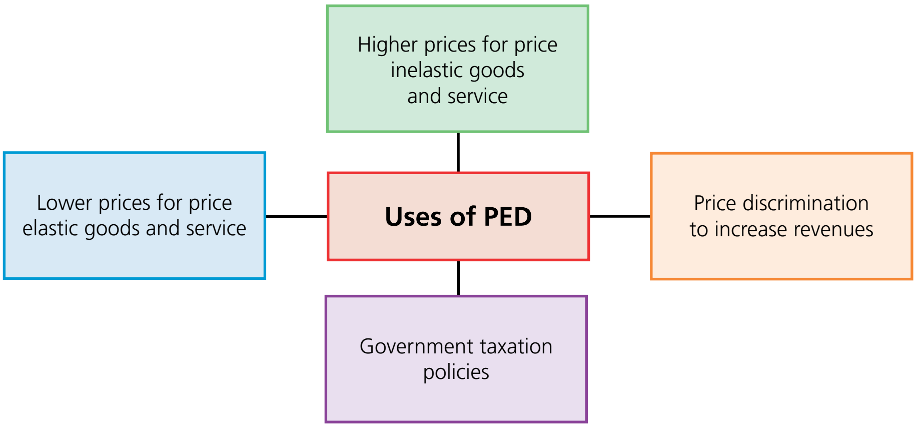
PAGES 46–56

REVISED



▲ **Figure 11.1** Determinants of price elasticity of demand

Uses of PED



▲ **Figure 11.2** Uses of PED

Formulae

Revenue (or sales revenue) is calculated using the equation:

Revenue = Price × Quantity demanded

Price elasticity of demand (PED) is calculated using the equation:

$$\text{PED} = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price}}$$

or annotated as:

$$\text{PED} = \frac{\%\Delta Q_D}{\%\Delta P}$$

▼ **Table 4.1** The relationship between PED and sales revenues

Price change	Inelastic demand	Unitary demand	Elastic demand
Increase price	Revenues rise	No change in revenues	Revenues fall
Reduce price	Revenues fall	No change in revenues	Revenues rise

Common errors

REVISED

Error	Why it is wrong
'A higher price causes the quantity demanded to fall if demand is price elastic.'	Demand will fall even if it is price inelastic, due to the law of demand. The error here is that the student should have mentioned that a higher price causes the quantity demanded to fall by a greater proportion if the demand is price elastic.
The demand for theatre tickets at \$50 is 5000 per month. If the theatre raises its price to \$60 per ticket and demand subsequently falls to 4500 per week, calculate the value of PED. '*PED* = [(\$60 – \$50)/50] × 100 ÷ [(4500 – 5000)/5000] × 100 = +20%/–10% = –2.0, i.e. price elastic'	This is a classic error, where the student does the right calculations, but then puts the figures the wrong way round in the PED formula: $\%\Delta Q_D / \%\Delta P$. *PED* = –10%/+20% = –0.5, i.e. price inelastic
'Demand is elastic if there are plenty of substitutes.'	Technically, demand is *price* elastic, i.e. customers are highly responsive to changes in price if there are plenty of substitutes to choose from.
'A lower price means there will be more customers, so the firm earns more revenue.'	This is only true if demand is price elastic. Demand increases if the price falls, ceteris paribus, but revenue actually falls if demand is relatively unresponsive to the lower price.

Target your revision

REVISED

- Price elasticity of demand (PED) measures the degree of responsiveness of quantity demanded for a product to a change in its price.
- PED is calculated using the formula: $\%\Delta Q_D/\%\Delta P$.
- Demand is price elastic if there is a relatively large change in the quantity demanded for a product following a relatively small change in its price. Hence, firms will tend to reduce price in order to increase sales revenue.
- Demand is price inelastic if there is a relatively small change in the quantity demanded for a product following a relatively large change in its price. Hence, firms will tend to raise price in order to increase sales revenue.
- Determinants of PED include: time, habits and tastes, income and the degree of substitution.
- Knowledge of PED enables producers to determine their pricing strategies (to maximise sales revenues) and governments to determine their tax policies (to maximise tax revenues).
- Knowledge of PED also enables firms to determine whether they can use price discrimination (i.e. charge different customers different prices for essentially the same product because of differences in their PED).

Test yourself

1 Complete the following sentence: Price ________________ demand describes demand for a product that is responsive to changes in price, usually because there are ________________ widely available for customers to choose from.

2 Firms should ________________ prices of products with price inelastic demand, and ________________ prices of products with price elastic demand.

3 State **two** key determinants of PED.

4 What do we know about the likely PED value for demerit goods (e.g. petrol and cigarettes)?

5 What is price discrimination?

Answers on page 140

Tip

One way to remember the determinants of price elasticity of demand (PED) is to use **THIS** acronym:

- **T**ime (to seek and switch to alternatives)
- **H**abits, addictions, fashions and tastes
- **I**ncome (real disposable income)
- **S**ubstitutes (availability and price of alternative products).

Sample questions and answers

REVISED

1 The demand for STC Football Club match tickets is 5000 tickets per week at an average price of $30. The football club raises its price to $34.50 per ticket and demand subsequently falls to 4750 per week. Calculate the value of price elasticity of demand for the match tickets. [2]

Student's answer

Demand falls by 5% from 5000 to 4750 tickets per week.

Prices increased by 15% from $30 to $34.50 per match ticket. [1]

∴ *PED = –5/15 = –0.33* [1]

Teacher's comments

This is a good answer, with the correct figures used to calculate the PED. It would be useful to see the working out of the percentage changes used in the calculation, but this omission does not detract from the correct answer being shown. 1 mark is awarded for appropriate working out and 1 mark for the correct answer, a total of 2 marks.

2 A cinema increases its ticket prices from $10 to $11 and notices that demand falls from 4500 to 4275 customers per week. Calculate the PED for tickets at the cinema and comment on your results. [3]

Student's answer

Percentage change in quantity demanded = ((4,500 – 4,275)/4,500) × 100 = –5%

Percentage change in price = ((11 – 10)/10) × 100 = +10% [1]

∴ *PED = –5/10 = –0.5* [1]

Teacher's comments

This is a good answer, but the last part of the question has not been answered. The calculations and answer are correct, but the student has not commented on what the final figure means. As PED is less than 1, the customers of the cinema are not so sensitive to the price change, i.e. demand for cinema tickets is price inelastic. 2 marks are awarded.

Exam-style questions

1 Define the term *price elasticity of demand*. [2]
2 Explain **two** key determinants of price elasticity of demand. [4]
3 Explain **two** reasons why the price elasticity of demand (PED) for a product might be inelastic. [4]
4 Explain how knowledge of PED can help a firm with price discrimination. [4]
5 Analyse why the demand for a good or service may be more price inelastic in one country than in another country. [6]

Answers on pages 140–41

12 Price elasticity of supply

Key objectives

The objectives of this chapter are to revise:

- the definition and calculation of price elasticity of supply (PES)
- drawing and interpreting supply curve diagrams to show different PES values
- the determinants of PES
- the significance of PES for decision makers.

Key definitions

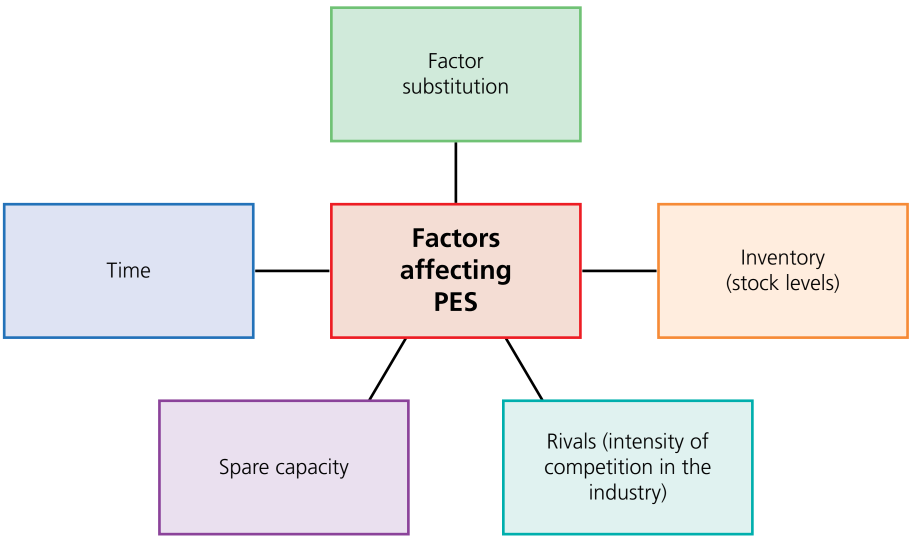
REVISED

Term	Definition
Price elastic supply	Describes the supply of a product that is responsive to changes in price, usually due to there being spare capacity or large volumes of stocks (inventory).
Price elasticity of supply (PES)	Measures the degree of responsiveness of quantity supplied of a product to a change in its price.
Price inelastic supply	Describes the supply of a product that is unresponsive to changes in price, mainly due to the lack of spare capacity.
Stocks	Stocks (also known as inventory) are the raw materials, components and finished goods (ready for sale) used in the production process.
Unitary price elasticity of supply	Occurs when the percentage change in the quantity supplied is proportional to the percentage change in the price, so there is no change in the firm's sales revenue.

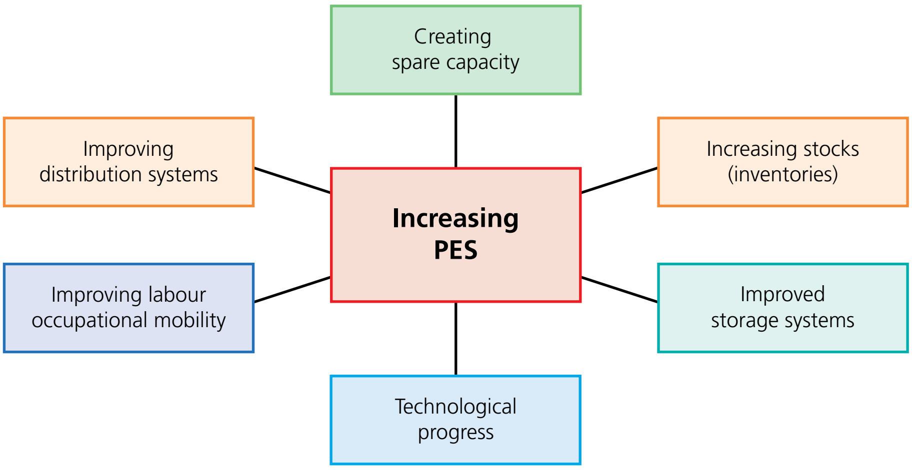
Price elasticity of supply

PAGES 57–62

REVISED



▲ **Figure 12.1** Determinants of price elasticity of supply (FIRST)



▲ **Figure 12.2** Methods firms use to be more responsive to price changes

Formula

Price elasticity of supply (PES) is calculated using the equation:

$$\text{PES} = \frac{\text{Percentage change in quantity supplied}}{\text{Percentage change in price}}$$

or annotated as:

$$\text{PES} = \frac{\%\Delta Q_S}{\%\Delta P}$$

Common errors

REVISED

Error	Why it is wrong
'Supply is elastic if there are plenty of stocks (inventory) available.'	Technically, supply is *price* elastic, i.e. firms can be highly responsive to changes in price if there are plenty of stocks (inventory) to use.
'A lower price means there will be more customers, so firms will supply more.'	This defies the law of supply – firms do not have an incentive to supply more if price falls; in fact, they would be less willing and able to supply at lower prices.

Target your revision

REVISED

- Price elasticity of supply (PES) measures the degree of responsiveness of the supply of a product to a change in its price.
- PES is calculated using the formula: $\%\Delta Q_S/\%\Delta P$.
- PES is positive due to the law of supply, i.e. there is a positive relationship between price and quantity supplied.
- If $PES > 1.0$, supply is price elastic, i.e. supply is relatively responsive to changes in price.
- If $PES < 1.0$, supply is price inelastic, i.e. supply is relatively unresponsive to changes in price.
- If the PES of a product is equal to 0, its supply is perfectly price inelastic, i.e. a change in price has no impact on the quantity supplied.
- If the PES of a product is equal to infinity (∞), its supply is perfectly price elastic, i.e. the quantity supplied can change without any corresponding change in price, e.g. downloadable Apps.

- Determinants of supply include: spare capacity, inventory (stock) levels, the number of firms in the industry, the ease and the cost of factor substitution, and the time period under consideration.

Test yourself

1. Complete the following sentence: Price elasticity of supply (PES) measures the responsive of ________________ of a product to a change in its ________________.
2. If the value of *PES* > 1.0, supply is said to be price ________________. If the value of *PES* < 1.0, supply is said to be price ________________.
3. What do we know about a product with a PES value of 0?
4. What do we know about a product with a PES value of ∞ (infinity)?
5. What do we know about the PES of a product if the supply curve starts at the origin?

Answers on page 141

Tip

Although there are several determinants of price elasticity of supply, the key factors can be remembered by the acronym BITS:

- **B**arriers to entry (which determine the degree of competition and hence supply in the market)
- **I**nnovation and technology (which impact on how much can be supplied in a given time period)
- **T**ime (to complete the production process)
- **S**tock levels and spare capacity – the greater these are, the more responsive supply can be to changes in price.

Another way to remember the determinants of price elasticity of supply is to use the acronym FIRST:

- **F**actor substitution – the cost and suitability of switching between factors of production
- **I**nventory (stock levels)
- **R**ivals – the intensity of competition in the industry
- **S**pare capacity
- **T**ime

Sample questions and answers

REVISED

1. Explain how barriers to entry, such as in the airline manufacturing industry, affect the value of the price elasticity of supply. [4]

Student's answer

Barriers to entry prevent firms from easily entering an industry [1]. For example, government legislation or high set-up costs in the airline industry [1] can make it very difficult for new manufacturers to enter the market [1]. This therefore limits the value of price elasticity of supply in the industry [1].

Teacher's comments

This is a succinct answer, with good use of examples to explain barriers to entry in the context of the airline industry. 4 marks are awarded.

2 The market price of beans increases from \$2 per unit to \$2.20 per unit, causing quantity supplied to rise from 10,000 units to 10,500 units per month. Calculate the value of the PES for beans. [2]

Student's answer

PES = %ΔQs/%ΔP

PES = ((10,500 − 10,000)/10,000) × 100 ÷ ((\$2.20 − \$2.0)/\$2.0) × 100

PES = +5%/+10% = 0.5 [2]

Teacher's comments

This answer clearly shows appropriate working out and the correct answer. It is not necessary for the student to include the formula in the answer; by using the numbers correctly, the student is showing that they know the formula for calculating PED. Both marks are awarded.

3 Using an example, explain why the production process time affects the price elasticity of supply (PES) for a product. [4]

Student's answer

The longer time the production of a product takes, the more price inelastic the supply of the product will be [1]. If the production process time is very lengthy, it's difficult for producers to bring up (or down) the amount of supply in a short period of time [1]. For example, with passenger aeroplanes, if a customer suddenly asks the aircraft manufacturer for another 10 planes and asks them to deliver them in a month, this would not be possible – no matter how much they offer the producer they wouldn't be able to make them [1]. Hence supply is price inelastic in the short run [1].

Teacher's comments

This is an excellent answer, with a very good example used. The student clearly understands the demands of the question and the concept of PES. 4 marks are awarded.

Exam-style questions

1 Define the term *price elasticity of supply*. [2]
2 Explain **two** key determinants of price elasticity of supply (PES). [4]
3 Explain **two** reasons why the price elasticity of supply (PES) for a product may be inelastic. [4]
4 Explain why the PES of smartphones is higher than that for organic vegetables. [6]

Answers on page 141

13 Market economic system

Key objectives

The objectives of this chapter are to revise:

- the market economic system
- the advantages of the market economic system
- the disadvantages of the market economic system.

Key definitions

REVISED

Term	Definition
Economic system	The way in which an economy is organised and run, such as how best to allocate society's scarce resources.
Market economy	An economic system that relies on the market forces of demand and supply (the price mechanism) to allocate resources.
Mixed economy	An economic system that combines the planned and market economic systems, with some resources owned and controlled by the private sector and others by the government.
Planned economy	An economic system that relies on the government to allocate scarce resources. It is often associated with a communist political system that strives for social equality.
Private sector	Economic activity of private individuals and firms. The private sector's main aim is to earn profit for its owners.
Public sector	Economic activity directly involving the government, e.g. the provision of state education and healthcare services. The public sector's main aim is to provide a service.

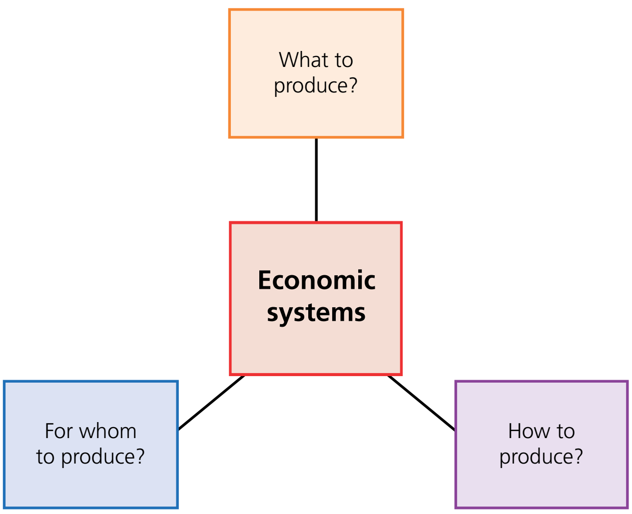
Market economic system

PAGES 63–66

REVISED

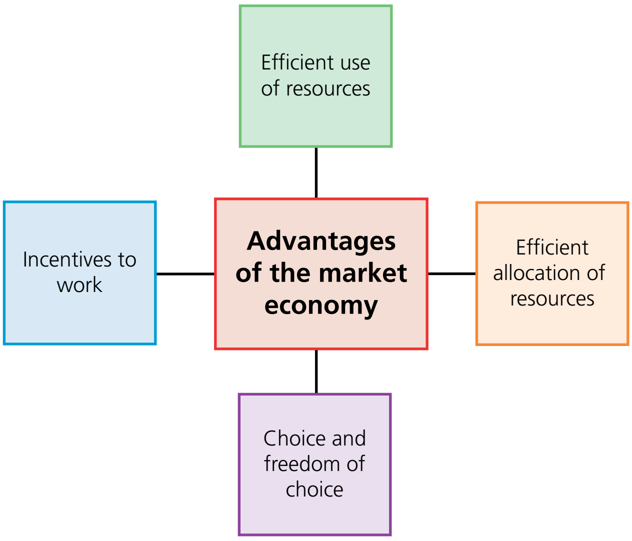
Fundamental economic questions

There are three fundamental economic questions that all countries must address.

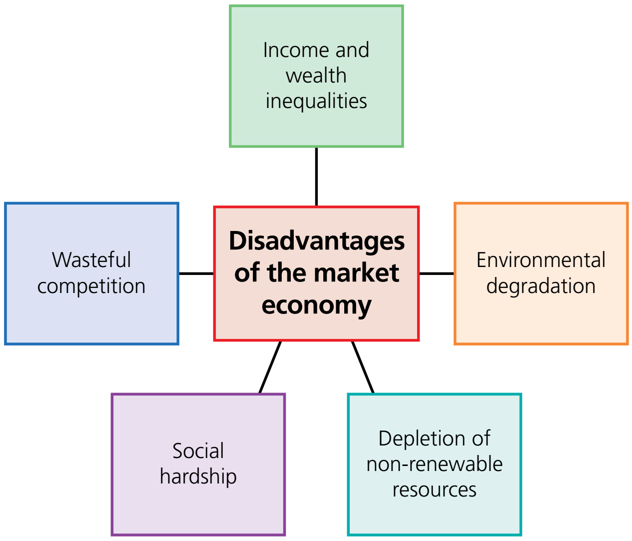


▲ **Figure 13.1** The three fundamental economic questions

Advantages and disadvantages of the market economy



▲ **Figure 13.2** Advantages of the market economy



▲ **Figure 13.3** Disadvantages of the market economy

▼ **Table 13.1** Advantages and disadvantages of the market economy

Advantages	Disadvantages
● **Competition** creates choice and opportunities for firms and private individuals. ● **Efficiency**, as competition helps to ensure private individuals and firms pay attention to what customers want. ● **Freedom of choice**, as individuals can choose which goods and services to purchase and which careers to pursue. ● **Incentives** are created as the profit motive creates incentives to work hard.	● **Environmental concerns** due to the negative impacts of economic prosperity under the market system, e.g. resource depletion, pollution and climate change. ● **Income and wealth inequalities**, as the wealthy few have far more choice and economic freedom. ● **Under-provision of merit and public goods**, e.g. street lighting, public roads, education and healthcare. ● **Wasteful competition** due to the unnecessary use of resources, e.g. excess packaging and advertising clutter.

Common errors

REVISED

Error	Why it is wrong
'Public goods are those that are produced by the public sector.'	Private sector firms do not have incentives to produce public goods (e.g. public roads or lighthouses), so the government intervenes to do so.
'The market economy is better than the planned economy as people have more choice.'	The word 'better' is subjective, rather than objective – what is 'better' for one person is not necessarily so for others. Having more choice is not always a good thing; there is an opportunity cost to having more choice, e.g. advertising clutter or wasteful competition.

Target your revision

REVISED

- An economic system refers to the way in which an economy is organised in terms of how it best allocates scarce resources.
- There are three main types of economic system: the market economy, planned economy and mixed economy.
- Advantages of the market economy include: efficiency in the use and allocation of scarce resources, freedom of choice and incentives to work.
- Disadvantages of the market economy include: income and wealth inequalities, environmental degradation, depletion of non-renewable resources, social hardship and wasteful competition.

Test yourself

1 Complete the following sentence: The market economic system relies on the market forces of ________________ and supply (in the ________________ sector) to allocate scarce resources.
2 The market economic system creates ________________ for firms and individuals to work. Firms are motivated by the ________________ they can earn, while workers are motivated by potential ________________.
3 What are the key features of the market economic system?
4 In a market economic system, who or what decides what, how and for whom production should take place?

Answers on page 141

Tip

Despite the potential advantages, a purely free market economic system will not succeed in the real world due to sources of market failure (see Chapter 14). In reality, almost all economies are mixed economies.

Sample question and answer

REVISED

1 France is an example of a mixed economy. Explain how resources are allocated in a mixed economy. [4]

Student's answer

A mixed economy is a combination of both the free market and the planned economy [1]*. This means resources are allocated using the price mechanism of demand and supply* [1] *and government intervention about how, when and for whom production should take place* [1].

Teacher's comments

This is a good answer, although the definition could have been improved by mentioning that a mixed economy has both a private sector and a public sector. The explanation is just about enough, although the use of an example would have helped to clarify the explanation, such as that the prices of many primary sector goods (e.g. agricultural produce), manufactured products (e.g. cars and books) and tertiary sector services (e.g. banking and insurance) are determined by market forces, while the prices of other resources are determined by the government (e.g. public healthcare services and state pensions). 3 marks are awarded.

Exam-style questions

1 Describe **two** advantages of the market economy. [4]
2 Describe **four** disadvantages of the market economy. [4]
3 Explain what is meant by a mixed economy and how resources are allocated in such an economy. [4]

Answers on page 141

14 Market failure

Key objectives

The objectives of this chapter are to revise:

- the concept of market failure
- the causes of market failure
- the consequences of market failure.

Key definitions

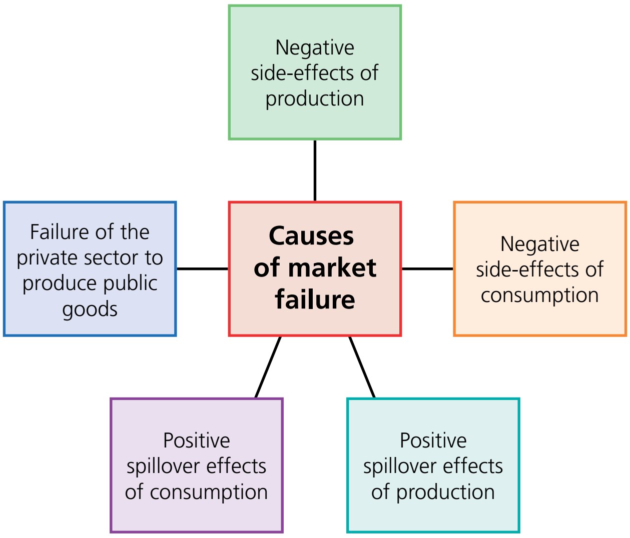
REVISED

Term	Definition
Demerit goods	Goods or services which, when consumed, create negative spillover effects, e.g. cigarettes, alcohol and gambling.
External benefits	The positive side-effects of production or consumption enjoyed by third parties for which no money is paid by the beneficiary.
External costs	The negative side-effects of production or consumption incurred by third parties for which no compensation is paid.
Externalities (spillover effects)	These occur when the actions of firms and/or individuals have either a positive or negative side-effect on third parties.
Free riders	People who take advantage of the goods or services provided by the government but have not contributed to government revenue through taxation.
Market failure	Occurs when market forces fail to allocate resources efficiently and so cause external costs or external benefits.
Merit goods	Goods or services which, when consumed, create positive spillover effects, e.g. education, training and healthcare.
Private benefits	The benefits of production and consumption enjoyed by a firm, individual or government.
Private costs	The actual costs of production or consumption of a firm, individual or government.
Public goods	Goods and services that are non-excludable and non-rivalrous, and which are a cause of market failure as there is a lack of a profit motive to produce them.
Social benefits	The true (or full) benefits of consumption or production, i.e. social benefits = private benefits + external benefits.
Social costs	The true (or full) costs of consumption or production, i.e. social costs = private costs + external costs.

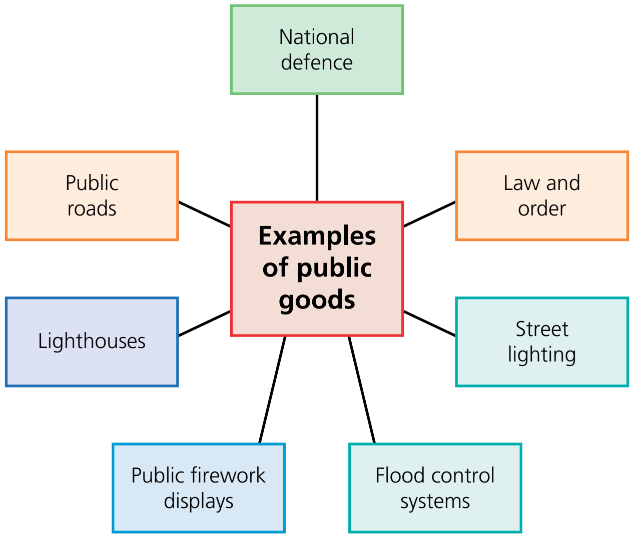
Market failure

PAGES 67–72

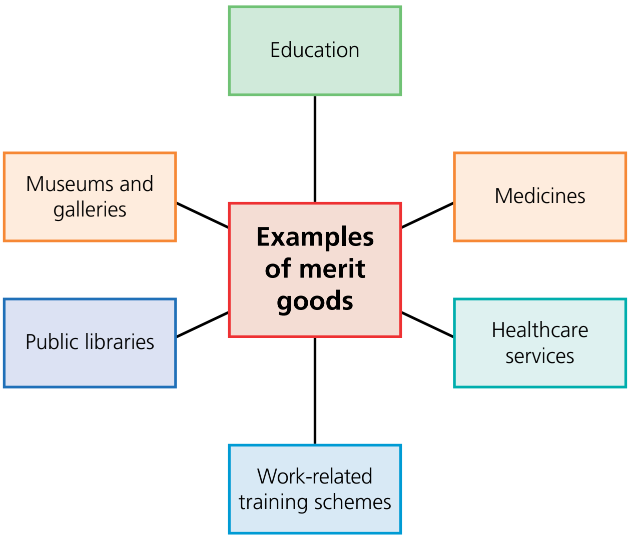
REVISED



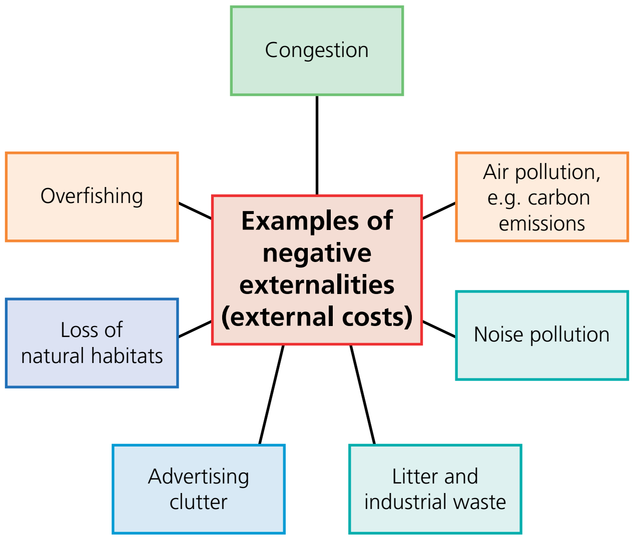
▲ **Figure 14.1** Causes of market failure



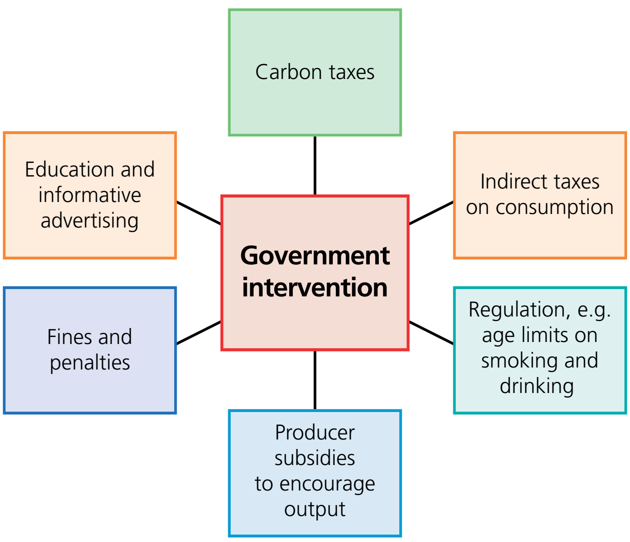
▲ **Figure 14.2** Examples of public goods



▲ **Figure 14.3** Examples of merit goods



▲ **Figure 14.4** Examples of external costs



▲ **Figure 14.5** Government intervention to correct market failures

Common errors

REVISED

Error	Why it is wrong
'Externalities are the negative spillover effects of production or consumption, e.g. pollution.'	While this is not entirely incorrect, externalities can be positive as well as negative.
'External costs are the costs of economic activity to the society as a whole.'	Social costs comprise both private costs and external costs of consumption and/or production.
'Taxation ensures that drivers pay for the pollution they create.'	This depends on the price elasticity of demand for the product, e.g. the more price inelastic the demand, the greater the proportion of the tax that can be passed on to the consumer.
'Public goods are those that are produced by the public sector.'	Private sector firms do not have incentives to produce public goods (e.g. public roads), so the government intervenes to do so or to provide the funds for private sector firms to do so.

Target your revision

REVISED

- Market failure occurs when the production and/or consumption of a good or service causes positive or negative side-effects to a third party.
- Private costs (of production and consumption) are the actual costs to an individual firm, consumer or government.
- External costs are the negative spillover effects (or side-effects) of production and consumption incurred by third parties, without any compensation being paid.
- The true cost of an economic activity is called the social cost, which comprises both private and external costs.
- Private benefits are the actual benefits of production and consumption experienced by an individual firm, household or government.
- External benefits are the positive side-effects of production and consumption experienced by third parties.
- The true value of an economic activity is called the social benefit, which comprises both private and external benefits.
- Causes of market failure include: public goods, merit goods, demerit goods, abuse of monopoly power and factor immobility.
- Consequences of market failure include: inefficiencies, misallocation of scarce resources, over-production and over-consumption of demerit goods, and under-production and under-consumption of merit goods.

Test yourself

1. Complete the following sentence: Market failure occurs when the ________________ mechanism (the market forces of demand and supply) fails to ________________ resources efficiently.
2. People tend to underestimate the ________________ of merit goods, such as education, whereas they tend to underestimate the ________________ of demerit goods.
3. State **four** examples of public goods.
4. State **four** examples of merit goods.
5. State **four** examples of demerit goods.

Answers on page 142

Tip

Too often, students confuse merit goods with public goods. Ensure you know the differences, in terms of both the definitions and relevant examples of each. Merit goods are those whose consumption yields more social benefits than private benefits (e.g. healthcare and education). Public goods are non-rivalrous and non-excludable (e.g. street lighting and public roads).

Sample questions and answers

REVISED

1 With the use of examples, explain the difference between merit and demerit goods. [4]

Student's answer

Merit goods are beneficial to society, i.e. they have positive externalities [1]*, e.g. education and healthcare* [1]*. By contrast, demerit goods are harmful to the society* [1] *but are overconsumed due to people's ignorance, e.g. tobacco, alcohol and gambling* [1]*, which have negative externalities.*

Teacher's comments

This is an excellent answer. The student makes effective use of appropriate economic terms (e.g. positive and negative externalities). There is good use of examples to clarify the answer. Full marks are awarded.

2 Discuss whether the social costs of operating power stations using fossil fuels are greater than the social benefits. [8]

Student's answer

Social costs are private costs plus external costs whereas social benefits are private benefits plus external benefits [1]*. Operating power stations using fossil fuels such as coal results in external costs (negative externalities), i.e. the harmful effects on third parties* [1]*, such as air pollution and noise pollution* [1]*. By contrast, external benefits create positive impacts on third parties* [1]*, such as employment opportunities created by the power stations* [1]*.*

Teacher's comments

This is a classic example of the student not reading the (entire) question carefully. The candidate has ignored private costs and benefits. Also, there is no conclusion, which should address the question of whether the social costs or benefits are greater. Nevertheless, relevant examples are used, and there is appropriate use of relevant economic terminology. 5 marks are awarded.

The allocation of marks is as follows: up to 3 marks for explaining social costs (private and external costs), up to 3 marks for explaining social benefits (private and external benefits), up to 3 marks for an evaluative conclusion.

Exam-style questions

1 State **three** reasons why the market economic system could fail to allocate scarce resources efficiently. [3]

2 Explain how users of private motor vehicles create negative externalities. [4]

3 Explain why the social costs of alcohol consumption are greater than the private costs. [4]

4 Analyse the causes of market failure. [6]

5 Discuss whether university students should pay for the full cost of their university education. [8]

Answers on page 142

15 Mixed economic system

Key objectives

The objectives of this chapter are to revise:

- the mixed economic system
- maximum and minimum prices
- government intervention to address market failure.

Key definitions

REVISED

Term	Definition
Direct provision	Government directly providing certain goods and services, free of charge to their citizens, funded through tax revenues. Examples include: education, healthcare, public libraries, parks, museums, public roads and motorways (highways), garbage or refuse collection, street lighting, street signs and national defence.
Maximum price	A price control system that involves setting the price below the market equilibrium price in order to make products more affordable.
Minimum price	The imposition of a price guarantee, set above the market price to encourage supply of a certain good or service.
Mixed economy	An economic system that combines the planned and market economic systems, with some resources owned and controlled by the private sector and others by the government.
Nationalisation	The purchase of private sector assets by the government, bringing these into the ownership and control of the public sector.
Privatisation	The transfer of ownership of assets from the public sector to the private sector.
Rules and regulations	Laws used in an attempt to solve market failures, e.g. smoking bans in public places, or minimum age laws for the purchase of alcohol and tobacco products.
Subsidy	Financial assistance from the government to a producer in order to reduce production costs and/or price to consumers (to reduce the price of consumption).
Taxation	Government levy (charge) used to correct market failures, e.g. taxes on cigarettes, alcohol and petroleum.

Mixed economic system

PAGES 73–83

REVISED

Economic systems

There are three main categories of economic systems.

Planned economy

- Relies on the government to allocate resources
- Associated with a communist political system that aims for social equality
- The economy prefers to be self-sufficient

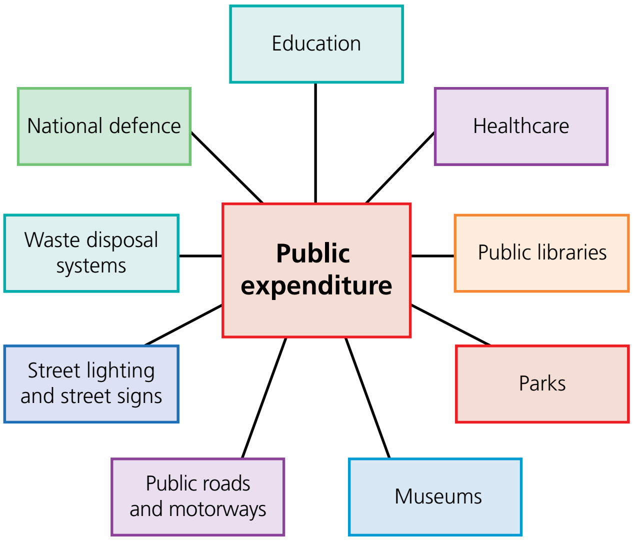
Market economy

- Relies on the market forces of demand and supply (the price mechanism) to allocate scarce resources
- No or minimal government intervention in economic activities

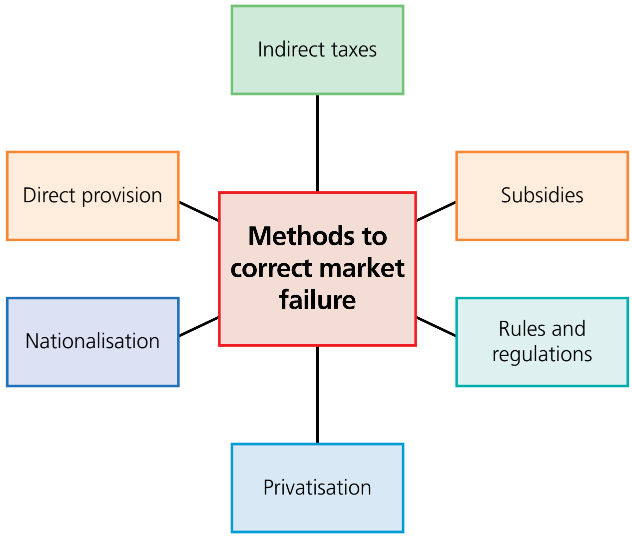
Mixed economy

- Combination of resources owned and controlled by the private sector and the public sector
- The degree of public and private sector involvement is determined by the government

▲ **Figure 15.1** Economic systems



▲ **Figure 15.2** Public expenditure



▲ **Figure 15.3** Methods used to correct market failure

The mixed economy

▼ **Table 15.1** Advantages and disadvantages of the mixed economy

Advantages	Disadvantages
• **Provision of essential services** from the public sector, e.g. state education, healthcare and postal service. • **Redistribution of income and wealth**, e.g. welfare benefits and state pensions. • **Incentives** for producers and individuals to work hard, invest and save.	• **Taxation** is required to fund public sector activities, so such levies and charges can act as disincentives. • **Disincentives** can occur as people default to relying on the government to provide essential goods and services.

Common errors

REVISED

Error	Why it is wrong
'Public goods are those that are produced by the public sector.'	Private sector firms do not have incentives to produce public goods (e.g. public roads), so the government intervenes to do so.
'The market economy is better than the planned economy as people have more choice.'	The word 'better' is subjective, rather than objective – what is 'better' for one person is not necessarily so for others. Having more choice is not always a good thing; there is an opportunity cost to having more choice, e.g. advertising clutter or wasteful competition.

Target your revision

REVISED

- The mixed economic system is a combination of both the planned economy and the market economy, i.e. resources are owned and controlled by both the private sector and the public sector.
- The degree of public and private sector involvement is determined by the government.
- A maximum price is a price control system that involves setting the price below the market equilibrium price in order to make products more affordable.

- A minimum price is the imposition of a price guarantee set above the market price to encourage supply of a certain good or service.
- Excess supply occurs when a minimum price is imposed above the market equilibrium price, as supply exceeds demand at higher prices.
- Consumers tend to pay higher prices if minimum prices are imposed.
- An indirect tax causes costs of production to increase, thereby shifting the supply curve of demerit goods to the left. This results in a higher equilibrium price and a contraction in demand.
- Subsidies can be used to lower the cost of provision of merit goods and services. This helps to cut prices and encourage demand for such socially beneficial products.
- Rules and regulation can limit access to certain goods and services that have negative externalities, e.g. tobacco, alcohol and gambling.
- Privatisation is the transfer of ownership of assets from the public sector to the private sector. It can help to correct market failures by making resource allocation more efficient, as the private sector has incentives to be innovative and competitive.
- Nationalisation is the purchase of private sector assets by the government, bringing these into the ownership and control of the public sector. This can protect employment and promote economic stability in key industries.

Test yourself

1. Complete the following sentence: The mixed economic system is a combination of both the planned economy and the ____________ economy, i.e. there is both ____________ and private sector involvement in economic activity.
2. A ____________ price control sets the price below the market equilibrium in order to make products more affordable. A ____________ price is set above the market equilibrium in order to encourage output of a certain good or service.
3. Which form of price control results in excess supply?
4. Which form of price control results in excess demand?
5. How are scarce resources allocated in a mixed economy?
6. State **four** methods of government intervention to address market failure.

Answers on page 142

Tip

Rarely do economies fall perfectly into the categories of planned or market economies. In reality, most countries tend be mixed economies with a stronger element of either market-based policies or central planning from the government.

Sample question and answer

REVISED

1 Sweden is an example of a mixed economy. Describe **two** benefits of a mixed economy. [4]

Student's answer

Some resources are allocated by the market forces of demand and supply [1], so there are incentives for firms and households to produce [1].

Government intervention ensures resources are allocated in the economy to benefit everyone [1].

Teacher's comments

The first part of the answer shows a benefit of the private sector within a mixed economy, and the answer is just sufficient to be awarded 2 marks. However, it is not entirely clear how government intervention 'benefits everyone', so clarity is needed here. 3 marks are awarded.

Exam-style questions

1 Define the term *mixed economic system*. [2]
2 Define the term *privatisation*. [2]
3 Explain what a mixed economy is and how resources are allocated in such an economy. [4]
4 Explain why a government might impose a maximum price. [2]
5 Explain why a government might impose a minimum price. [2]

Answers on page 143

16 Money and banking

Key objectives

The objectives of this chapter are to revise:

- the forms, functions and characteristics of money
- the role and importance of central banks
- the role and importance of commercial banks.

Key definitions

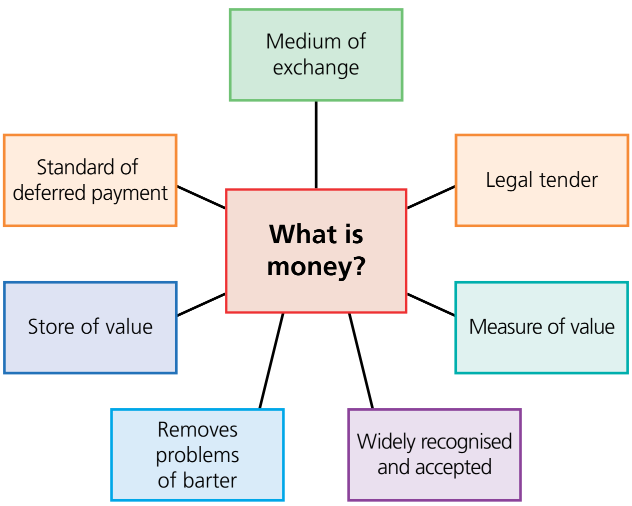
REVISED

Term	Definition
Bank deposits	Money reserves placed in commercial bank accounts.
Bartering	Exchange made by swapping items for other items through a process of bargaining and negotiation.
Cash	Banknotes and coins as a physical form of money.
Central bank	The monetary authority that oversees and manages the economy's money supply and banking system.
Commercial banks	Retail banks that provide financial services to customers, e.g. savings account deposits and bank loans.
Functions of money	The role that money plays in the economy: money is a medium of exchange, a store of value and a measure of value.
Money	A commodity that is widely accepted as a means of exchange in economic transactions.
Stock exchange	An institutional marketplace for trading (buying and selling) the shares of public limited companies.

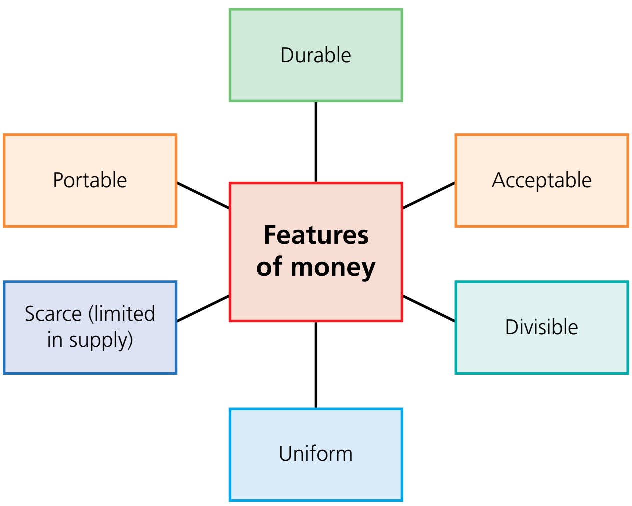
Money and banking

PAGES 86–95

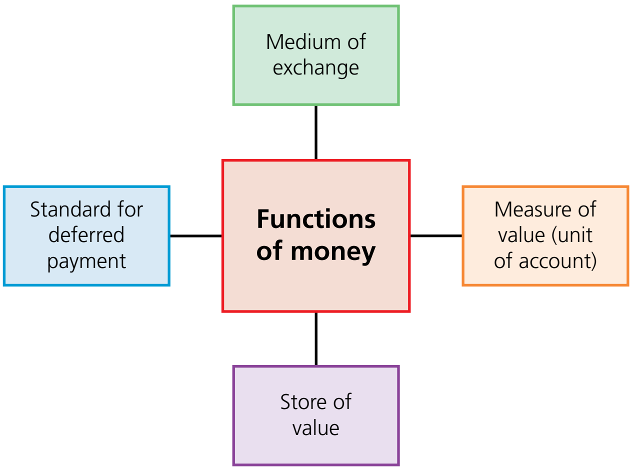
REVISED



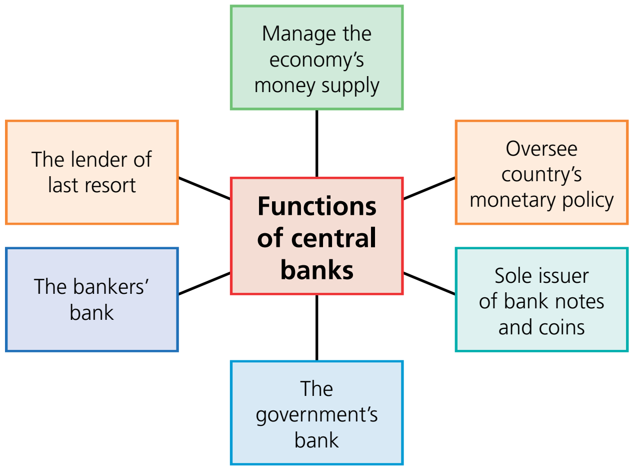
▲ **Figure 16.1** What is money?



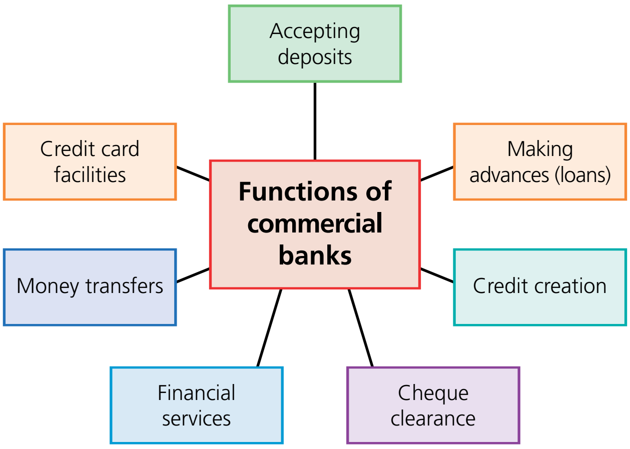
▲ **Figure 16.2** Characteristics of money



▲ **Figure 16.3** The functions of money



▲ **Figure 16.4** The functions of central banks



▲ **Figure 16.5** The functions of commercial banks

Common errors

REVISED

Error	Why it is wrong
'Money refers to all banknotes and coins in the economy.'	Money is any medium of exchange that is widely accepted, so this includes banknotes and coins, but also gold and bank account deposits.
'A key function of banks is to issue banknotes and coins.'	This is a key function of a central bank; commercial banks are not allowed to issue notes and coins. Ensure you know the difference between the functions of central and commercial banks.
'Capital is the money used by a firm to purchase machinery and equipment.'	Capital, as a factor of production, refers to any human-made good used in the production process, e.g. machinery, buildings, vehicles and equipment. Capital is not money.

Target your revision

REVISED

- Money is any commodity that can be used as a medium of exchange for the purchase of goods and services, e.g. banknotes and coins.
- Forms of money include: cash (notes and coins), commercial bank deposits and central bank reserves.

- There are four functions of money: a medium of exchange, a measure of value (unit of account), a store of value and a standard for deferred payment.
- Characteristics of money include: durability, acceptability, divisibility, uniformity, scarcity and portability.
- In the absence of money, the economy uses a bartering system, although this requires a double coincidence of wants.
- The central bank is the monetary authority of a country that oversees and manages the economy's money supply and the banking system.
- Central banks have four key functions: the sole issuer of legal tender, the government's bank, the bankers' bank and the lender of last resort.
- Commercial banks are retail banks that provide financial services to their customers, e.g. savings, bank loans and mortgages.
- Functions of commercial banks include: accepting deposits, making (approving) advances, credit creation and a range of other banking services (e.g. cheque clearance, foreign exchange dealings, money transfer facilities and online banking).

Test yourself

1 Complete the following sentence: Money is any commodity that can be used as a ______________ of exchange for the ______________ of goods and services, e.g. banknotes and coins.
2 What is meant by *money*?
3 State the **four** functions of money.
4 What is bartering?
5 What is a central bank?

Answers on page 143

Tip

Remember that 'money' in an economy is far more than just cash (banknotes and coins). In fact, bank deposits account for far more of the money supply in an economy than banknotes and coins.

Sample question and answer

REVISED

1 Explain the role of a commercial bank. [4]

Student's answer

A commercial bank is a retail bank, run for profit [1], by providing financial services to its customers [1]. Its role includes accepting savings deposits [1] and making advances, such as bank loans and mortgages [1] in order to facilitate economic activity.

Teacher's comments

This is a very clear answer, with two correct functions identified (accept deposits and making advances) and explained. Full marks are awarded.

Exam-style questions

1 Explain what is meant by *a medium of exchange*. [2]
2 State **three** key functions of a central bank. [3]
3 Explain why banknotes and coins are examples of money. [4]
4 Explain **two** functions of money. [4]
5 Analyse the importance of a country's central bank for its economy. [6]

Answers on page 143

17 Households

Key objectives

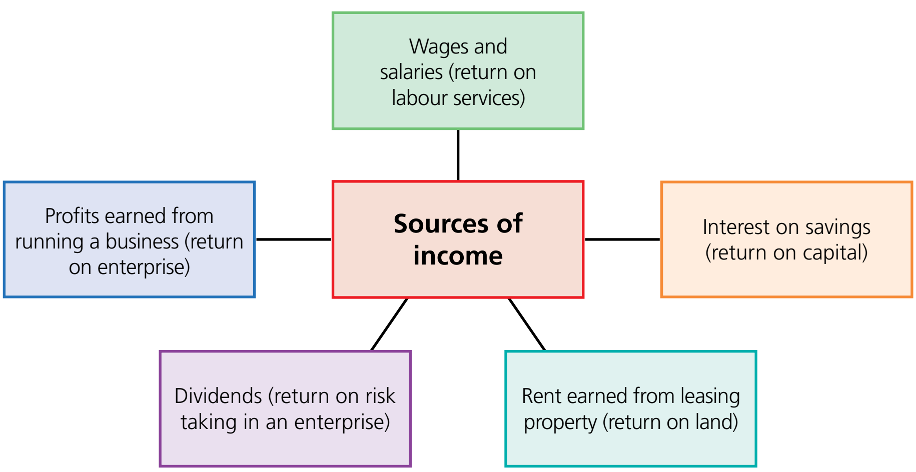
The objectives of this chapter are to revise:

- the factors that influence household spending
- the factors that influence household savings
- the factors that influence household borrowing.

Key definitions

REVISED

Term	Definition
Bad debts	Debts that cannot be recovered because households and firms fail to repay a loan.
Borrowing	An individual, firm or the government takes out a loan from a financial institution, paying back the debt with interest over an agreed period of time.
Capital expenditure	The money spent on fixed assets (items owned by an individual or firm which last more than 12 months), e.g. machinery, equipment, buildings and vehicles.
Collateral	The security used for a loan to minimise risk and bad debts, e.g. the property that is financed using a mortgage.
Conspicuous consumption	The purchase of highly expensive goods and services due to status or a desired image.
Consumer spending	The amount of household expenditure per time period.
Current expenditure	The money spent on goods and services consumed within the current year, e.g. on food, clothing, entertainment and haircuts.
Disposable income	An individual's earnings after income tax and other deductions have been made.
Dissaving	Describes the act of households spending their savings, perhaps due to very low interest rates or a fall in real incomes.
Income	The total amount of earnings an individual receives in a given time period, consisting of wages, interest, dividends, profits and rental income.
Mortgage	A long-term secured loan for the purchase of property.
Saving	The act of putting aside an amount of current income for future spending.
Savings ratio	The proportion of household income that is saved instead of spent.
Wealth	A measure of the value of a person's assets minus their liabilities (the amount they owe to others).



▲ **Figure 17.1** Sources of income

Households

PAGES 96–107

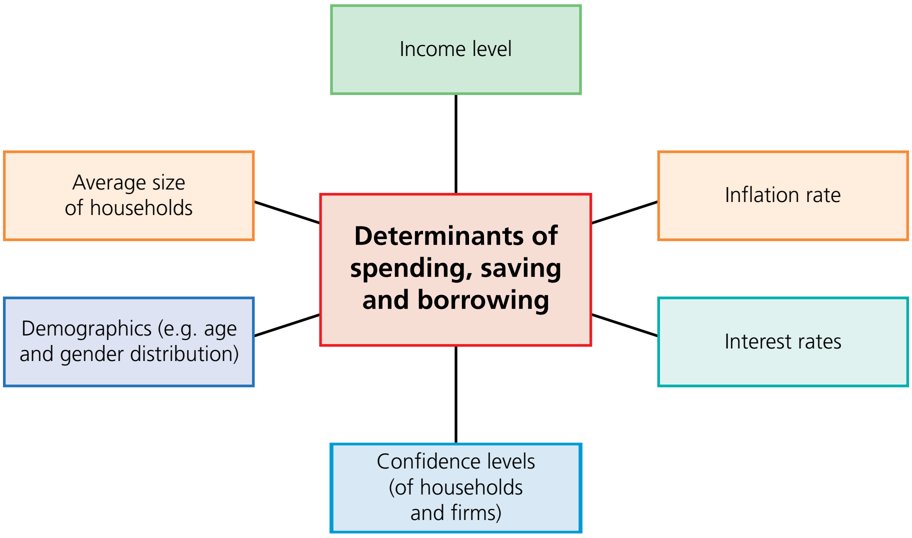
REVISED

Income and expenditure

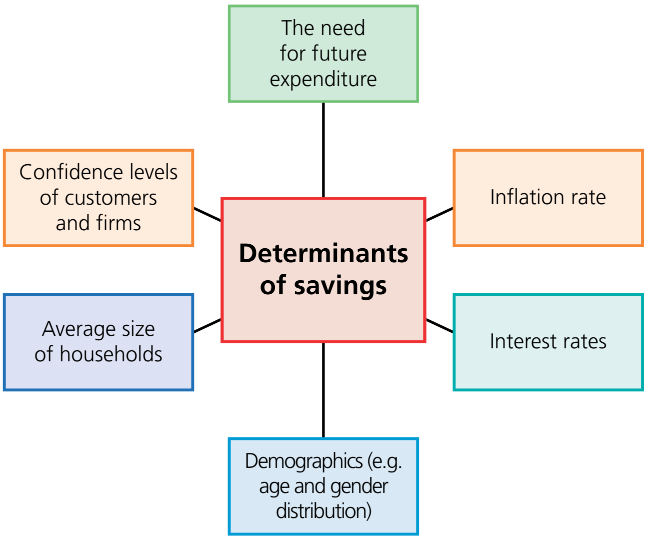
▼ **Table 17.1** Reasons for different expenditure patterns

Income group	Spending	Saving	Borrowing
Low	Spend most of their income on necessities, e.g. food, clothing and housing	Low, as there is not much, if any, income left after buying necessities	Borrow to fund expenditure on capital items, e.g. furniture and phones In extreme circumstances, they borrow to fund current expenditure on necessities Banks less likely to lend to low-income earners due to the higher risk
Middle	Spend on necessities and some luxuries Spend a lower proportion of income on food and other necessities	Able to save some money from their incomes	Borrow to fund expenditure on capital items, e.g. furniture, cars and computers Use credit cards to pay for both capital and current expenditure Some will have a mortgage (long-term secured loan) to purchase a home
High	Spend a small proportion of income on necessities Purchase luxury goods and services	Able to save a greater proportion of their income	Banks lend money rather easily as there is only a small risk of high income earners not being able to repay loans and mortgages There is less need to borrow money to fund items of expenditure

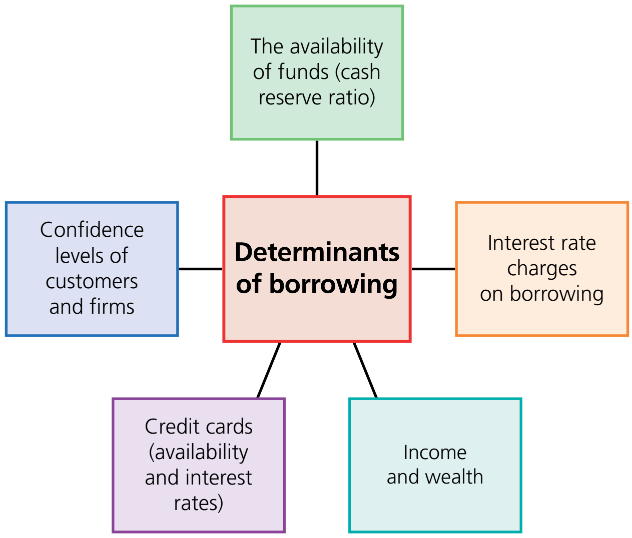
Consumer spending, saving and borrowing



▲ **Figure 17.2** Determinants of the level of spending, saving and borrowing



▲ **Figure 17.3** Determinants of saving



▲ **Figure 17.4** Determinants of borrowing

Common errors

REVISED

Error	Why it is wrong
'Income refers to the wealth of an individual.'	Wealth consists of more than a person's income (which mainly comes from their wage or salary). Wealth includes a person's savings and assets, in addition to their income.
'Higher interest rates mean that people save more money, so they spend less.'	This is not entirely incorrect, although the main reason for the fall in spending is that higher interest rates reduce the amount of income available to households with existing loans and mortgages. Thus, they have less disposable income to spend.

Target your revision

REVISED

- The amount of money that individuals spend on goods and services is largely dependent upon their level of disposable income.
- Disposable income is the amount of income a person has available to spend after payment of income tax.
- Direct taxation reduces the amount of disposable income and therefore the amount of spending and savings in the economy.
- Current expenditure is money spent on goods and services consumed within the current year. By contrast, capital expenditure is money spent on fixed assets.
- The wealth of an individual is measured by the amount of assets they own minus their liabilities (the amount they owe).
- Apart from levels of income, other determinants of the level of the economy's spending, saving and borrowing include: interest rates, confidence levels, the inflation rate and the size of households.
- Savings occur when people put away part of their current income for future spending. Saving money at a bank offers both security and interest.
- Determinants of savings include: the level of disposable income, age, attitudes towards savings, confidence levels and interest rates for savings.

- Borrowing occurs when an individual, firm or the government takes out a loan, paying it back to the financial lender over a period of time, with interest charges imposed by the bank.
- Factors that affect the level of borrowing in an economy include: the level of disposable income, interest charges, confidence levels, the availability of funds (money supply), credit (including store cards) and wealth.

Test yourself

1 Complete the following sentence: The main source of most people's income is ______________ from their employment. ______________ income is what a worker can spend after paying income tax.
2 How is the value of a person's wealth measured?
3 What is meant by *interest rates*?
4 What is a credit card?
5 State **three** factors that affect the level of borrowing in an economy.

Answers on pages 143–44

Tip

There are always different interest rates in an economy, used to influence the level of savings, spending and borrowing. The interest rate for savers will be lower than the rate of interest charged to customers who borrow money or purchase goods and services using credit cards and store cards.

Sample question and answer

REVISED

1 Explain **two** reasons why individuals in an economy might spend most of their income. [4]

Student's answer

Poor people might need to buy basic necessities [1] which takes up the majority of their income [1]. Alternatively, interest rates might be really low, so there are few incentives to save money in the bank [1], so people spend a large proportion of their money instead [1].

Teacher's comments

Although this is a basic answer, it is succinct and clearly identifies and explains two reasons why people might spend a large proportion of their income. Full marks are awarded.

Exam-style questions

1 Identify **three** factors that influence the amount of money that people save. [3]
2 Explain **two** reasons why the government might encourage people to borrow more. [4]
3 Explain **two** reasons why the government might discourage an increase in the amount borrowed by households. [4]
4 Analyse the effects of an increase in bank lending on the country's level of economic growth. [6]
5 Discuss whether those on low incomes are more likely to borrow than those on high incomes. [8]

Answers on page 144

18 Workers

Key objectives

The objectives of this chapter are to revise:

- the wage and non-wage factors affecting an individual's choice of occupation
- the factors that determine wages
- the reasons for differences in earnings.

Key definitions

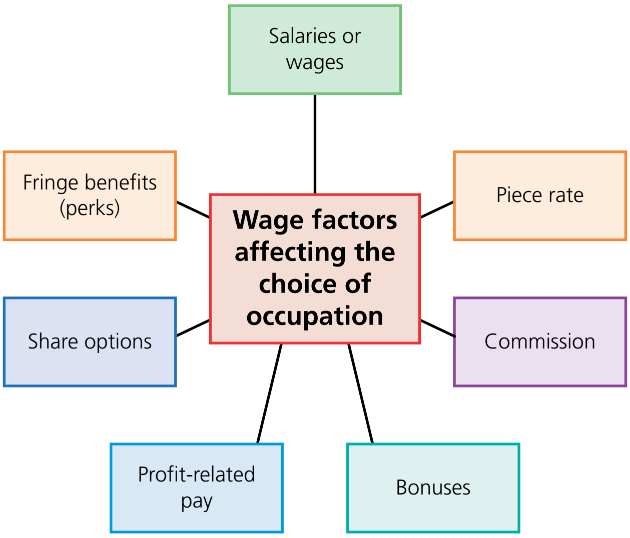
REVISED

Term	Definition
Backward-bending supply of labour curve	Occurs when wage rates rise to a high enough point that people can work less and enjoy more leisure hours.
Demand for labour	The number of workers whom firms are willing and able to hire at a given wage rate.
Derived demand	Implies that labour (or any factor of production) is not demanded for itself but for the goods and services it is used to produce.
Division of labour	Refers to workers being experts in a particular aspect or task as part of the larger production process.
Equilibrium wage rate	Wage determination based on the wage rate that firms are prepared to pay and at which workers are willing to supply their labour services.
Fringe benefits (perks)	Additional benefits made to workers, which have a monetary value, e.g. pensions, health insurance, company car, laptop, mobile phone, education for children, or membership of a health club.
Geographical mobility of labour	The willingness and ability of a person to relocate from one geographical area to another for work purposes.
Labour force participation rate	The percentage of the working population that is working, rather than unemployed.
National minimum wage	The lowest legal amount any firm must pay its workers as determined by the government.
Non-wage factors	Non-financial factors that influence workers' choice of job or career, e.g. challenge, career prospects, qualifications required, recognition and personal satisfaction.
Occupational mobility of labour	The extent to which a person is able and willing to change between jobs or careers.
Piece rate	Financial payment system using a fixed amount paid per item produced or sold by the worker.
Productivity of labour	A measure of the efficiency of workers obtained by calculating the output per worker over a period of time.
Salaries	Financial payment system used to reward workers by monthly payments at a fixed rate, irrespective of the amount of work done.
Specialisation	Refers to workers being experts in a particular profession.
Supply of labour	Everyone in the economy who is of working age and is both willing and able to work, at different wage rates.
Wage determination	The process of deriving an equilibrium wage rate for workers, based on the interaction of the demand for labour and the supply of labour in a particular labour market.
Wage factors	The financial rewards that workers receive in return for their labour services, which have a major influence on their choice of occupation.
Wages	Time-based payment system, paid to workers based on an hourly, daily or weekly rate.

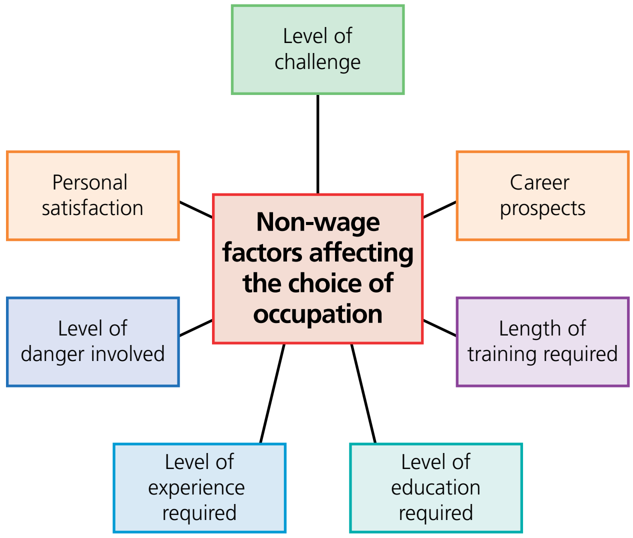
Workers

PAGES 108–22

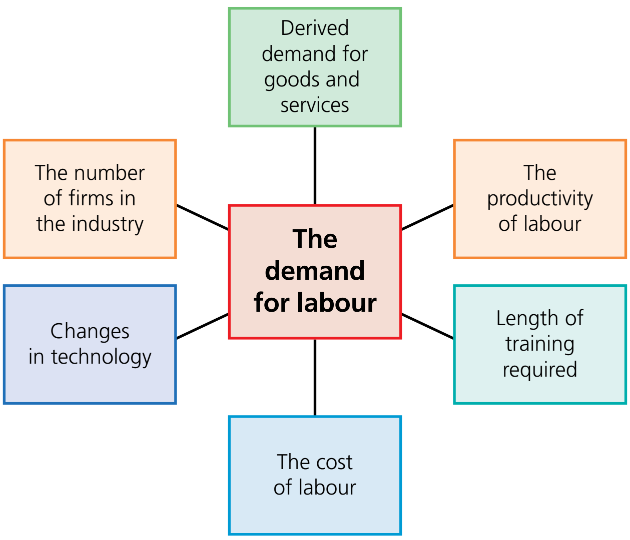
REVISED



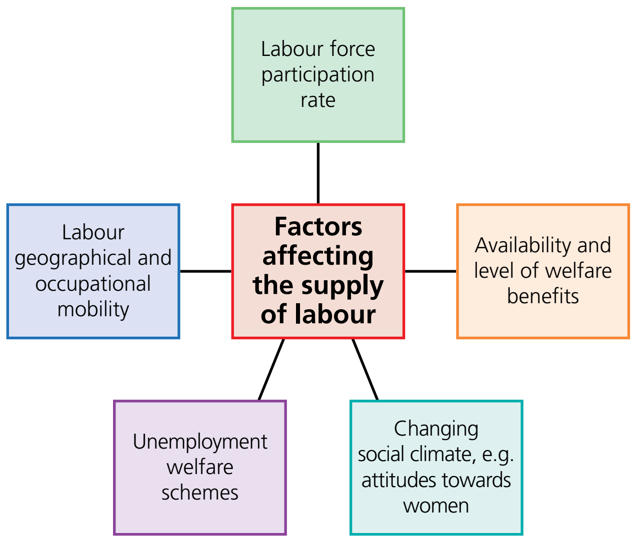
▲ **Figure 18.1** Influences on an individual's choice of occupation (wage factors)



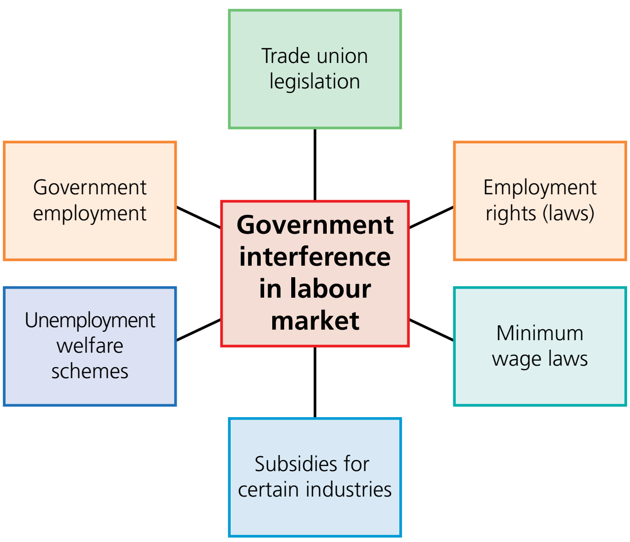
▲ **Figure 18.2** Influences on an individual's choice of occupation (non-wage factors)



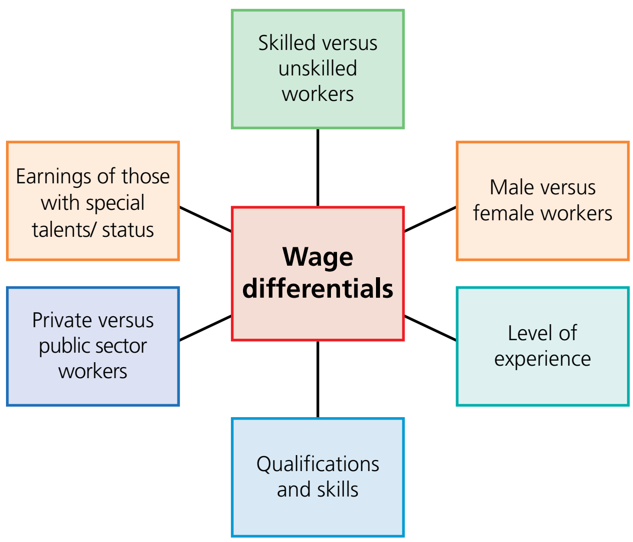
▲ **Figure 18.3** Factors that influence the demand for labour



▲ **Figure 18.4** Factors affecting the supply of labour

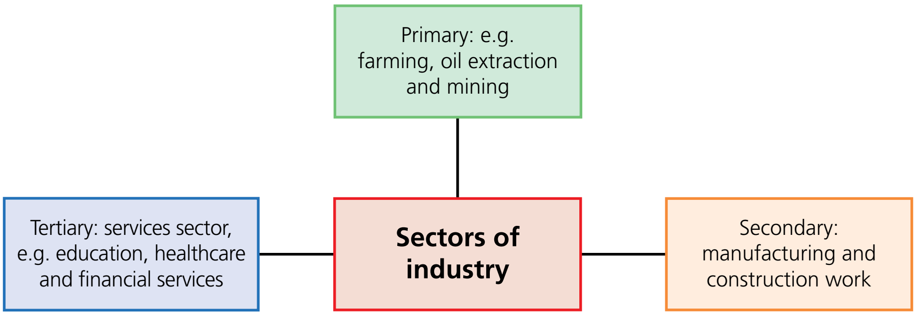


▲ **Figure 18.5** Government interference in the labour market



▲ **Figure 18.6** Wage differentials

Sectors of industry



▲ **Figure 18.7** Sectors of industry

Common errors

REVISED

Error	Why it is wrong
'Private sector workers are paid more than public sector workers.'	It is incorrect to assume that all workers in the private sector are paid more than those in the public sector. This depends on many variables, e.g. the level of qualifications, skills and experience of the workers.
'Tertiary sector workers are paid more than those in the primary sector.'	Again, this depends on many factors: for example, there are plenty of unskilled workers in the tertiary sector (e.g. supermarket cashiers) who earn less than those in the primary sector (e.g. oil rig workers).

Target your revision

REVISED

- An individual's choice of occupation depends on many factors, which can be categorised as wage and non-wage factors.
- Wage factors are the financial rewards that workers receive.
- Non-wage factors are the non-financial factors that influence an individual's choice of occupation.
- Wages are determined by the interaction of the demand for labour and the supply of labour.
- The demand for labour is the number of workers whom firms are willing and able to hire at a given wage rate.
- The supply of labour refers to everyone in an economy who is of working age and is both willing and able to work at different wage rates.
- The equilibrium wage rate is determined when the demand for labour is equal to the supply of labour.
- The national minimum wage is the lowest amount a firm can pay its workers as set by the government.
- The various factors that can influence differences in earnings between workers include: level of skills, the production sector, gender, private or public sector employment, and the age of the worker.
- Specialisation of labour refers to workers being expert in a particular profession.
- Division of labour refers to workers being expert in a particular part of the production process.

Test yourself

1 Complete the following sentences: The demand for labour is ______________ from the demand for the goods or services it is required to produce. The main factor affecting the demand for labour is the ______________ of labour.
2 When workers are prepared to relocate to another area for work, they are said to be ______________ mobile. When workers are willing and able to move from one job to another, they are said to be ______________ mobile.
3 State **three** wage factors that affect the choice of a worker's occupation.
4 State **three** non-wage factors that affect the choice of a worker's occupation.
5 What is the difference between wages and salaries?

Answers on page 144

Tip

It is possible for the objectives of both workers (employees) and firms (employers) to be met at the same time. For instance, firms may agree to the demands of workers in return for productivity gains from their labour force.

Sample question and answer

REVISED

1 Explain whether a business would have to raise wage rates in order to attract more workers. [4]

Student's answer

Wage rates are the main factor affecting the supply of labour [1]. *In order to attract more workers, wage rates need to be raised, especially if there is a shortage of workers* [1]. *For an individual firm, businesses might raise wage rates to compete for workers* [1].

Teacher's comments

The first part of the answer is good because a reason has been identified (wage rates affect the supply of labour) and an explanation given. The second reason lacks sufficient depth (reasoning). 3 marks are awarded.

Exam-style questions

1 Describe what is meant by *wage differentials*. [2]
2 Identify **two** reasons why some people may choose to work despite a low wage. [2]
3 Identify **three** factors that can influence a person's choice of occupation. [3]
4 Explain **two** reasons why unskilled workers are usually paid less than skilled workers. [4]
5 Explain **two** reasons why people may decide to work in another country. [4]

Answers on page 145

19 Trade unions

Key objectives

The objectives of this chapter are to revise:

- the meaning of trade unions
- the role of trade unions in the economy
- the advantages and disadvantages of trade union membership.

Key definitions

REVISED

Term	Definition
Collective bargaining	The act of negotiation between a trade union representative on behalf of its members and the employer in order to reach an agreement which both sides find acceptable.
Craft union	The oldest type of trade unions, formed originally to organise workers according to their particular skill (or craft).
General union	Type of trade union which is usually prepared to accept anyone, regardless of the place they work, the nature of their work, or their industrial qualifications.
Go-slow	Industrial action that involves employees deciding to work at the slowest acceptable pace, thus causing productivity to fall.
Industrial action	Measures taken by trade union members during major disagreements or disputes with their employers, e.g. strike action.
Industrial union	Trade union that represents all workers in a particular industry, irrespective of their skills or the type of work done.
Sit-in	Industrial action that involves union members occupying the work premises but not undertaking their normal work, causing disruption to the employer.
Strike	An extreme form of industrial action that occurs when union members withdraw their labour services by refusing to work.
Trade union	An organisation that aims to protect the interests of its members, in terms of pay and conditions of employment.
White-collar union	Type of labour union for professional, administrative and clerical staff (salaried workers) and other non-manual workers.
Work-to-rule	Industrial action that involves employees working to fulfil the minimum requirements of their job and avoiding anything beyond what is written in their employment contract.

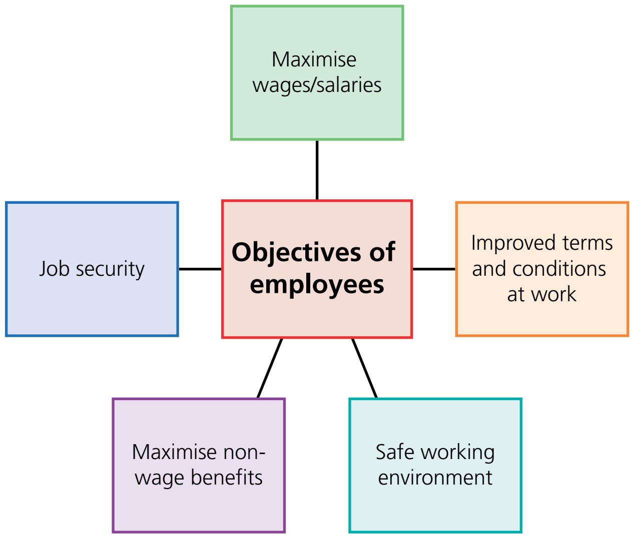
Trade unions

PAGES 123–29

REVISED

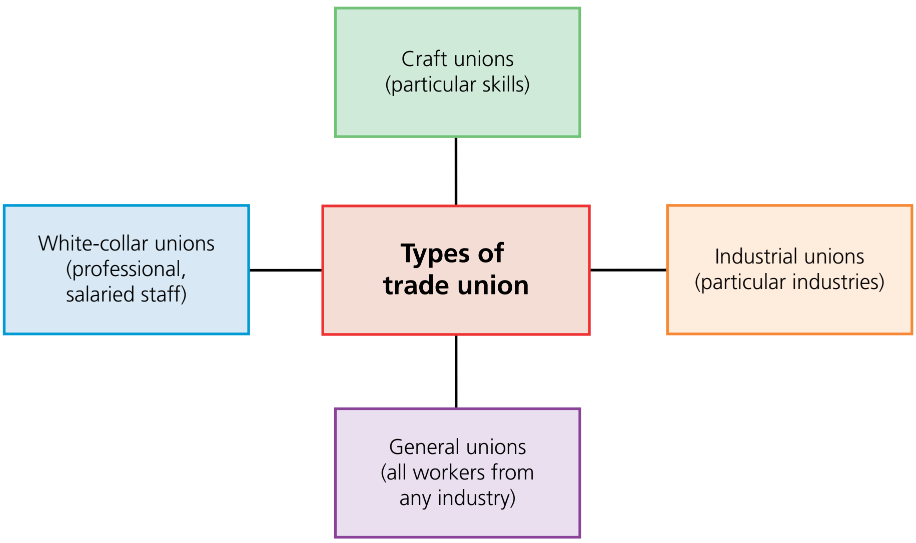
Employer and employee objectives

▲ **Figure 19.1** Objectives of employers



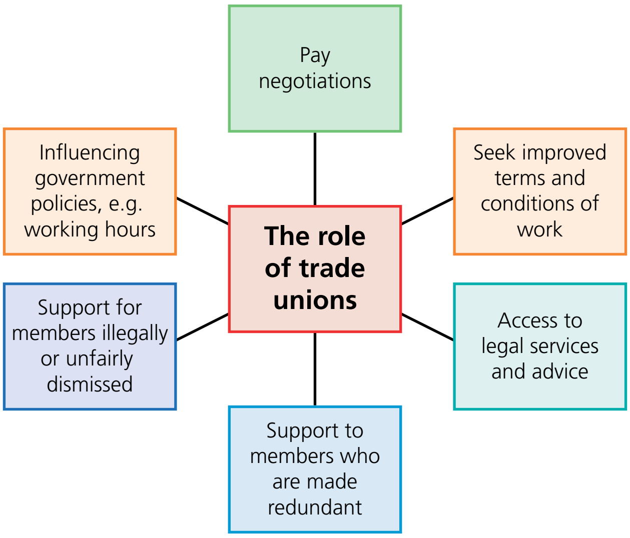
▲ **Figure 19.2** Objectives of employees

Types of trade union

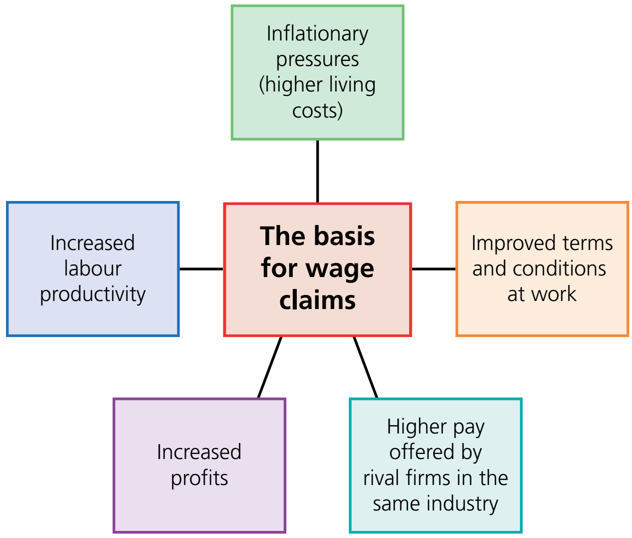


▲ **Figure 19.3** Types of trade union

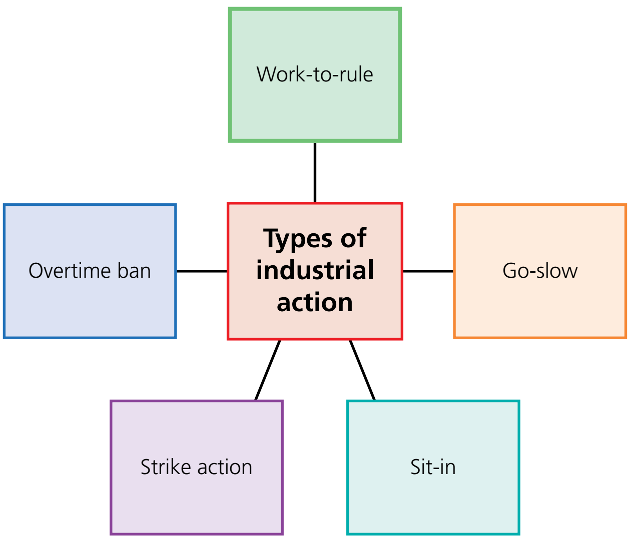
The role of trade unions



▲ **Figure 19.4** The role of trade unions



▲ **Figure 19.5** The basis for wage claims



▲ **Figure 19.6** Types of industrial action

Common errors

REVISED

Error	Why it is wrong
'Trade unions provide protection for all workers against their employers.'	Members of a trade union may get such protection, rather than 'all' workers. Of course, there is little a trade union can do to 'protect' a worker/member if employment laws are broken.
'If workers do not get what they want, they can go on strike to force employers to meet their demands.'	Strike action is an extreme form of industrial action. Trade unions are therefore not likely to take such action, especially as workers who strike do not get paid their usual wages or salaries.

Target your revision

REVISED

- A trade union is an organisation which aims to protect the interests of its worker members, i.e. the pay and terms and conditions of employment.
- Types of trade union include: craft unions, industrial unions, white-collar unions and general unions.

- Collective bargaining is the process of trade union representatives negotiating on behalf of their worker members with employer representatives for better pay and conditions.
- Industrial action refers to measures taken by trade union members during major disagreements or disputes with their employers, e.g. strike action.
- The two main factors affecting the strength of trade unions are the number of members and the degree of their unity.
- Advantages of trade unions include: acting as a communication channel between employers and employees, negotiating with employers for better pay and working conditions for their members, negotiating with the government on matters such as raising the minimum wage, and offering legal support and advice to member workers.
- Disadvantages of trade unions include: negative portrayal in the mass media, industrial action which may cause lost productivity, strike action causing serious disruption to the economy, and increased production costs due to higher wage claims (resulting in lower profits and international competitiveness).

Test yourself

1 Complete the following sentence: A trade union is an organisation that operates for the ______________ of its ______________.
2 State **two** factors that influence the level of strength of a trade union.
3 State **three** functions (roles) of a trade union.
4 State **three** examples of industrial action.
5 State **three** benefits to workers of joining a trade union.

Answers on page 145

Tip

It is possible for the aims of both employees and employers to be met at the same time. For instance, firms may agree to the demands of trade unions in return for productivity gains from their workforce.

Sample question and answer

REVISED

1 Explain how trade unions can influence the level of unemployment. [4]

Student's answer

Trade unions may raise wages for employees. Higher wages may encourage more people to find employment [1]. *However, higher wages might mean that firms prefer to use more capital-intensive methods of production* [1] *so unemployment rises* [1].

Teacher's comments

There is some misunderstanding in the first sentence as trade unions are not the employers, so cannot increase wage rates – instead, they put pressure on employers and/or influence the government to raise wage rates. The rest of the student's answer is sound. 3 marks are awarded.

Exam-style questions

1 Describe the collective bargaining process. [2]
2 Define the term *industrial action*. [2]
3 Explain the role of a trade union. [4]
4 Explain **two** reasons why a firm might benefit from encouraging its employees to join a trade union. [4]
5 Discuss whether workers always benefit from joining a trade union. [6]

Answers on pages 145–46

20 Firms

Key objectives

The objectives of this chapter are to revise:

- the classification of firms in terms of primary, secondary and tertiary sectors
- the classification of firms in terms of public and private sector
- the advantages and disadvantages of small firms
- the causes of the growth of firms
- the advantages and disadvantages of different types of merger
- economies and diseconomies of scale.

Key definitions

REVISED

Term	Definition
Average costs	Unit costs of production, calculated by dividing total costs by the number of units produced.
Conglomerate integration	Also known as *lateral integration* or *diversification*, this happens when a merger or takeover occurs between two firms from unrelated areas of business.
Demerger	Occurs when two previously integrated firms decide to break up and become two separate firms.
Diseconomies of scale	Higher average costs of production as the size of the firm increases due to inefficiencies.
Economies of scale	Cost savings of large-scale operations, i.e. average costs of production fall as the size of the firm increases.
External economies of scale	Cost savings that arise from factors beyond the firm, e.g. favourable location, proximity to transport networks and the availability of skilled workers.
External growth	Also known as inorganic growth, this occurs when business growth involves another organisation, e.g. mergers, takeovers and franchises.
Franchise	Growth that involves a person or business buying a licence to trade using another firm's name, logos, brands and trademarks.
Horizontal integration	Growth that occurs when two firms at the same stage of production integrate via a merger or takeover.
Interdependence	The three sectors of industry (primary, secondary and tertiary) are dependent upon each other for the production of goods and services.
Internal economies of scale	Cost savings that arise from the business itself, e.g. financial, bulk-buying and technological economies of scale.
Internal growth	Also known as organic growth, this occurs when firms expand using their own resources, e.g. opening new branches (stores).
Market share	This measure of a firm's size calculates the firm's sales revenue as a proportion of the industry's sales revenue.
Merger	Type of integration that occurs when two or more firms join together to create one firm.
Primary sector	Segment of the economy that involves firms extracting raw materials from the earth.
Private sector	Economic activity of private individuals and firms. The private sector's main aim is to earn profit for its owners.
Public sector	Economic activity directly involving the government, e.g. the provision of state education and healthcare services. The public sector's main aim is to provide a service.
Secondary sector	Segment of the economy that focuses on manufacturing goods, and changing raw materials into finished products.

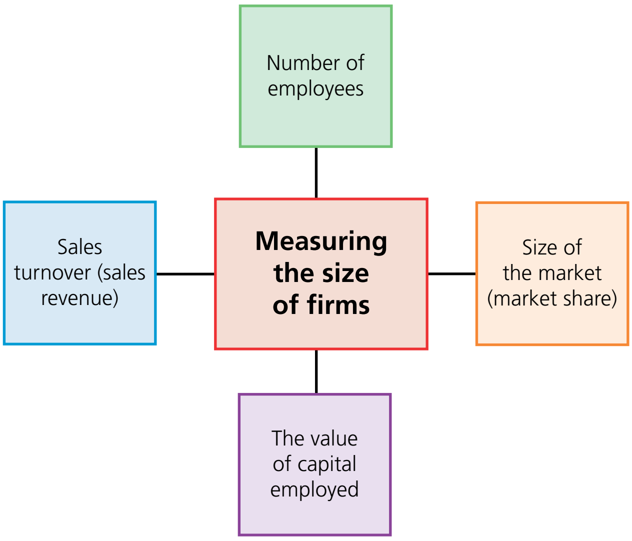
Term	Definition
Takeover	Type of integration that occurs when one firm is taken over by another firm. A takeover may be hostile or the two firms may agree to the takeover.
Tertiary sector	Segment of the economy that contains firms providing services to the general public and other firms.
Vertical integration	Growth that occurs via a takeover or merger between two firms operating in different sectors of industry (stages of production).

Firms

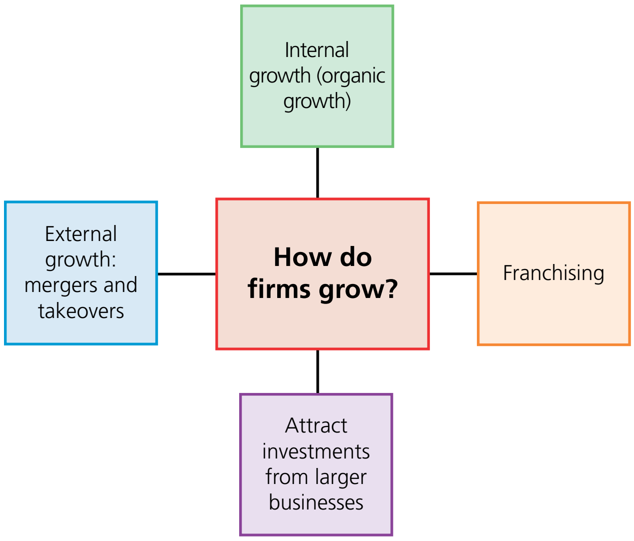
PAGES 130–44

REVISED

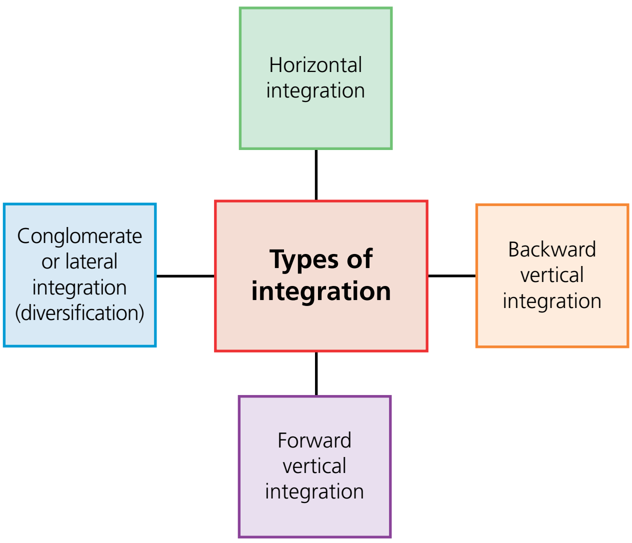
Business growth



▲ **Figure 20.1** Measuring the size of firms

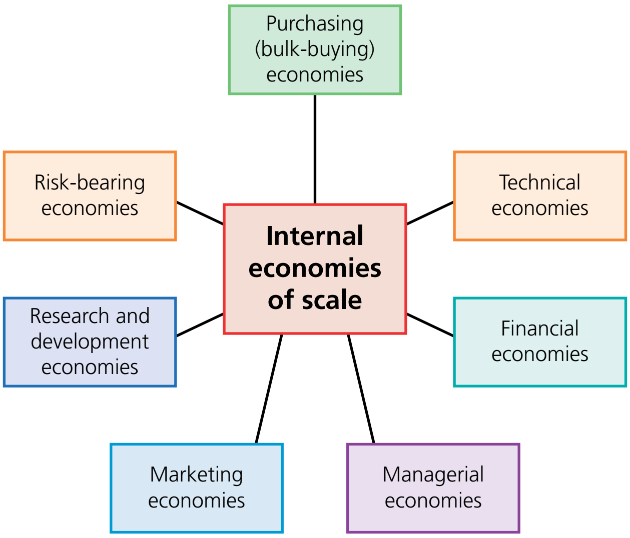


▲ **Figure 20.2** How do firms grow?

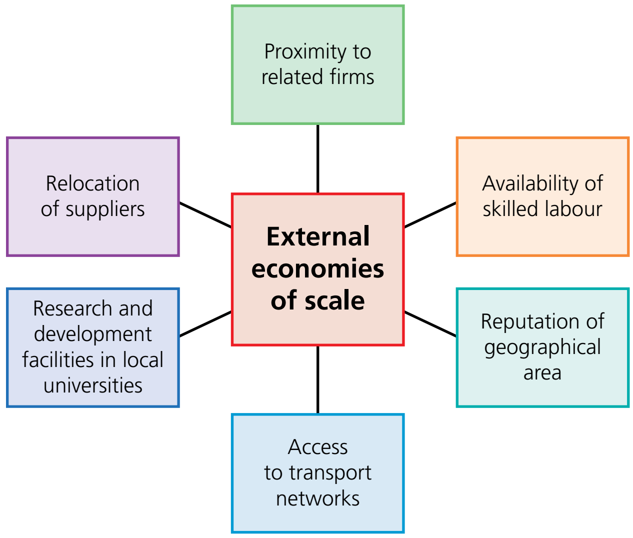


▲ **Figure 20.3** Types of integration

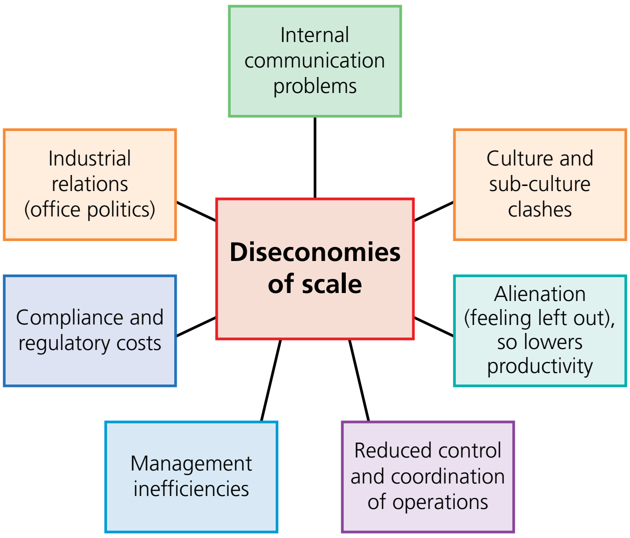
Economies and diseconomies of scale



▲ **Figure 20.4** Internal economies of scale



▲ **Figure 20.5** External economies of scale



▲ **Figure 20.6** Diseconomies of scale

Common error

REVISED

Error	Why it is wrong
'Economies of scale mean that firms can reduce their costs by operating at a higher level of output.'	This is a common mistake, as it is not possible to produce more output for lower costs (imagine being able to produce 1000 cars for less than 200 units of the same car!). Definitions of economies of scale should refer to the *average* cost of production, i.e. cost per unit, being lower when the level of output increases.

Target your revision

REVISED

- The primary sector of the economy contains firms that extract raw materials from the earth, e.g. fishing, mining and agricultural farming.
- The secondary sector of the economy contains firms that manufacture goods.
- The tertiary sector contains firms that provide services to the general public and other firms, e.g. retail, legal, financial and accounting services.

- The various ways to measure the size of firms include: the number of employees, market share, market capitalisation and sales revenue.
- Small firms are able to co-exist with larger firms due to the advantages of being small, e.g. low set-up costs, profit incentives and being able to provide a personalised service.
- Growth of firms can occur internally (organic) or externally (inorganic).
- A merger occurs when two or more firms join together to create one firm.
- There are different types of merger: horizontal, vertical and conglomerate mergers.
- Economies of scale are the cost-saving benefits of large-scale operations, which reduce average costs of production.
- Diseconomies of scale occur when average costs of production start to increase as the size of a firm increases.
- Economies and diseconomies of scale can be classified as internal or external.
- A demerger occurs when two previously merged firms decide to break up and become two separate firms.

Tip

Franchising, as a method of growth, is a hybrid of internal and external growth methods. The franchisor (such as McDonald's) grows by selling a licence to an independent individual or firm to trade using the name of the parent company. The franchisee pays for this privilege, by purchasing the franchise licence and paying a percentage of the sales revenue earned to the franchisor.

Test yourself

1 State **two** ways in which the size of firms can be measured.
2 State **three** ways in which firms can grow.
3 Give **four** examples of external economies of scale.
4 State **five** examples of internal economies of scale.
5 List **five** examples of diseconomies of scale.

Answers on page 146

Sample question and answer

REVISED

1 Using examples, explain the difference between vertical, horizontal and conglomerate forms of integration. [6]

Student's answer

Vertical integration happens when two or more firms at different stages of production [1] come together through a merger or takeover [1]. Horizontal integration happens when these firms are at the same stage of production [1]. By contrast, conglomerate integration occurs when firms in different industries spread their risks by being involved in different industries [1].

Teacher's comments

This answer is theoretically correct with a clear understanding of the three terms. However, since examples have not been provided (candidates should always refer to the demands of the question), a maximum of 4 marks can be awarded.

Exam-style questions

1 Explain **two** factors that influence the size of a firm. [4]
2 Explain why large firms may experience diseconomies of scale. [4]
3 Explain **two** reasons why aircraft manufacturing is usually done by very large firms. [4]
4 Explain the difference between a merger and takeover. [4]
5 Analyse how an increase in the size of a firm can increase its level of profit. [6]

Answers on page 146

21 Firms and production

Key objectives

The objectives of this chapter are to revise:

- the demand for factors of production
- the advantages and disadvantages of labour-intensive and capital-intensive production
- the influences on production and productivity.

Key definitions

REVISED

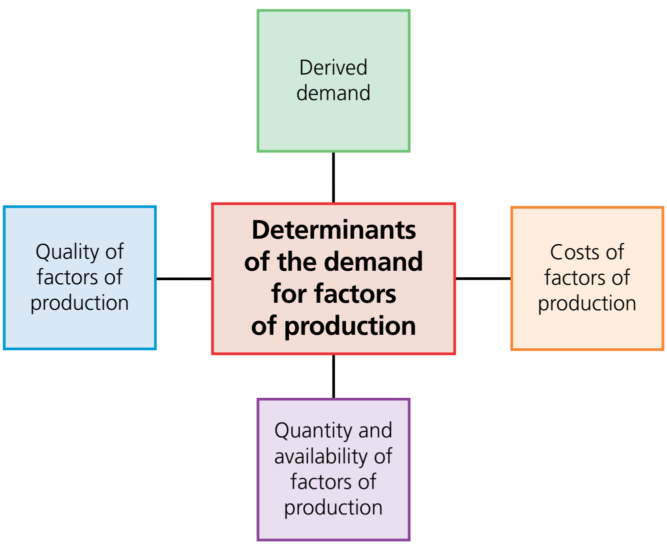
Term	Definition
Capital-intensive	In these industries, the use and cost of capital is more prominent than any other factor of production, e.g. car manufacturing.
Derived demand	The demand for factors of production is dependent on the demand for the goods and services which they will be used to produce.
Innovation	The commercialisation of new ideas and products, which acts as a vital source of productivity.
Labour productivity	Measures the efficiency of the workforce by calculating the output per worker.
Labour-intensive	In these industries, the cost of labour is proportionately higher than other factors of production, e.g. accountancy, real-estate services and tourism.
Production	The total output of goods and services in the production process.
Productivity	A measure of efficiency obtained by calculating the amount of output per unit of a factor input, e.g. output per worker or output per machine hour.

Firms and production

PAGES 145–54

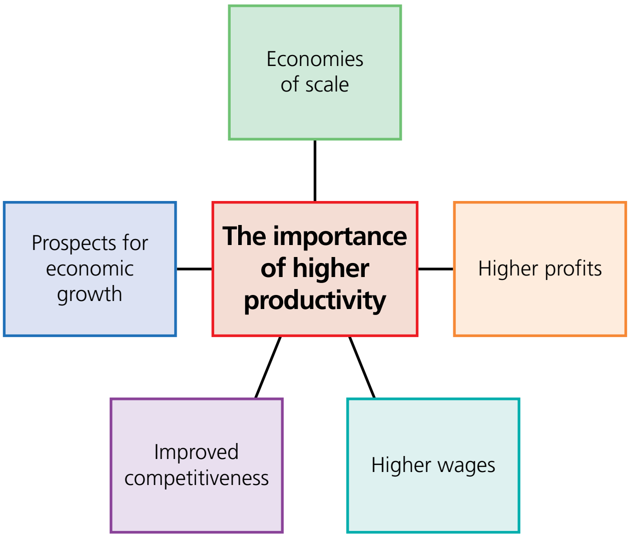
REVISED

The demand for factors of production

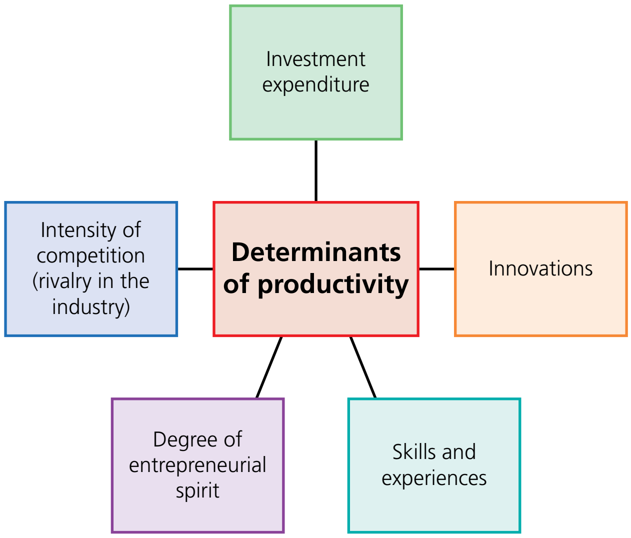


▲ **Figure 21.1** The demand for factors of production

Productivity

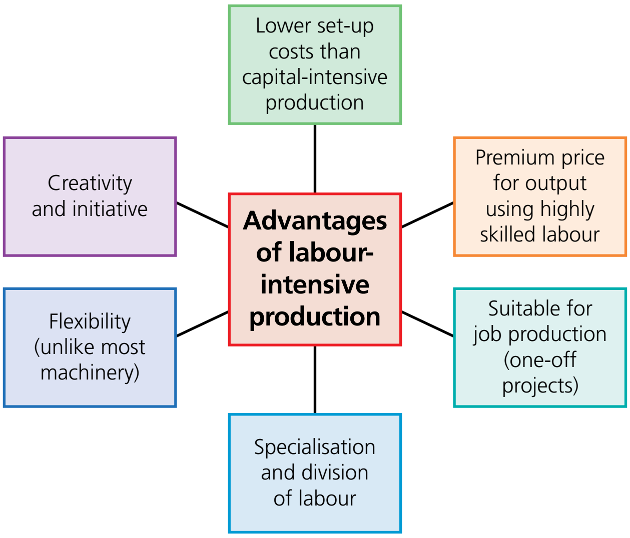


▲ **Figure 21.2** The importance of higher productivity

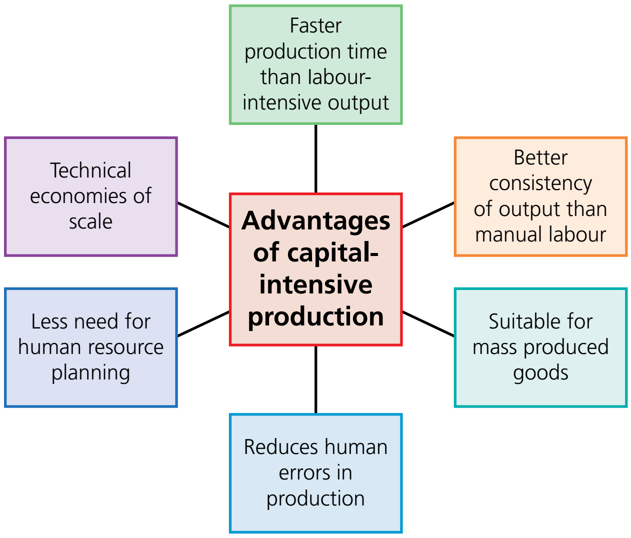


▲ **Figure 21.3** Determinants of productivity

Labour- and capital-intensive production



▲ **Figure 21.4** Advantages of labour-intensive production



▲ **Figure 21.5** Advantages of capital-intensive production

Common errors

REVISED

Error	Why it is wrong
'The more labour that is hired, the more productive the workforce will be.'	Hiring more workers does not necessarily mean they will be more productive (i.e. produce more output per worker). A larger workforce can cause inefficiencies and diseconomies of scale.
'Paying workers more money will always result in lower profits for a firm due to higher costs.'	While higher pay can indeed raise production costs, profits can actually increase if workers become more highly motivated and hence more productive.

Target your revision

REVISED

- Factors of production (land, labour, capital and enterprise) are the resources required to produce goods and services.
- The demand for factors of production is a derived demand, i.e. their demand is dependent on the demand for the goods and services which they are used to produce.
- The demand for factors of production also depends on their cost, availability and quality.
- In labour-intensive industries (e.g. teaching, accountancy, banking and tourism services), the cost of labour is proportionately higher than other factors of production.
- In capital-intensive industries (e.g. car manufacturing and mass-produced soft drinks), the use and cost of capital is more obvious than any other factor of production.
- Production refers to the total output of goods and services in the production process.
- Productivity is a measure of how well (efficiently) resources are used in the production process, e.g. labour productivity measures the efficiency of the workforce in terms of output per worker.
- The main determinants of productivity are the degree of: investment expenditure, innovation, skills and experiences of the labour force, entrepreneurial spirit and competition in the industry.
- Innovation is the commercialisation of new ideas and products, and is a vital source of productivity.

Test yourself

1 Complete the following sentence: The demand for all factors of production (e.g. land, labour, ____________ and enterprise) is said to be ____________ demand.
2 State **two** factors that affect the demand for factors of production.
3 State **three** determinants of productivity.
4 State **four** disadvantages of capital-intensive output.
5 State **four** disadvantages of labour-intensive output.

Answers on pages 146–47

Tip

Remember the difference between 'production' and 'productivity'. Production is the total amount of output of goods and services during the production process. Productivity is how efficient production is, calculating the amount of output per unit of a factor input.

Sample question and answer

REVISED

1 Discuss whether it is in the best interest of workers to specialise. [8]

Student's answer

One argument for specialisation is that workers can be in high demand due to their level of expertise [1]. This can lead to good employment opportunities and high wages for them [1]. It allows workers to develop their skills [1] which can benefit employers from the increased labour productivity.

Another benefit is that specialisation can enable workers to focus on areas they most enjoy [1], e.g. Economics lecturers at university.

However, highly specialised workers have low occupational mobility [1] so will find it difficult should they wish to find alternative careers [1]. Also, doing the same job or tasks every day can be boring and demotivating [1].

Teacher's comments

This is a very good answer, with both advantages and disadvantages given. Relevant examples are also used, such as Economics lecturers. However, there are occasional lapses, such as stating that employers benefit from improved labour productivity (the question is about the benefits of specialisation for workers). Instead, the candidate could have developed the point by mentioning that improved labour productivity and efficiencies enable workers to be paid more for the value of their extra output. 7 marks are awarded.

Exam-style questions

1 Define the term *labour productivity*. [2]
2 Explain why hiring more workers does not necessarily increase productivity. [2]
3 Study the table below and explain which firm is considered to be more labour intensive. [4]

Firm	Labour costs ($)	Capital costs ($)	Other costs ($)
A	80,000	50,000	30,000
B	60,000	30,000	20,000

4 Explain why labour intensity may increase a firm's production costs. [4]
5 Explain why higher productivity is important for an economy. [4]

Answers on page 147

22 Firms' costs, revenue and objectives

Key objectives

The objectives of this chapter are to revise:

- costs of production
- total cost (TC), average total cost (ATC), fixed cost (FC), variable cost (VC), average fixed cost (AFC) and average variable cost (AVC)
- diagrams that show how changes in output affect costs of production
- total revenue (TR) and average revenue (AR)
- the objectives of firms: survival, social welfare, profit maximisation and growth.

Key definitions

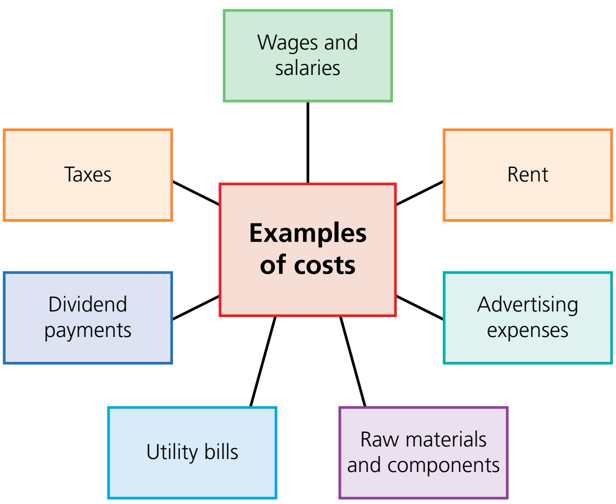
REVISED

Term	Definition
Average fixed cost	A firm's fixed cost per unit of output.
Average revenue	The typical price received from the sale of a good or service.
Average total cost	This refers to the total cost of making one product, i.e. it is the unit cost of production.
Average variable cost	The variable cost of production per unit of output.
Costs of production	A firm's expenditure, e.g. on wages, salaries, rent, fuel bills and loan repayments.
Fixed costs	Costs that a firm has to pay, irrespective of how much it produces or sells, e.g. management salaries, administrative costs, loan repayments and rent.
Objectives	A firm's goals, e.g. business survival, growth, higher market share and profit maximisation.
Profit	The positive difference between a firm's total revenues and its total costs of production.
Profit maximisation	The greatest positive difference between sales revenue and production costs.
Sales revenue	The payment received by a firm from the sale of its goods and/or services.
Total cost	The sum of all fixed costs of production and all variable costs of production.
Total revenue	The amount earned by a firm from the sale of its goods and services.
Variable costs	Costs that change as the level of output changes, e.g. raw material costs and wages.

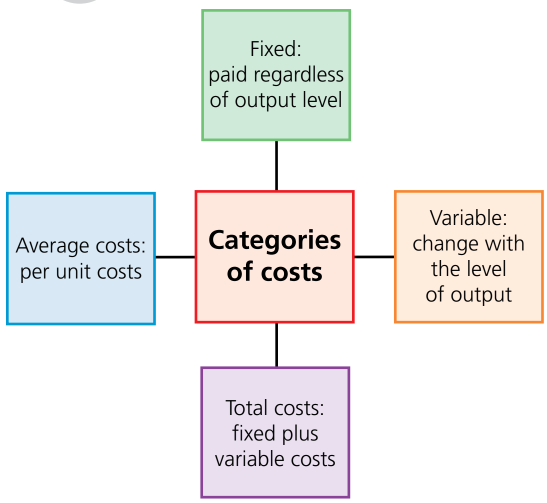
Firms' costs, revenues and objectives

PAGES 155–61

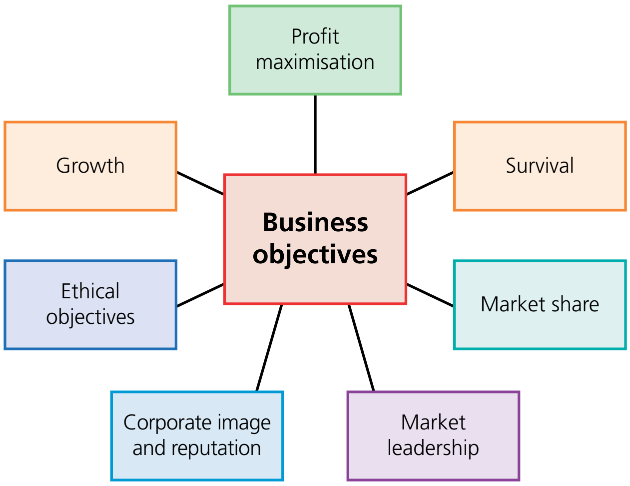
REVISED



▲ **Figure 22.1** Examples of costs



▲ **Figure 22.2** Categories of costs



▲ **Figure 22.3** Business objectives

Common errors

REVISED

Error	Why it is wrong
'The price of a good or service is the cost paid by the customer.'	Costs (of production) are paid by businesses, whereas customers pay the price charged by firms. Price needs to be higher than costs for the business to earn a profit.
'Fixed costs are costs that don't change.'	This is slightly incorrect as fixed costs *can* be changed, e.g. rent charges can be increased. Fixed costs are not directly related to the level of output, so they do not change when the output level changes.

Target your revision

REVISED

- Costs of production are the payments made by firms in the production process, e.g. salaries, advertising expenditure and taxes.
- Fixed costs are the costs of production that a firm has to pay irrespective of its output level, e.g. rent and insurance costs.
- Variable costs are costs of production that change when the level of output changes, e.g. raw material costs and utility bills.
- Total cost is the sum of all fixed and variable costs of production, i.e. $TC = FC + VC$.
- Average fixed cost (*AFC*) is a firm's fixed cost per unit of output, which continually declines as output increases.
- Average variable cost (*AVC*) is a firm's variable cost per unit of output. It falls when the firm experiences economies of scale, e.g. due to discounts for bulk purchases of raw materials.
- The average total cost (*ATC*) is the cost per unit of output, i.e. the total cost of making one product.
- Revenue is the money earned by a firm from the sale of its goods and services.
- Total revenue (*TR*) is the aggregate sum of money a firm receives from selling goods and services, i.e. $TR = P \times Q$.
- Average revenue (*AR*) refers to the typical price received from the sale of a good or service, i.e. $AR = TR \div Q$.

- Objectives (goals) of firms include: survival, social welfare, growth and profit maximisation.
- Profit maximisation is the main goal of most private sector firms.

Test yourself

1. List **five** examples of costs paid by a firm.
2. List **three** examples of fixed costs.
3. What is the formula for calculating total costs?
4. What is the formula for calculating total revenue?
5. State **four** objectives of firms.

Answers on page 147

Tip

When calculating costs and revenues, don't forget to include the currency sign (e.g. $) in your final answer, and write answers to 2 decimal places where appropriate.

Sample question and answer

REVISED

1 Gupta's Candles has fixed costs of $6000 each month. Its average variable costs are $4 per candle. The firm's current level of demand is 3000 candles per month. The average price of its candles is $8.

a) Calculate the firm's current average costs each month. [2]

b) Calculate the firm's current total costs of production each month. [2]

c) Calculate the profit if demand at Gupta's Candles increases to 3500 candles per month. [3]

Student's answer

a) AC = AFC + AVC = ($6000 ÷ 3000) + $4 = $6 [2]

b) TC = TFC + TVC = $6000 + ($4 × 3000) = $18,000 [2]

c) Profit = TR – TC = ($8 × 3500) – ($6000 + ($4 × 3500)) = $8000 [3]

Teacher's comments

For each of the first two questions, 1 mark would be awarded for the working out and 1 mark for the correct answer, which is full marks for each question. For the final question, 2 marks are awarded for the full working out, plus 1 mark for the correct answer. Again, the candidate is awarded full marks.

Exam-style questions

1. Define the term *fixed cost*. [2]
2. Using an example, explain the meaning of variable costs in the car manufacturing industry. [3]
3. Explain why most private sector firms aim to maximise profits. [4]
4. Analyse the effects of an increase in output on a firm's fixed, variable and average costs of production. [6]
5. The data below show the monthly cost structure for a manufacturing company. Assume its average variable costs of production remain constant at all levels of output.

Output level (units)	Total cost ($)
1000	40,000
2000	70,000
3000	100,000

a Calculate the average variable cost of production for the firm. [2]

b Calculate the value of the firm's monthly total fixed cost. [2]

c Calculate the change in the firm's average cost of production if it increases production from 1000 units to 3000 units and comment on your findings. [4]

Answers on page 147

23 Market structure

Key objectives

The objectives of this chapter are to revise:

- the effect of having a high number of firms on price, quality, choice and profit
- the characteristics of monopoly
- the advantages and disadvantages of monopoly.

Key definitions

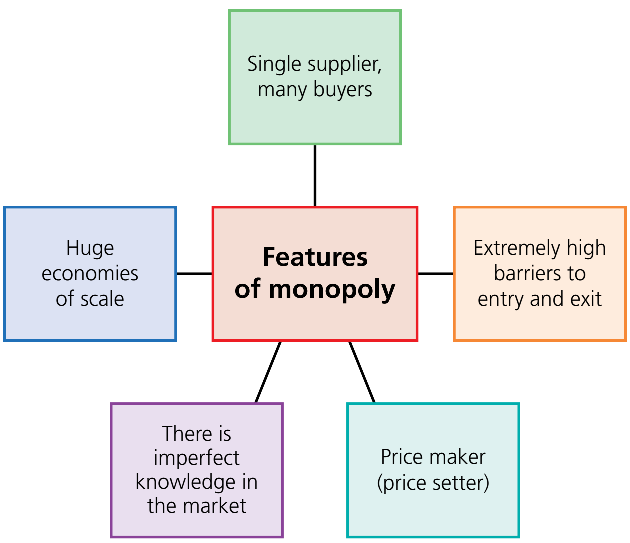
REVISED

Term	Definition
Barriers to entry	The obstacles that prevent firms from entering a market, e.g. the existence of intellectual property rights, large advertising budgets of existing firms, or legal constraints to prevent wasteful competition.
Competitive markets	Industries with a high degree of competition, with low barriers to entry.
Market structure	The characteristics of a particular industry, such as the number and size of firms, the degree and intensity of price and non-price competition, and the nature of barriers to entry.
Monopoly	A market structure where there is only one supplier of a good or service, with the power to affect market supply and prices.
Price maker (price setter)	A firm with significant market power so that it can control enough of the market supply to affect the market price.
Price takers	Firms that set their price according to the market forces of demand and supply, rather than determining their own prices.

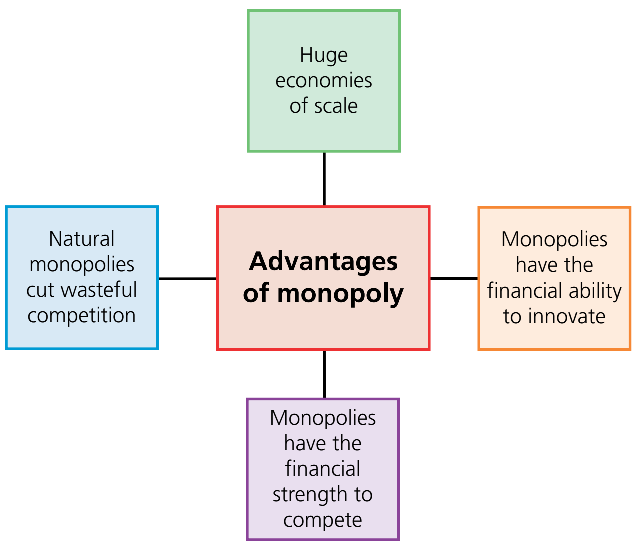
Market structure

PAGES 162–68

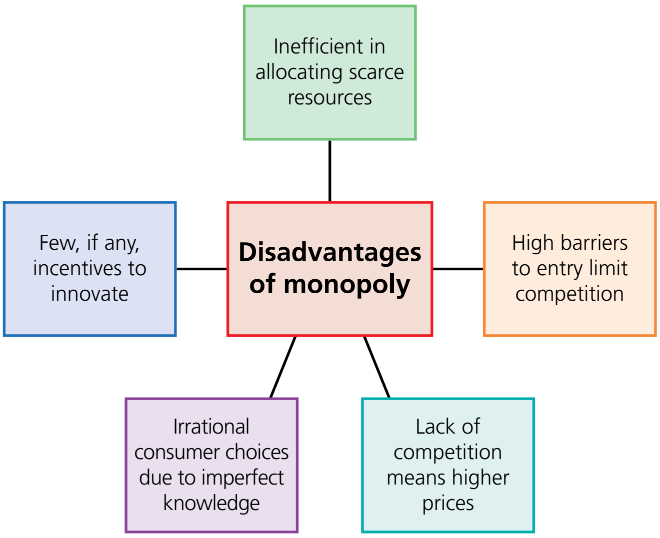
REVISED



▲ **Figure 23.1** Characteristics of monopoly



▲ **Figure 23.2** Advantages of monopoly



▲ **Figure 23.3** Disadvantages of monopoly

Common errors

REVISED

Error	Why it is wrong
'Monopolists can charge whatever price they want as they are the only supplier of a good or service.'	While monopolists have the ability to control market supply, they cannot control the level of market demand. Customers will demand less or go without if prices rise too high. Hence, monopolists must lower prices if they want to sell more.
'Competition is always better than monopoly as a market structure, as prices are lower.'	Competition is not always desirable in a market where a monopolist might be able to provide goods and services at a lower cost due to large economies of scale. Essentially, there are advantages to (some) monopolies.

Target your revision

REVISED

- Market structure refers to the key characteristics of a particular market, in terms of: the number and size of firms in the market, the degree and intensity of price and non-price competition, and the nature of barriers to entry.
- Barriers to entry are the obstacles that prevent firms from entering the market.
- Competitive markets are those with a high degree of competition.
- Price takers are firms that set their price according to the market price, rather than determining their own prices.
- In general, a high degree of competition tends to benefit consumers in terms of higher-quality products, better customer service, greater choice and more competitive prices.
- Monopoly is a market structure where there is only one supplier of a good or service, with the power to affect market supply and prices.
- Characteristics of monopoly include: a single supplier in the market, being a price maker, imperfect knowledge and high barriers to entry.
- Advantages of monopoly include: the potential to supply larger quantities and at lower prices, having the financial resources for research and development, and the elimination of wasteful competition.

- Disadvantages of monopoly include: the potential to exploit customers through higher prices and limited supply, high entry barriers to limit competition, imperfect knowledge which can lead to irrational decision making, and a lack of innovation due to the absence of competition.

Test yourself

1 Complete the following sentence: Monopoly is a market structure where there is ________________ supplier of a good or service, with sufficient market power to affect the industry ________________ or price.
2 What is meant by *market structure*?
3 What are the main characteristics of a monopoly?
4 State **three** advantages of monopoly.
5 State **three** disadvantages of monopoly.

Answers on pages 147–48

Tip

Remember that there can be advantages of monopolies to the economy; they are not necessarily 'bad' for society. More importantly, students should explain and justify their answers.

Sample question and answer

REVISED

1 Analyse why monopolies might be regarded as being inefficient compared to firms in a competitive market. [6]

Student's answer

A monopoly could be said to be inefficient because they can restrict output [1] in order to force prices to increase, i.e. they are price makers [1]. Also, there are major barriers to entry [1], resulting in few/no competitors/substitutes [1]. Again, customers are forced to pay higher prices.

A firm in a more competitive market will have less influence on price [1] if they raise prices. By contrast, firms in competitive markets have to be efficient in order to remain attractive to customers due to the large number of substitutes [1]. They must keep their costs low in order to remain competitive.

Teacher's comments

This is a very good and detailed answer. There is good analysis, with a balanced argument. The last sentence is a bit repetitive, given that the previous sentence says the same thing. Nevertheless, full marks are awarded.

Exam-style questions

1 Explain **two** advantages of reducing monopoly power. [4]
2 Discuss whether more competition in the airline industry would benefit consumers. [8]
3 Discuss whether price is likely to be higher under monopoly or competition. [8]

Answers on page 148

24 The role of government

Key objective

The objective of this chapter is to revise:

- the role of government (locally, nationally and internationally).

Key definitions

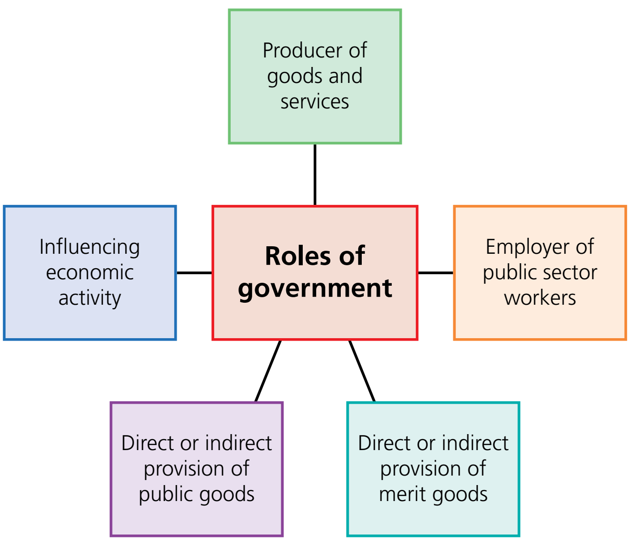
REVISED

Term	Definition
Direct taxes	Government levies (charges) imposed on income, in order to raise government revenue and to redistribute income and wealth in the economy.
Employer	A person or a firm that hires workers to an organisation.
Indirect taxes	Government levies (charges) in order to raise costs and to reduce consumption of certain products, e.g. tobacco, alcohol and petroleum.
Producer	An organisation engaged in the production of goods and/or the provision of services.
Regulation	The rules and laws that govern business behaviour in the economy, e.g. consumer protection legislation and environmental protection laws.
Subsidies	Government financial support to reduce the costs of private sector firms, thereby encouraging output and consumption of certain goods or services, e.g. education and healthcare.
Trading bloc	A free trade area which also promotes the free movement of factors of production between member countries.

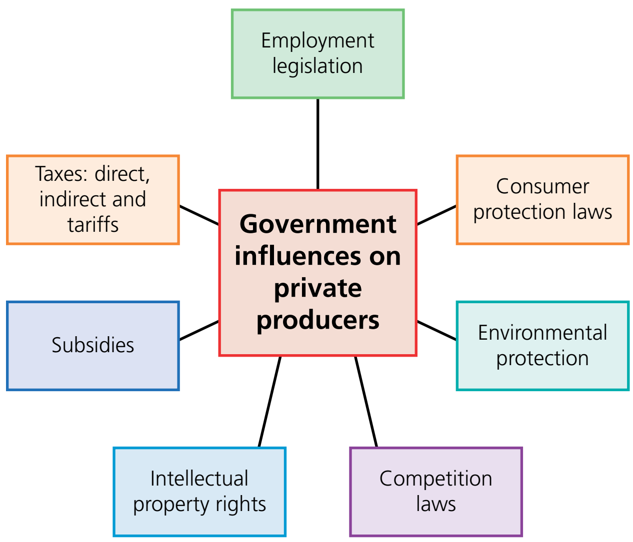
The role of government

PAGES 170–72

REVISED



▲ **Figure 24.1** Roles of government



▲ **Figure 24.2** Government influences on private producers

Common error

REVISED

Error	Why it is wrong
'It is not possible for a government to achieve its macroeconomic objectives without conflicts occurring.'	In the long run, it is possible to achieve several government aims simultaneously, e.g. economic growth is coupled with higher employment, and can happen without inflationary pressures or trade deficits.

Target your revision

REVISED

- The general role of the government is to improve the general welfare of its people.
- The government collects taxes in order to fund its expenditure on essential services.
- The government operates at three levels: local, national and international.
- The national government makes macroeconomic decisions about how best to achieve its macroeconomic aims.
- The national government may make decisions on fiscal policies, monetary policies and supply-side policies in order to achieve its macroeconomic aims.
- It also uses policy measures, such as the Paris Agreement, to protect the environment.
- A regional trading bloc, such as the European Union, is a region that promotes free trade and mobility of factors of production between its member countries.
- The formation of trading blocs requires the international cooperation of governments to facilitate trade agreements with other countries.

Test yourself

1 What is the main role of the government?
2 What is meant by *regulation*?
3 Why do governments impose taxes?
4 State the macroeconomic objectives.

Answers on page 148

Tip

When referring to the role of government, remember to consider the three levels at which it operates: locally, nationally and internationally.

Sample questions and answers

REVISED

1 Explain how governments can influence the economy by using subsidies. [4]

Student's answer

Government subsidies are financial payments made to producers in order to reduce their production costs [1]. *In theory, this encourages an increase in supply, so results in lower prices and more demand* [1]. *Subsidies also help to make domestic producers more internationally competitive* [1], *enabling them to export more goods and services, thus creating domestic employment* [1].

Teacher's comments

This is a very good answer, with two impacts explained very clearly. The candidate shows good understanding of subsidies, their purpose and impact. Full marks are awarded.

2 Explain two ways in which a government can influence the price of a product. [4]

Student's answer

A subsidy [1] *can be used to help lower production costs and hence prices for customers, e.g. healthcare and education* [1]. *A second way is for the government to impose a minimum price* [1], *such as in the case of a minimum wage, when it is trying to encourage more people to find work* [1].

Teacher's comments

This answer shows a good level of understanding of how subsidies and minimum prices can be used to influence the price of a product. Relevant examples are also given, so full marks are awarded.

Exam-style questions

1. Explain how the government may be a producer and an employer. [4]
2. Analyse how government subsidies to agricultural farmers may affect the market for food. [6]
3. Analyse the reasons why a government might choose to build and operate services such as airports. [6]

Answers on pages 148–49

25 The macroeconomic aims of government

Key objectives

The objectives of this chapter are to revise:

- the macroeconomic aims of government
- the reasons behind the choice of aims and the criteria that governments set for each aim
- the possible conflicts between macroeconomic aims.

Key definitions

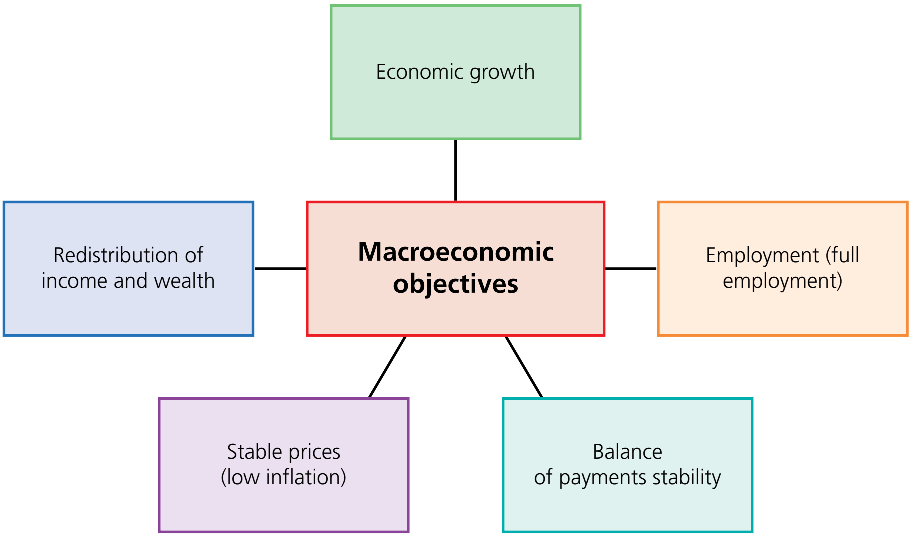
REVISED

Term	Definition
Balance of payments	A financial record of a country's transactions with the rest of the world for a given time period, usually over one year.
Credit items	All payments received from other countries, recorded on the balance of payments.
Debit items	All payments made to other nations, recorded on the balance of payments.
Economic growth	An increase in a country's real gross domestic product (GDP) over time.
Inflation	A sustained rise in the general price level in an economy.
Redistribution of income	The macroeconomic aim of achieving greater equality in the distribution of income in an economy.
Unemployment	Occurs when people are willing and able to work, and are actively seeking employment, but are unable to find work.
Unemployment rate	A measure of the percentage of the labour force that is unemployed: (Number of unemployed people/Number in the labour force) × 100.

The macroeconomic aims of government

PAGES 173–77

REVISED



▲ **Figure 25.1** The macroeconomic aims of government

Common error

REVISED

Error	Why it is wrong
'It is not possible for a government to achieve its macroeconomic objectives without conflicts occurring.'	In the long run, it is possible to achieve several government aims simultaneously, e.g. economic growth is coupled with higher employment, and can happen without inflationary pressures or trade deficits.

Target your revision

REVISED

- Governments try to achieve five macroeconomic aims: economic growth, full employment or low unemployment, stable prices or low inflation, balance of payments stability, and redistribution of income and wealth.
- The government makes macroeconomic decisions about how best to achieve its macroeconomic aims.
- Economic growth refers to an increase in a country's real gross domestic product (GDP) over time. It is shown by an outward shift of the production possibility curve. The government aims to achieve economic growth as it tends to raise standards of living for the majority of the population.
- Unemployment occurs when people are willing and able to work, and actively seeking employment, but are unable to find work.
- Inflation is a sustained rise in the general price level in an economy. It is calculated using a weighted price index, which measures the change in prices of a representative basket of goods and services consumed by the average household.
- The balance of payments is a financial record of a country's transactions with the rest of the world, for a given time period (usually one year).
- Governments aim to achieve greater equality in the distribution of income.
- It is not usually possible for a government to achieve all of its macroeconomic aims at once because there are a number of conflicts between these goals.

Test yourself

1. What are the five macroeconomic objectives of the government?
2. Diagrammatically, how is economic growth shown in a *PPC* diagram?
3. How is the unemployment rate calculated?
4. What is the consumer price index (CPI)?
5. What is the difference between debit and credit items on a country's balance of payments?

Answers on page 149

Tip

One way to remember the five macroeconomic objectives of the government is to use the acronym BUPER:

- **B**alance of payments stability
- **U**nemployment (full employment or low unemployment)
- **P**rice stability (low inflation)
- **E**conomic growth
- **R**edistribution of income and wealth.

Sample questions and answers

REVISED

1 The following table shows the inflation rates for a country over three years. Referring to the data, explain why prices were at their highest in the third year. [2]

Year	1st	2nd	3rd
Inflation rate (%)	1.5	1.1	0.9

Student's answer

Prices were highest in the third year as there has been continual inflation throughout the time period [1]. Although the rate of inflation fell to its lowest in the third year, this only means that prices in general rose at a slower pace of 0.9% [1], so prices were still higher on average [1].

Teacher's comments

This answer shows a good understanding of the meaning and calculation of inflation, so full marks are awarded.

2 Explain why the government aims to achieve low and stable inflation. [4]

Student's answer

Inflation is a sustained rise in the general price level in an economy [1]. The government aims to achieve low or stable inflation in order to make goods and services affordable to the average household [1]. By contrast, high inflation rates make a country less competitive [1].

Teacher's comments

This is a good answer, showing a good understanding of inflation. However, for 4 marks, the answer lacks depth in explaining why low and stable inflation is desirable, and hence a government macroeconomic objective. For example, the candidate could have explained why high inflation makes a country less (internationally) competitive, and why this would be detrimental to the economy. 3 marks are awarded.

Exam-style questions

1 Define the term *economic growth*. [2]
2 Define the term *unemployment*. [2]
3 Define the term *inflation*. [2]
4 Explain why governments try to avoid a persistent deficit on the balance of payments. [2]
5 Explain why governments aim to redistribute income in the economy. [2]

Answers on page 149

26 Fiscal policy

Key objectives

The objectives of this chapter are to revise:

- the budget
- the reasons for government spending
- the reasons for taxation
- the various classifications of taxes
- the principles of taxation
- the impact of taxation on various stakeholders
- fiscal policy
- fiscal policy measures
- the effects of fiscal policy on macroeconomic aims.

Key definitions

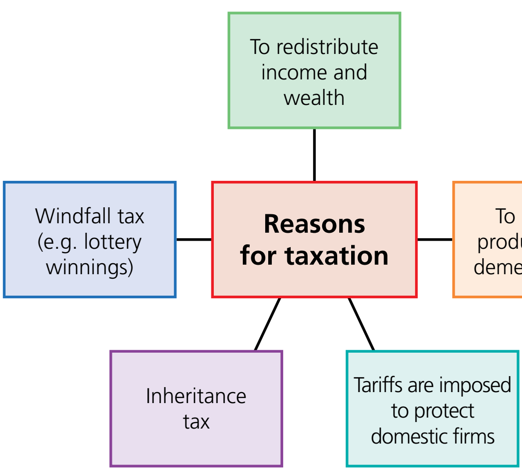
REVISED

Term	Definition
Budget (government budget)	The government's financial plans, in terms of its planned revenues (mainly from taxes) and expenditure (e.g. healthcare, education and welfare payments).
Contractionary fiscal policy	Category of fiscal policy used to combat inflationary pressures by reducing the level of economic activity, i.e. cutting government spending and/or raising taxes.
Direct taxes	Government levies imposed on income, profit and wealth, e.g. income tax.
Expansionary fiscal policy	Category of fiscal policy used to stimulate the economy, by increasing government spending and/or lowering taxes.
Fiscal policy	The use of taxes and government spending to affect macroeconomic objectives, including redistribution of income and wealth.
Indirect taxes	Government levies imposed on expenditure, e.g. sales taxes, customs duties.
Progressive taxation	A tax system that deducts a larger proportion of tax as a person's income level increases, e.g. income tax and capital gains tax.
Proportional taxation	A tax system that deducts the same proportion of tax at all levels of income.
Regressive taxation	A tax system that deducts a smaller proportion of tax as a person's income increases, e.g. sales taxes and customs duties.
Tax	A government levy on income and expenditure, used to fund government spending and affect the level of economic activity in a country.

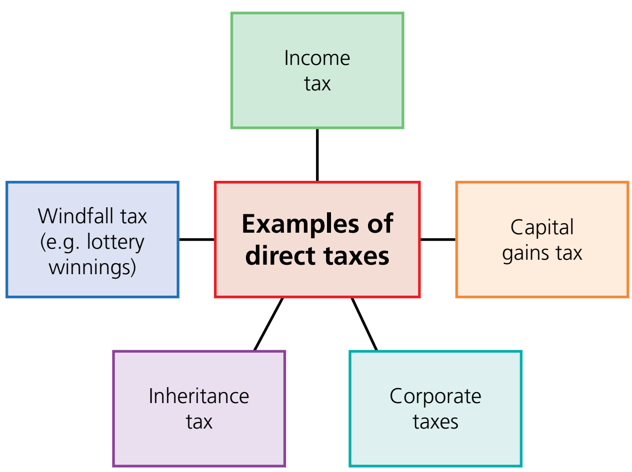
Fiscal policy

PAGES 178–88

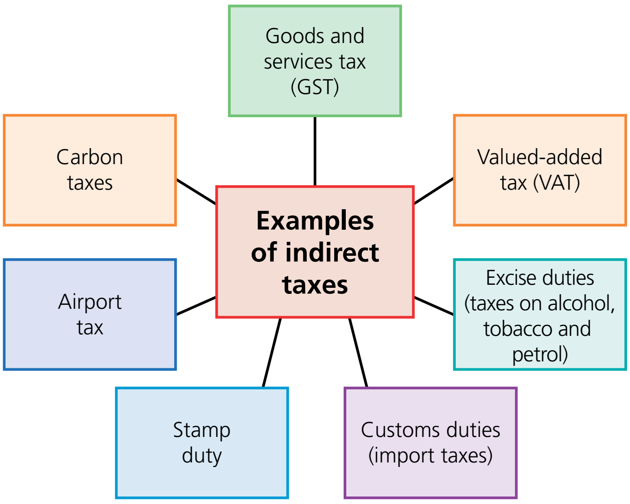
REVISED



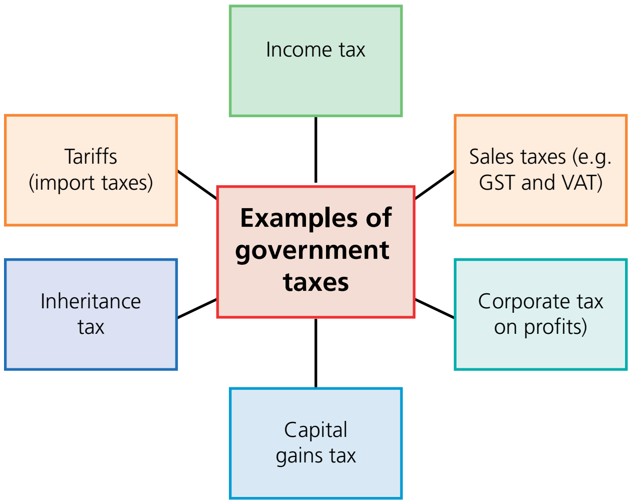
▲ **Figure 26.1** Reasons for taxation



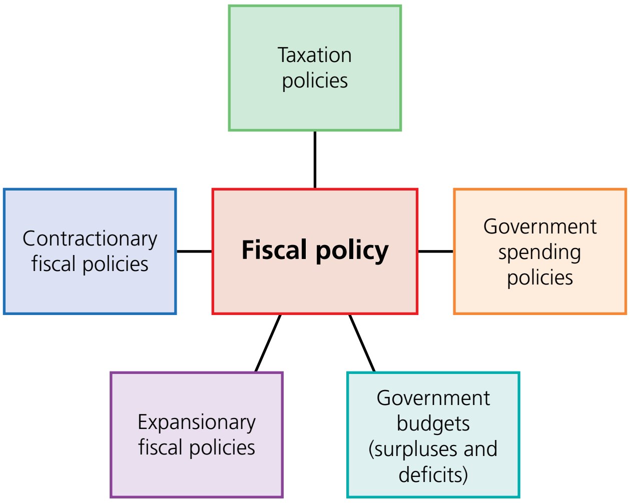
▲ **Figure 26.2** Examples of direct taxes



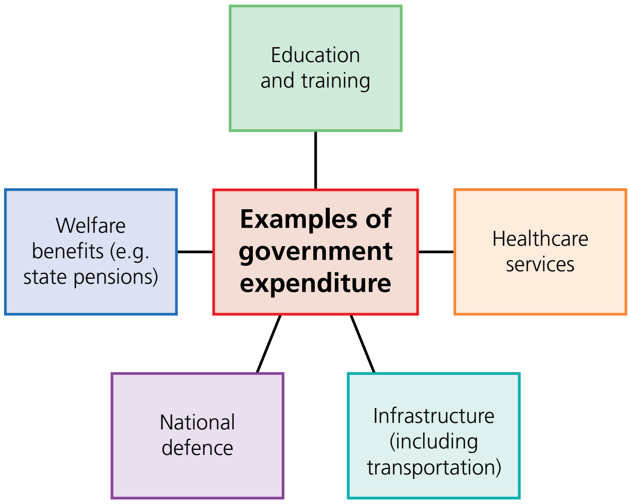
▲ **Figure 26.3** Examples of indirect taxes



▲ **Figure 26.4** Examples of government taxes

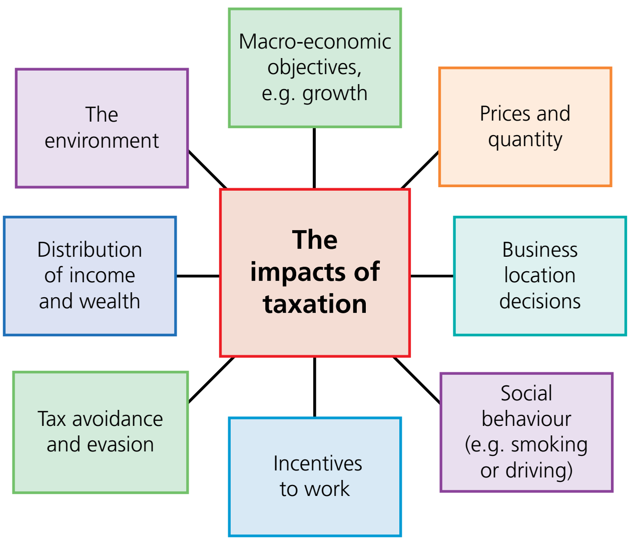


▲ **Figure 26.5** Fiscal policy



▲ **Figure 26.6** Government spending

The impacts of taxation



▲ **Figure 26.7** The impacts of taxation

Common errors

REVISED

Error	Why it is wrong
'A progressive tax system is one in which the rich pay more tax than the poor.'	The rich would pay more tax than the poor even if there were a flat-rate tax system – the amount paid by a higher income earner would be more than the amount paid by a low income earner. In a progressive tax system, the rich pay a higher *rate* (percentage) of tax.
'Proportional income taxes are the fairest category of taxation.'	This type of tax deducts the same proportion of tax at all levels of income, but this does not mean it is 'fair' – the relatively rich have a greater ability to pay a higher proportion of their income in tax.
'Fiscal policies only affect the demand side of the economy.'	While changes in government spending and/or taxes have a direct impact on the level of aggregate demand, expansionary fiscal policies do have an indirect impact on aggregate supply in the long run.

Target your revision

REVISED

- The budget is a financial plan of the government's intended revenues and expenditure.
- The budget can be in balance (revenue = expenditure), deficit (revenue < expenditure) or surplus (revenue > expenditure).
- Reasons for government spending include: to provide essential goods and services, to redistribute income and wealth, and to correct market failures.
- The main reason for taxation is to raise funds for government expenditure.
- A tax is a government levy on income or expenditure.
- Taxation directly impacts on consumers, the government and the economy as a whole.
- Tax burden refers to the amount of tax that households and firms have to pay.
- Classifications of tax include: direct, indirect, progressive, proportional and regressive.
- The principles of a good tax are: equity, economy, convenience, certainty, efficiency and flexibility.
- Fiscal policy is the use of taxation and government expenditure strategies to influence the level of economic activity and macroeconomic aims.
- Taxation and government spending have a direct impact on all five macroeconomic aims.

Tip

Make sure you know the difference between tax evasion (the illegal act of not paying the correct amount of tax) and tax avoidance (the legal act of minimising tax payments).

Test yourself

1. List **four** items of government spending.
2. What is the difference between a budget deficit and a budget surplus?
3. What are the **six** principles of taxation?
4. What is the difference between tax evasion and tax avoidance?
5. What is the difference between expansionary and contractionary fiscal policy?

Answers on page 149

Tip

Fiscal policy has macroeconomic impacts, so when analysing the impact of either contractionary or expansionary fiscal policy, consider the likely impacts on economic growth, employment, inflation, the balance of payments and the redistribution of income.

Sample question and answer

REVISED

1 Discuss whether increasing the rate of sales tax in a country would benefit the economy. [8]

Student's answer

Increasing the rate of sales tax can generate more tax revenue [1]*, enabling the government to spend more on education and healthcare* [1]*. It can also discourage the consumption of demerit goods* [1] *such as alcohol and cigarettes which cause external costs to third parties* [1]*. Finally, raising sales taxes can help to reduce consumption in the economy, so helps to combat demand-pull inflation* [1]*.*

However, sales taxes are regressive [1] *so raising them simply means the poor end up paying an even larger proportion of their income on sales taxes when they buy goods and services* [1]*. Also, if sales taxes are raised too much, it can cause cost-push inflation* [1] *and reduce the international competitiveness of the economy* [1]*, possibly leading to lower GDP and higher unemployment.*

Teacher's comments

This is an excellent answer, as the candidate has provided a balanced and in-depth discussion of the costs and benefits of raising sales taxes. There is consideration of several stakeholder groups, including the government, low-income earners, consumers and producers. Full marks are awarded.

Exam-style questions

1 Explain the difference between progressive and regressive taxes. [3]
2 Explain **two** reasons why governments impose taxes. [4]
3 Explain why an increase in economic activity is likely to increase tax revenue. [4]
4 Explain **two** advantages of using fiscal policy to achieve macroeconomic objectives. [4]
5 Explain **two** disadvantages of using fiscal policy to control the economy. [4]

Answers on pages 149–50

27 Monetary policy

Key objectives

The objectives of this chapter are to revise:

- money supply
- monetary policy
- monetary policy measures
- the effects of monetary policy on macroeconomic aims.

Key definitions

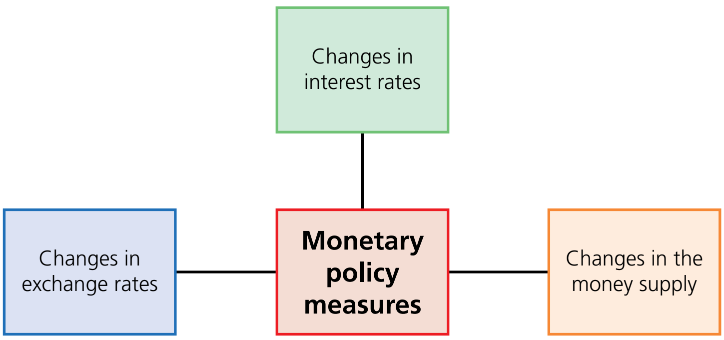
REVISED

Term	Definition
Contractionary monetary policy (tight monetary policy)	Category of monetary policy that aims to slow down economic activity by increasing interest rates to cut spending and investment in the economy.
Expansionary monetary policy (loose monetary policy)	Category of monetary policy that aims to boost economic activity by expanding the money supply, achieved mainly by lowering interest rates.
Monetary policy	The use of interest rates and the money supply to control macroeconomic objectives and to influence the level of economic activity.
Money supply	The amount of money in the economy at a particular point in time, e.g. coins, banknotes, bank deposits and central bank reserves.
Quantitative easing (QE)	A form of monetary policy which involves directly injecting money into the economy via the central bank purchasing bonds (a debt security or a promise to pay a lender at a later date).

Monetary policy

PAGES 189–92

REVISED



▲ **Figure 27.1** Monetary policy measures

Common error

REVISED

Error	Why it is wrong
'The money supply is the sum of all notes and coins (money) in the economy at any point in time.'	The money supply is more than just banknotes and coins; it also includes bank deposits and central bank reserves. In fact, physical notes and coins at any point in time tend to be only a very small proportion of the money supply.

Target your revision

REVISED

- The money supply refers to the amount of money in the economy at a particular point in time.
- The money supply consists of coins, banknotes, bank deposits and central bank reserves.
- Monetary policy refers to the use of interest rates, exchange rates and the money supply to control macroeconomic objectives and to affect the level of economic activity.
- Monetary policy measures include: controlling the money supply, the manipulation of exchange rates, and the use of interest rate policy.
- Expansionary (or loose) monetary policy is used to boost economic activity by expanding the money supply or lowering interest rates.
- Tight (or contractionary) monetary policy involves increasing interest rates in order to reduce overspending and limit investment in the economy.

Tip

When referring to interest rates, remember that there is no single interest 'rate' in an economy. Instead, a structure of different interest rates exists for different financial services, such as short-term bank overdrafts, medium-term loans, credit cards and long-term mortgages.

Test yourself

1. Complete the following sentence: The money supply is the amount of ______________ and banknotes, bank ______________ and central bank reserves at a particular point in time.
2. What is meant by monetary policy, and what is it used to achieve?
3. What is the difference between expansionary and contractionary monetary policy?
4. State **two** limitations of monetary policy.

Answers on page 150

Sample question and answer

REVISED

1. Analyse how monetary policies can be used to control the general price level. [6]

Student's answer

An increase in interest rates [1] helps to reduce the amount of borrowing in the economy [1], so limits pressures on demand-pull inflation. It also encourages some people to save more [1], so they spend less. Another way is to reduce the exchange rate in order to increase the price of imported goods and services. This helps to give domestic firms a price advantage as they have lower prices.

Teacher's comments

The first part of the answer is good. However, the second reason is incorrect. A lower exchange rate is likely to lead to more export earnings, thus adding to inflationary pressures rather than helping to control the general price level. 3 marks are awarded.

Exam-style questions

1. Define the term *monetary policy*. [2]
2. Explain how monetary policy can be used to influence the level of economic activity. [4]
3. Explain how the use of interest rate policy can help a country to control its inflation rate. [4]
4. Analyse how monetary policy can be used to reduce the rate of inflation in an economy. [6]

Answers on page 150

28 Supply-side policy

Key objectives

The objectives of this chapter are to revise:

- the definition of supply-side policy
- the various supply-side policy measures
- the effects of supply-side policy measures on macroeconomic aims.

Key definitions

REVISED

Term	Definition
Deregulation	A form of supply-side policy aimed at making markets more competitive by removing barriers to entry and market imperfections.
Enterprise zones	Locations with relatively high rates of unemployment, which are therefore targeted by the government as areas in need of support, by creating financial incentives for firms to (re)locate to these areas.
Labour market reforms	Supply-side policies that make labour markets more flexible, resulting in greater productivity. Examples include reducing the power of trade unions, unemployment benefits and the national minimum wage.
Privatisation	A form of supply-side policy that involves selling off state-owned assets to the private sector, to raise government revenue and to improve competition, efficiency and productivity.
Supply-side policies	The long-term strategies aimed at increasing the productive capacity of the economy by improving the quality and/or quantity of factors of production.

Supply-side policies

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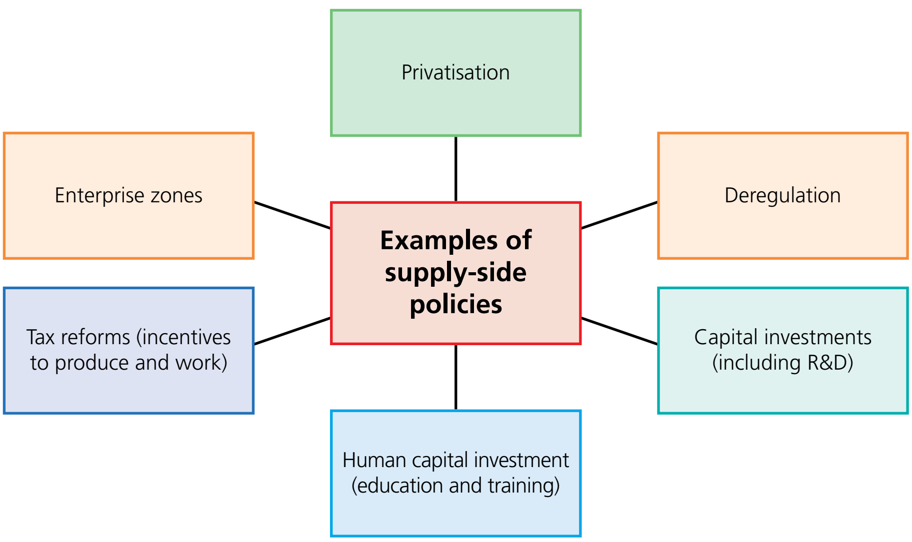
REVISED



▲ **Figure 28.1** Supply-side policies

Common error

REVISED

Error	Why it is wrong
'Supply-side policies have no impact on demand in the economy.'	While supply-side policies are long-term strategies aimed at increasing the productive capacity of the economy, measures such as improved education and labour market reforms can certainly increase consumption and investment expenditure in the economy.

Target your revision

REVISED

- Supply-side policies are long-term measures to increase the productive capacity of the economy, leading to an outward shift of the production possibility curve.
- Examples of supply-side policy measures include: education and training, labour market reforms, deregulation, incentives to work, incentives to invest and privatisation.
- Supply-side policies focus on the importance of investment in research and development (R&D), new product development, new technologies and infrastructure.
- Lower direct taxes tend to create incentives for work, especially for those on low wages.
- Reducing welfare benefits to the unemployed can create incentives for them to seek employment.
- Deregulation involves the reduction or removal of barriers to competitive markets.
- Lower direct taxes can create incentives for firms to invest in their pursuit of profit maximisation.
- Privatisation is the act of selling state-owned assets in order to increase competition, productivity and efficiency.
- Supply-side policy measures can be used to achieve sustainable economic growth, full employment/low unemployment, stable prices/low inflation and balance of payments stability, and to redistribute income in the economy.

Test yourself

1 Complete the following sentence: Supply-side policies are ________________-term measures to increase the productive ________________ of the economy, leading to an outward shift of the ________________ possibility curve.
2 State **four** examples of supply-side policies.
3 What is meant by labour market reforms in the context of supply-side policies?
4 How do direct tax cuts help to improve incentives to work?
5 Why is deregulation an example of supply-side policies?

Answers on page 150

Tip

Although supply-side policies take time to implement and to reap benefits, make sure you can explain how and why such policies can help the government to achieve all five of its macroeconomic aims: economic growth, full employment (low unemployment), stable prices (low inflation), balance of payments stability and the redistribution of income.

Sample question and answer

REVISED

1 Analyse how supply-side policies can help to achieve any **two** macroeconomic objectives. [6]

Student's answer

Supply-side policies can help to achieve economic growth and low unemployment. Supply-side policies, such as education and healthcare [1], aim to shift the production possibility curve of the economy outwards to the right [1]. This means a greater ability to achieve higher levels of national output [1], thus leading to economic growth. Supply-side policies ultimately help to improve the efficiency and competitiveness of firms [1]. Therefore, in the long run, more jobs are created [1]. Hence, this helps the government to achieve its macroeconomic goal of low unemployment [1].

Teacher's comments

This is a detailed answer, which explains how supply-side policies help to achieve economic growth and low unemployment. There is appropriate use of Economics terminology and suitable use of examples. Full marks are awarded.

Exam-style questions

1 Define the term *supply-side policies*. [2]
2 Define the term *privatisation*. [2]
3 Explain how supply-side policies can help to achieve a healthy balance of payments. [3]
4 Explain how lower taxes can create incentives to work and invest. [4]
5 Analyse how **two** supply-side policy measures could improve the performance of an industry. [6]

Answers on pages 150–51

29 Economic growth

Key objectives

The objectives of this chapter are to revise:

- the definition of economic growth
- the measurement of economic growth using real gross domestic product (GDP) and GDP per head
- the causes and consequences of recession
- the causes and consequences of economic growth
- the effectiveness of policies to promote economic growth.

Key definitions

REVISED

Term	Definition
Boom	A phase in the business cycle when the level of economic activity rises, caused by an increase in any combination of consumption, investment, government spending and net export earnings.
Business cycle (trade cycle)	Fluctuations in a country's economic activity over time, thus creating a long-term trend of economic growth in the economy.
Consumption	The value of all private household expenditure in a country, per time period.
Economic growth	The increase in the level of national output over time, i.e. the annual percentage change in GDP.
GDP per capita (or GDP per head)	Measures the GDP of a country divided by the population size. It is a key measure of a country's standard of living.
Government expenditure	The total value of a government's consumption and investment spending.
Gross domestic product (GDP)	Measures the monetary value of all goods and services produced within a country, per time period (usually one year).
Investment expenditure	The sum of capital spending by all businesses within a country.
Net exports	The monetary value of the difference between a country's export earnings and its expenditure on imports.
Nominal gross domestic product (GDP)	Measures the monetary value of goods and services produced within a country for a given period of time, usually one year.
Peak	A phase in the business cycle when economic activity is at its highest level, so unemployment is low and confidence levels are high.
Real GDP	The value of national income (GDP) adjusted for inflation to reflect the true value of goods and services produced in a given year.
Recession	A phase in the business cycle that occurs when there is a fall in GDP for two consecutive quarters.
Recovery	A phase in the business cycle when the level of GDP starts to rise, thus recovering from a slump. Gradually, employment opportunities emerge.
Slump (or trough)	A phase in the business cycle when consumption, investment and net export earnings are low, resulting in high unemployment and mass business failure.

Economic growth

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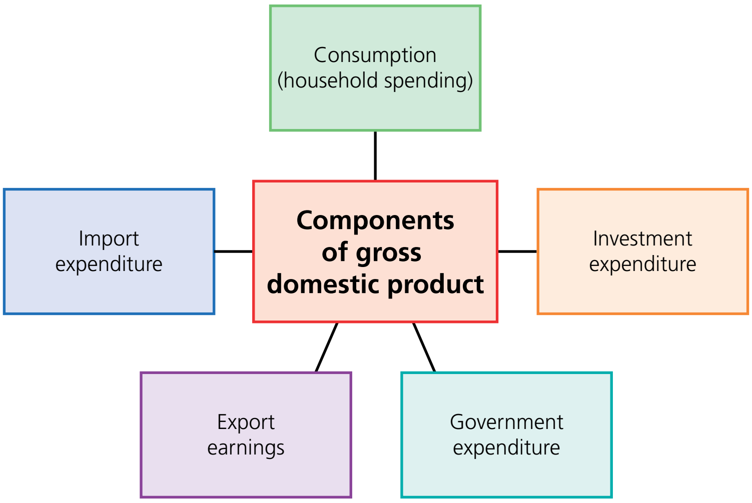
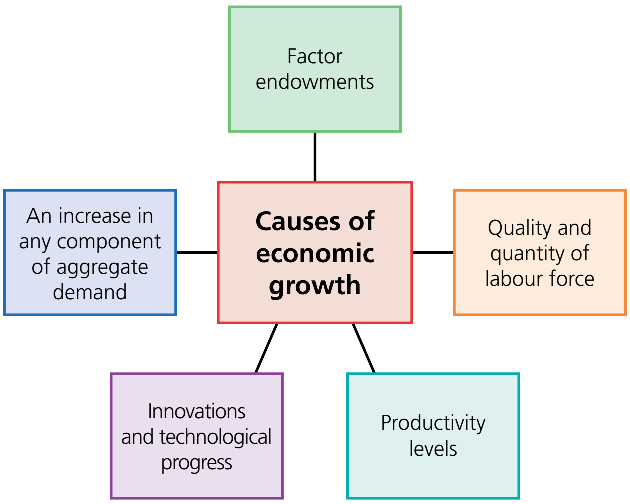
REVISED

Gross domestic product

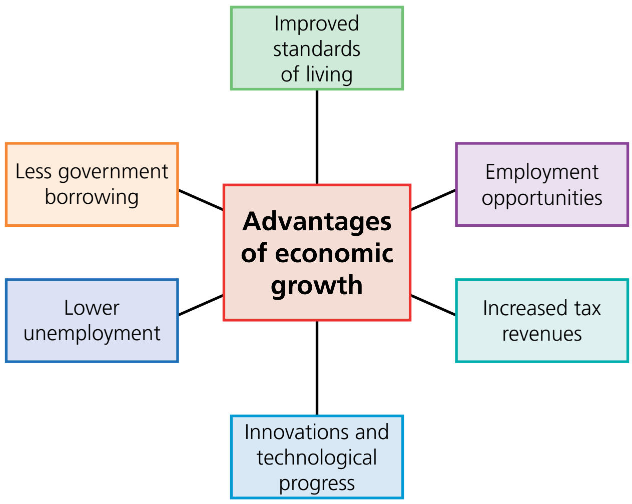


▲ **Figure 29.1** Components of gross domestic product

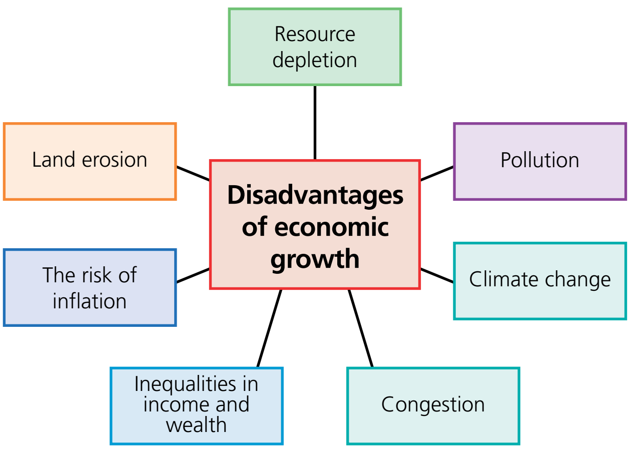
Economic growth



▲ **Figure 29.2** Causes of economic growth

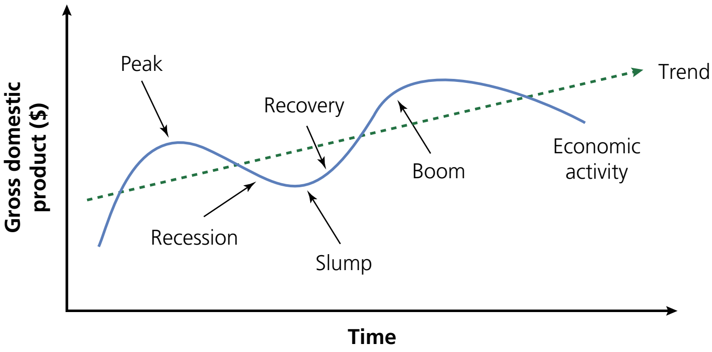


▲ **Figure 29.3** Advantages of economic growth



▲ **Figure 29.4** Disadvantages of economic growth

The business cycle



▲ **Figure 29.5** The business cycle

Common error

REVISED

Error	Why it is wrong
'Economic growth is a desirable macroeconomic objective because everyone benefits from it.'	While economic growth is generally seen as a desirable macroeconomic objective, individuals do not benefit equally from economic growth. It is important to consider the distribution of national income and income inequalities.

Target your revision

REVISED

- Economic growth is the increase in the level of national output, i.e. the annual percentage change in the country's gross domestic product (GDP). It can be represented in a diagram by an outward shift of the *PPC*.
- Economic growth can be measured using real gross domestic product (GDP) and GDP per head (or GDP per capita).
- Nominal gross domestic product (GDP) measures the monetary value of goods and services produced within a country, per year.
- Real GDP refers to the value of national income (GDP) that is adjusted for inflation.
- GDP per head (GDP per capita) measures the GDP of a country divided by the population size.
- The business cycle (also known as the **trade cycle**) describes the fluctuations in economic activity in a country over time: boom, recession, slump and recovery.
- Causes of economic growth depend on the quality and quantity of a country's factors of production, e.g. factor endowments, the labour force, labour productivity and investment expenditure.
- There are both positive and negative consequences of economic growth.
- Policies to promote economic growth include: expansionary fiscal policy, loose monetary policy and supply-side policies.

Test yourself

1 Complete the following sentence: Economic growth is an increase in the level of national ______________, i.e. the annual percentage change in the country's gross ______________ product.
2 What is the difference between consumption and investment?
3 What are net exports?
4 What is the business cycle?
5 What are the positives of economic growth?
6 What are the negatives of economic growth?
7 What are the **three** main macroeconomic objectives used to achieve economic growth?

Answers on page 151

Tip

While governments strive to achieve economic growth, remember that there can be negative impacts of economic growth. In reality, governments aim to achieve stable and sustainable rates of economic growth.

Sample question and answer

REVISED

1 Analyse how fiscal policies can be used to achieve economic growth. [8]

Student's answer

Fiscal policy refers to direct use of tax and government spending policies [1] *to influence the level of economic activity* [1]*. For example, a reduction in tax rates and an increase in government spending* [1] *can be used to achieve economic growth. A reduction in income tax rates may encourage people to go back to work* [1] *as they have to pay less income tax. A cut in corporate tax rates means firms can spend more on investment* [1] *as their profits are higher* [1]*. Government spending on large infrastructure projects, such as motorways, schools or hospitals* [1]*, can create many jobs, which helps to boost spending in the economy* [1]*. In the long run, government spending on these projects can make the economy more productive and attract foreign direct investment* [1] *which may lead to further economic growth* [1].

Teacher's comments

This is a thorough answer that shows a very good understanding of the demands of the question. The term 'fiscal policy' is clearly defined. The candidate refers to both tax cuts and increased government spending, and uses appropriate examples, to explain how fiscal policy can help to achieve economic growth. Full marks are awarded.

Exam-style questions

1 Define the term *economic growth*. [2]
2 Define the term *real GDP*. [2]
3 Explain what is meant by *the business cycle*. [2]
4 Explain **two** positive consequences of economic growth. [4]
5 Explain **three** causes of economic growth. [6]

Answers on page 151

30 Employment and unemployment

Key objectives

The objectives of this chapter are to revise:

- the definitions of employment, unemployment and full employment
- changing patterns and levels of employment
- the measurement of unemployment
- the causes/types of unemployment
- the consequences of unemployment
- policies to reduce unemployment.

Key definitions

REVISED

Term	Definition
Claimant count	Measures the number of people who are out of work and claiming unemployment benefits.
Cyclical unemployment	Type or cause of unemployment resulting from a lack of demand in the economy, which causes a fall in national income.
Employment	The use of factors of production in the production process. The term is usually applied to the use of labour resources.
Employment sector	The sector of the economy in which people work, i.e. primary, secondary (manufacturing) or tertiary sector.
Female participation rate	Measures the proportion of women who are active in the labour force.
Formal sector employment	Officially recorded employment, with workers paying income taxes and contributing to the country's official GDP.
Frictional unemployment	Transitional unemployment that occurs when people change jobs, due to the time delay between leaving a job and finding or starting a new one.
Full employment	Situation when everyone in a country who is willing and able to work has a job.
Labour force survey	Alternative measure of unemployment devised by the International Labour Organisation, using a standardised household-based survey to collect work-related statistics.
Structural unemployment	Type or cause of unemployment when the demand for products produced in a particular industry continually falls, often due to foreign competition.
Unemployment	This occurs when people of working age who are willing and able to work cannot find employment.
Unemployment rate	The percentage of a country's workforce that is out of employment.

Success groups (S & N)

Employment and unemployment

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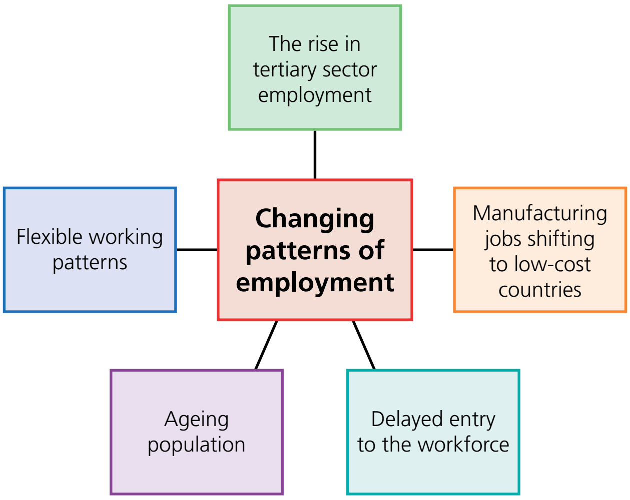
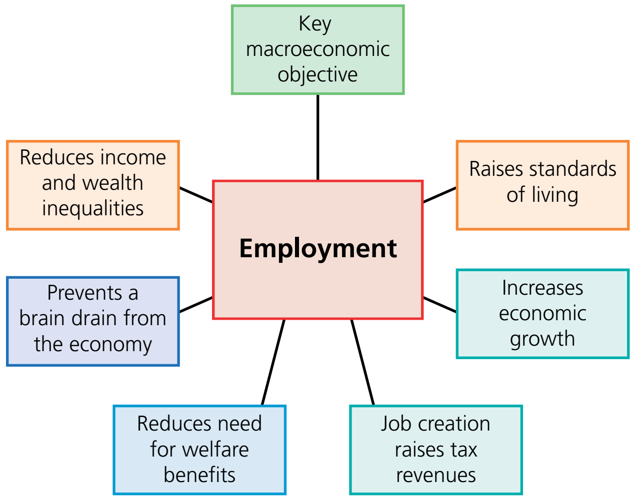
Employment

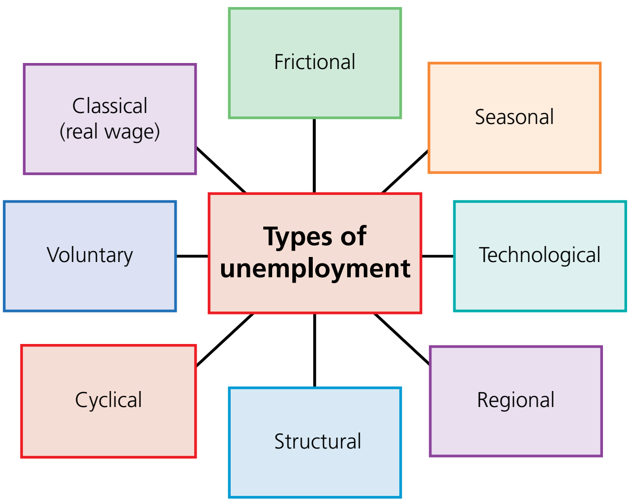


▲ **Figure 30.1** Changing patterns of employment

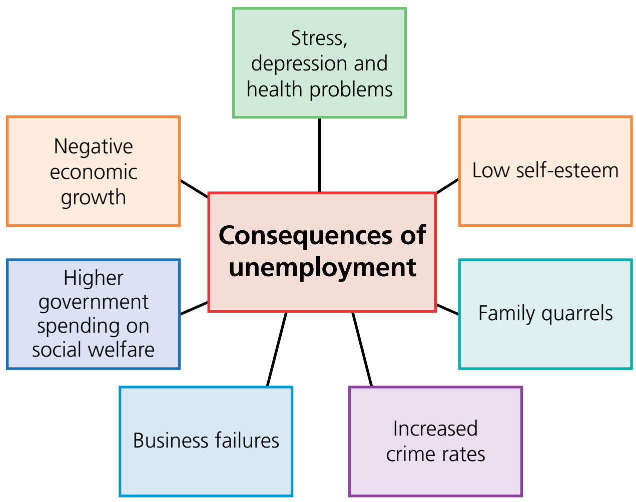


▲ **Figure 30.2** Employment

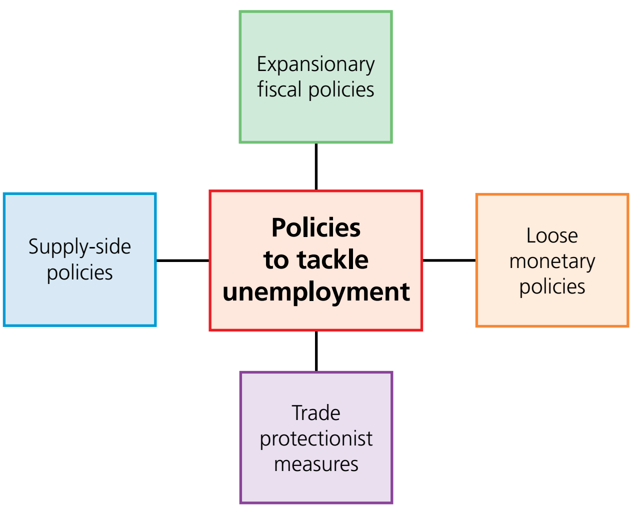
Unemployment



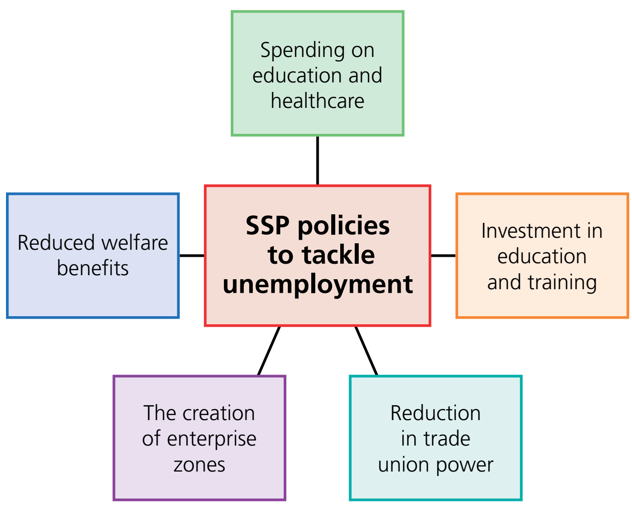
▲ **Figure 30.3** Types (causes) of unemployment



▲ **Figure 30.4** Consequences of unemployment



▲ **Figure 30.5** Policies to tackle unemployment



▲ **Figure 30.6** Supply-side policies to deal with unemployment

Unemployment rate

To work out the unemployment rate, use either of the following formulae:

$$\frac{\text{Number of unemployed}}{\text{Workforce}} \times 100$$

Alternatively, this can be expressed as:

$$\frac{\text{Number of unemployed}}{\text{Number of unemployed} + \text{employed} + \text{self-employed}} \times 100$$

Common errors

REVISED

Error	Why it is wrong
'Employment means everyone in the economy has a job.'	Not everyone of working age is *willing* to participate in employment. This depends on the country's welfare scheme (e.g. unemployment benefits) and social attitudes (e.g. attitudes towards women in the workforce).
'Employment measures the number of people who are hired by businesses in the country.'	Employment includes all people hired to work in businesses, but also includes people in self-employment.

Target your revision

REVISED

- Employment refers to the economic use of labour as a factor of production, with people working in the primary, secondary or tertiary sectors of the economy.
- Unemployment occurs when people of working age are both willing and able to work but cannot find employment.
- As a country develops, the number of people employed in the primary sector tends to fall, with the majority employed in the tertiary sector.
- Changing employment patterns include: delayed entry into the workforce, ageing populations, higher female participation rates, a lower proportion of public sector employment and flexible working patterns.
- Unemployment can be calculated using either the claimant count or labour force survey.
- Types of unemployment include: frictional, structural and cyclical unemployment.
- Policies to tackle unemployment include: fiscal policy, monetary policy, protectionist measures and supply-side policies (e.g. investment in education and training, reduction of trade union power, creating incentives for firms to increase output and reducing welfare benefits).

Test yourself

1 Complete the following sentence: Unemployment occurs when people of ________________ age are both willing and ________________ to work but cannot find employment.

2 State **three** reasons why high employment or full employment may be desirable.

3 What is full employment?

4 What is the claimant count?

5 What is the unemployment rate?

Answers on page 151

Tip

Students often define or comment on unemployment as being a situation when people do not have a job. This is not entirely accurate as there are people who are not willing and/or able to work, even if they are of working age, e.g. full-time university students or those who have chosen to retire early. Economists consider unemployment to exist if people are both able and willing to work, but are not able to find employment.

Sample questions and answers

REVISED

1 Calculate the unemployment rate if the population is 70 million people, of which 31 million are employed, 6 million are self-employed and 5 million are unemployed. [2]

Student's answer

Unemployment rate = (5m/(31m + 6m + 5m)) × 100 = 11.9% [2]

Teacher's comments

The candidate shows the correct working out and answer (to 1 decimal place in this case), so full marks are awarded.

2 Discuss whether unemployment is harmful for the economy. [8]

Student's answer

Unemployment is very harmful for the economy. First, there is lower output, so less GDP [1]*, which lowers standards of living in the economy* [1]*. In the long run this can cause increased poverty* [1]*. For the government, they have to pay out more for social security yet receive less income tax revenue* [1]*. For the unemployed, the pressures can cause family and marriage breakups, and health problems* [1]*.*

Teacher's comments

This is a good answer, but it is unbalanced, i.e. one-sided. The question asks not only for the problems of unemployment, but for a discussion (two-sided argument) about whether unemployment is (always) harmful. Some unemployment, such as frictional or voluntary unemployment, is always present, which is not necessarily harmful to the economy. The candidate could also have considered the duration of unemployment, e.g. short-term versus long-term unemployment (during a major recession). Some unemployment might also put downward pressure on inflation. For a one-sided answer, a maximum of 5 marks can be awarded.

Exam-style questions

1 Calculate the unemployment rate in a country with a population of 65 million people, of whom 36 million are employed and 4 million are unemployed. [2]
2 Explain the difference between the rate of unemployment and the level of unemployment. [2]
3 Explain how government spending on unemployment benefits is an example of opportunity cost. [3]
4 Explain why employment is a macroeconomic objective of all governments. [4]
5 Explain **two** causes of an increase in the size of a country's labour force. [4]
6 Explain the difference between cyclical and frictional unemployment. [4]
7 Analyse the impact of a rise in unemployment on the living standards in a country. [6]
8 Analyse why the pattern of employment in a country can change over time. [6]

Answers on pages 151–52

31 Inflation and deflation

Key objectives

The objectives of this chapter are to revise:

- the definitions of inflation and deflation
- the measurement of inflation and deflation using the Consumer Price Index (CPI)
- the causes and consequences of inflation
- the causes and consequences of deflation
- policies to control inflation and deflation.

Key definitions

REVISED

Term	Definition
Base year	The starting or reference year, used to calculate a price index.
Consumer Price Index (CPI)	A weighted index of consumer prices in an economy over a period of time, used to measure the cost of living for an average household.
Cost-push inflation	A cause of inflation, triggered by higher costs of production, which force up prices.
Deflation	The sustained fall in an economy's general price level, i.e. the inflation rate is negative.
Demand-pull inflation	A major cause of inflation, triggered by increased aggregate demand in the economy, which forces up the average price level.
Disinflation	This occurs when the inflation rate falls, but is still positive (above zero), i.e. prices are generally still rising, but at a slower rate.
Imported inflation	A cause of inflation triggered by higher import prices of raw materials and components. This raises production costs, so fuels domestic inflation.
Inflation	The sustained rise in the general level of prices of goods and services in an economy over time, usually measured by a consumer price index.
Reflation	The opposite of disinflation, this occurs when the rate of inflation increases.
Wage–price spiral	This occurs when trade unions negotiate higher wages due to inflation, but this fuels inflation as firms raise prices to preserve profit margins.

Inflation and deflation

PAGES 216–27

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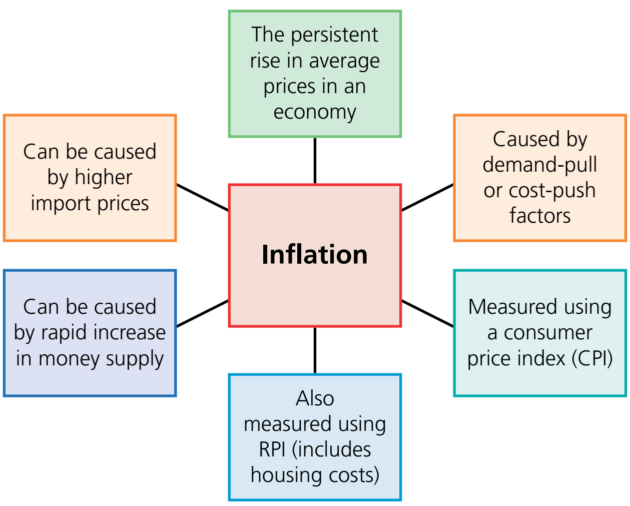
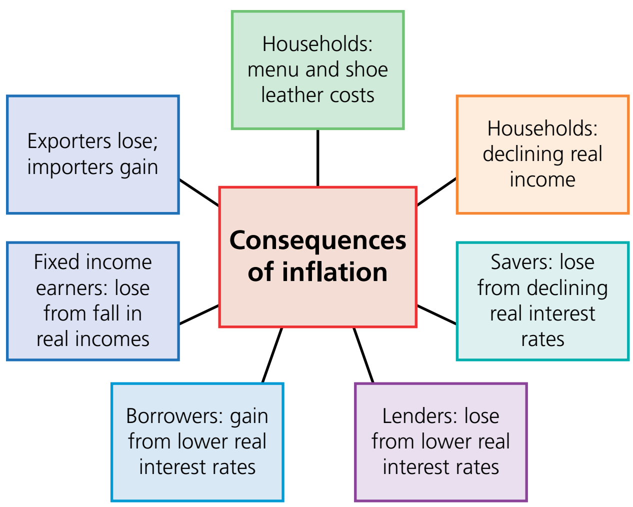
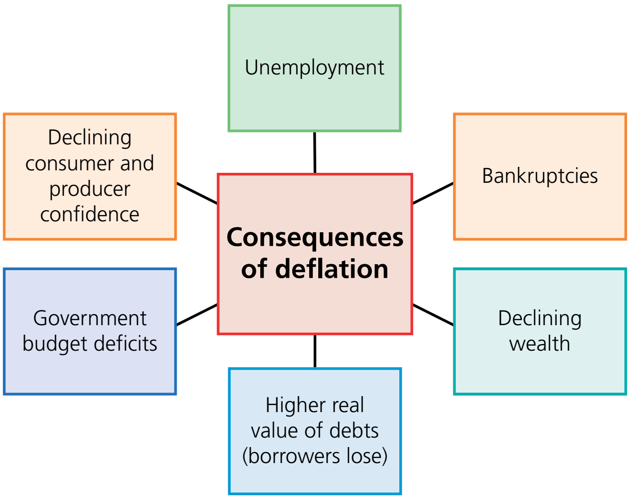


▲ **Figure 31.1** Inflation



▲ **Figure 31.2** Consequences of inflation



▲ **Figure 31.3** Consequences of deflation

Common errors

REVISED

Error	Why it is wrong
'Inflation is harmful to the economy.'	Low and sustainable rates of inflation are not usually harmful to the economy as higher prices can encourage firms to supply more output. It is when inflation rises too quickly that it can cause problems for the economy.
'Inflation affects all households in the economy.'	This is true to some extent. The CPI measures changes in the cost of living for the *average* household. However, spending patterns differ between single people, families with young children, high-income households and retired people, for example.
'Inflation means that the prices of all goods and services are rising.'	Inflation means prices, on average, are rising. The prices of some products increase more rapidly than others, while the prices of other products might actually fall.
'Disinflation is the opposite of inflation. It means that prices, on average, are falling.'	Disinflation happens when there is a fall in the rate of inflation – but that means prices are still rising on average, only at a slower rate. If average prices are falling, this is called deflation, not disinflation.

Target your revision

REVISED

- Inflation is the sustained rise in the general price level in an economy.
- Low and stable rates of inflation are not usually harmful to society.
- The Consumer Price Index (CPI) is used to calculate the inflation rate by measuring price changes of a representative basket of products.
- Cost-push inflation is caused by higher costs of production, which make firms raise their prices in order to maintain their profit margins.
- Demand-pull inflation is caused by higher levels of aggregate demand (total demand in the economy), thus driving up the general price level.
- Inflation can complicate planning and decision making for households, firms and governments.
- Costs of inflation include: menu costs, shoe leather costs, lower consumer and business confidence, and reduced international competitiveness (as exports become more expensive).
- Losers of inflation include: consumers, lenders, savers, fixed-income earners, low-income earners, exporters and employers.
- Winners of inflation include: borrowers and importers.

- Deflation is the persistent fall in the general price level of goods and services in the economy, i.e. the inflation rate is negative.
- A fall in the rate of inflation (known as disinflation) means that prices are still rising, only at a slower rate.
- The consequences of deflation include: unemployment, bankruptcies, negative wealth effect, declining confidence levels and higher debt burdens.
- Policies to tackle inflation include: deflationary fiscal policies, tight monetary policies and supply-side policies.

Test yourself

1 Complete the following sentence: Inflation is the ______________ rise in the ______________ price level in an economy over time.
2 The Consumer Price Index (CPI) is a ______________ index of consumer prices in the economy over time, used to measure the ______________ of living for the average household.
3 What is hyperinflation?
4 What are the **two** generic causes of inflation?
5 Who wins and who loses from inflation?
6 What are the consequences of deflation?
7 State the **three** generic policies used to combat inflation.

Answers on page 152

Tip

Students often write about inflation being a 'bad' thing for the economy. Remember to consider the cause(s) of inflation and the rate of inflation in the economy before deciding whether this is actually the case. Not all inflation is necessarily detrimental to the economy.

Sample question and answer

REVISED

1 Explain how the inflation rate is measured. [4]

Student's answer

The inflation rate of a country is measured by using a consumer price index (CPI) [1], which is a composite index of price changes based on spending patterns of the average household [1]. A base year is used to measure or compare price changes [1]. Weights are used for each item in the representative basket of goods and services, based on the proportion of total spending on these items [1].

Teacher's comments

This is a very succinct answer which clearly answers the question (CPI as a measure of inflation) and explains how inflation is calculated (using statistical weights). Full marks are awarded.

Exam-style questions

1 Define the term *deflation*. [2]
2 Explain how an increase in the money supply can cause inflation. [4]
3 Explain how the CPI is used to calculate inflation. [4]
4 Explain whether deflation harms an economy. [4]
5 Explain the difference between cost-push and demand-pull inflation. [4]
6 Explain **two** reasons why inflation is regarded as a problem. [4]
7 Analyse the reasons for price stability as a macroeconomic objective. [6]

Answers on pages 152–53

32 Living standards

Key objectives

The objectives of this chapter are to revise:

- the indicators of living standards
- the components of real GDP and the HDI
- the advantages and disadvantages of real GDP and HDI as measures of living standards
- living standards and income distribution
- reasons for differences in living standards and income distribution within and between countries.

Key definitions

REVISED

Term	Definition
Human Development Index (HDI)	A composite indicator of living standards obtained by measuring three dimensions of human development: education, healthcare and income. Poor countries have a low HDI and rich countries have a high HDI.
Real GDP per capita	A measure of standards of living obtained by calculating the GDP per person of the population, i.e. average incomes, adjusted for inflation.
Standards of living	A measure or indicator of social and economic wellbeing. The two main measures or indicators are GDP per head (or GDP per capita) and the Human Development Index (HDI).

Living standards

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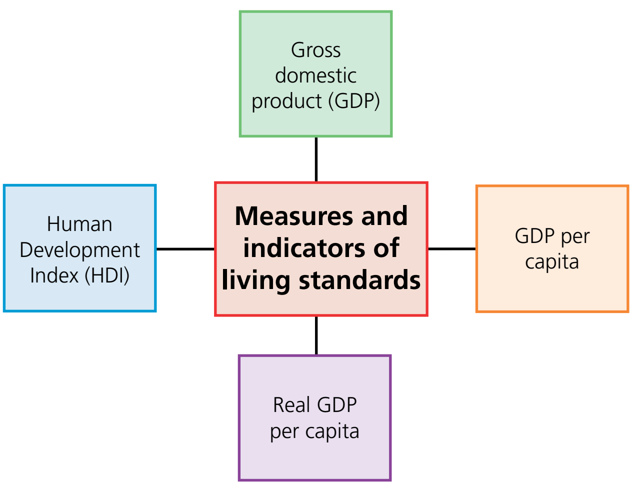
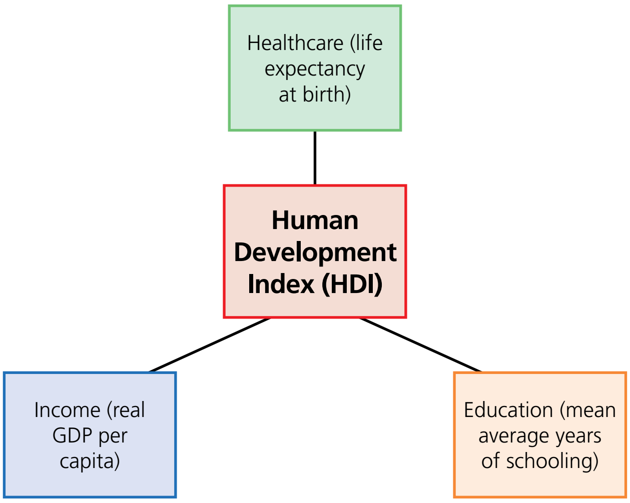
Measures and indicators of living standards

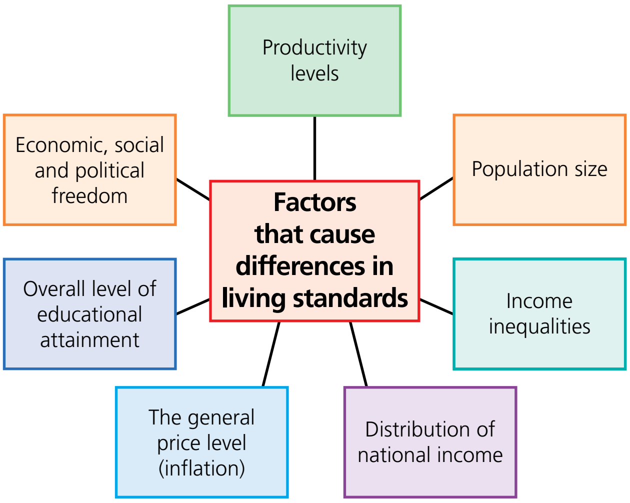


▲ **Figure 32.1** Measures and indicators of living standards

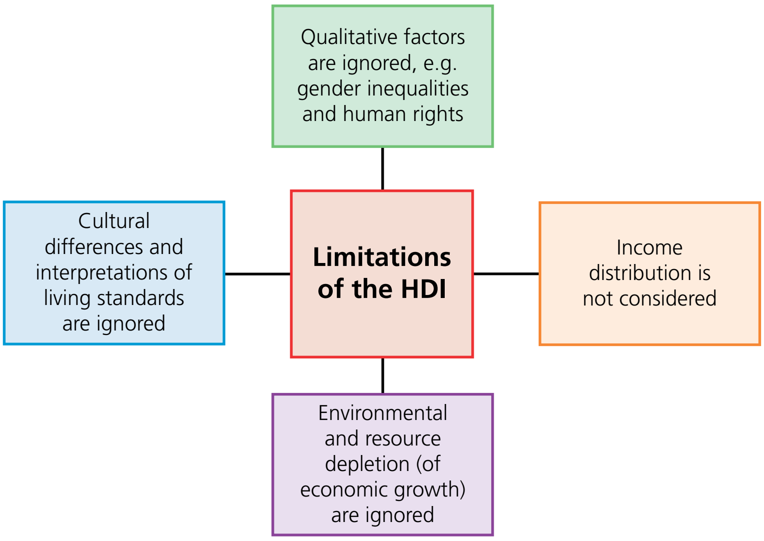
The Human Development Index



▲ **Figure 32.2** The Human Development Index (HDI)

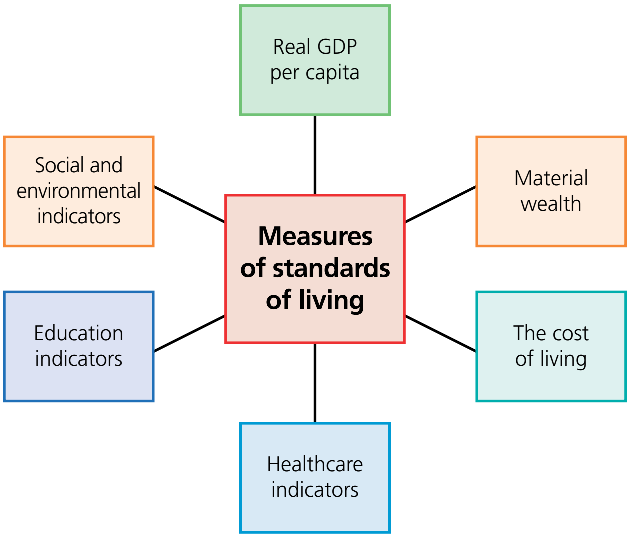


▲ **Figure 32.3** Factors that cause differences in living standards



▲ **Figure 32.4** Limitations of using the HDI to measure living standards

Standards of living



▲ **Figure 32.5** Measures of standards of living

Common errors

REVISED

Error	Why it is wrong
'Standard of living is dependent on how much money the average person earns'.	While this is not entirely incorrect, from the perspective of economics, standard of living is more than just what money can buy. Standard of living refers to the social and economic wellbeing of individuals, so it includes other measures such as access to education and healthcare.
'Countries with the highest GDP have the highest standard of living.'	This is not entirely true either, as standard of living also depends on several other factors, including the inflation rate (real GDP), population size (GPD per capita) and income distribution (the gap between the rich and the poor).

Target your revision

REVISED

- Standard of living refers to the social and economic wellbeing of individuals in a country at a particular point in time.
- The two main indicators of living standards are GDP per head and the Human Development Index (HDI).
- GDP per capita is a measure of living standards that involves dividing a country's GDP by the size of the country's population.
- The Human Development Index (HDI) is the United Nations' composite indicator of living standards in a country, obtained by measuring three dimensions of human development: healthcare, education and income levels.
- Factors that cause differences in living standards and income distribution within and between countries include differences in: productivity levels, population size, income inequalities, the distribution of national income, the general price level, the overall level of educational attainment, measures of freedom and regional differences in incomes.

Test yourself

1 What is real GDP per capita?
2 What is the Human Development Index (HDI)?
3 State **two** limitations of the HDI as a measure of standards of living.

Answers on page 153

Tip

While economists try to measure standards of living (using real GDP per capita or the HDI), definitions and interpretations of living standards vary from person to person and country to country. Qualitative factors, such as the degree of political freedom and social acceptance, are important factors that influence the standard of living that people experience.

Sample questions and answers

REVISED

1 Explain **two** limitations of using the Human Development Index (HDI) as a measure of standards of living in a country. [4]

Student's answer

Qualitative factors that affect living standards are ignored in the HDI **[1]**, *such as the country's attitude towards gender equalities, human rights or the environment* **[1]**. *Also, income distribution is ignored* **[1]**. *The HDI only considers an average figure for income, so by ignoring the distribution of income in the economy, thus is a less accurate indicator of living standards for the 'average' person* **[1]**.

Teacher's comments

This is a very good answer, with two limitations clearly explained. Full marks are awarded.

2 Analyse why a particular country might have a low Human Development Index (HDI) value. [8]

Student's answer

The HDI is a good measure of standards of living because it considers the quality of education and healthcare, and the amount of national income. A poor country will have poor healthcare facilities **[1]** *such as low expenditure and investment in hospitals* **[1]**. *This will reduce people's life expectancy in the country. In addition, it will have a poor education system* **[1]** *with low mean average number of years of schooling, so people find it hard to secure employment* **[1]**.

Teacher's comments

The first part of the answer is an attempt at defining the HDI, but does not directly address the question (why the HDI value might be low for a country). There is good coverage of two (healthcare and education) of the three components of the HDI. The candidate should also have referred to low GDP per head in such countries **[1]**, due to a low level of overall demand for goods and services **[1]** and/or poor quality of resources **[1]**. 4 marks are awarded.

Exam-style questions

1 Define the term *standard of living*. [2]
2 Explain the difference between absolute poverty and relative poverty. [3]
3 Explain **two** reasons why a poor country has a low GDP per head. [4]
4 Discuss whether a rise in a country's gross domestic product necessarily raises its citizens' standard of living. [8]

Answers on pages 153–54

33 Poverty

Key objectives

The objectives of this chapter are to revise:

- the difference between absolute and relative poverty
- the causes of poverty
- policies to alleviate poverty and to redistribute income.

Key definitions

REVISED

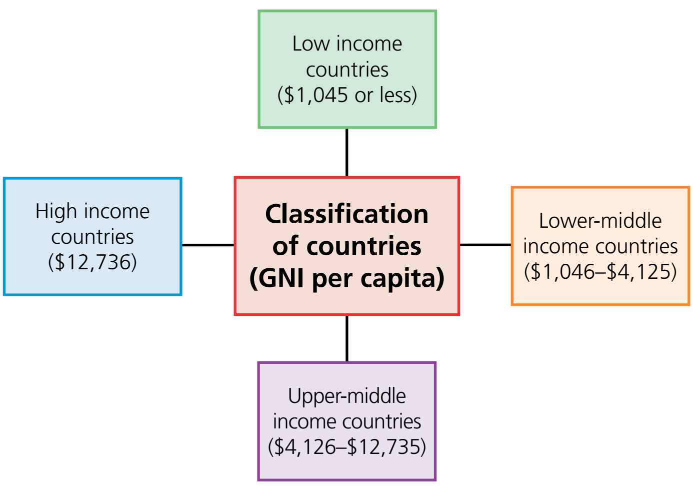
Term	Definition
Absolute poverty	An extreme type of poverty which indicates the number of people in an economy who cannot afford minimal standards of basic human needs (food, clothing, healthcare and shelter).
Foreign aid	A type of financial assistance for economic development from other countries or non-government organisations such as Oxfam and UNICEF.
Gross national income (GNI) per capita	A measure of the total expenditure in the economy (gross domestic product) plus net income from assets abroad, divided by the population size.
Less economically developed countries (LEDCs)	Developing countries, with low GDP per capita, where standards of living are therefore generally poor.
More economically developed countries (MEDCs)	Developed countries, with high GDP per capita, where standards of living are therefore generally good.
Poverty	A condition that exists when people lack adequate income and wealth to sustain a basic standard of living.
Relative poverty	A comparative measure of poverty. Those in relative poverty have a lower income than the average member of society, so their standard of living is comparatively lower.
Sustainable Development Goals (SDGs)	The United Nations' 17 international development goals to achieve by 2030 to end poverty, protect the planet and ensure prosperity for all.

Poverty

PAGES 235–42

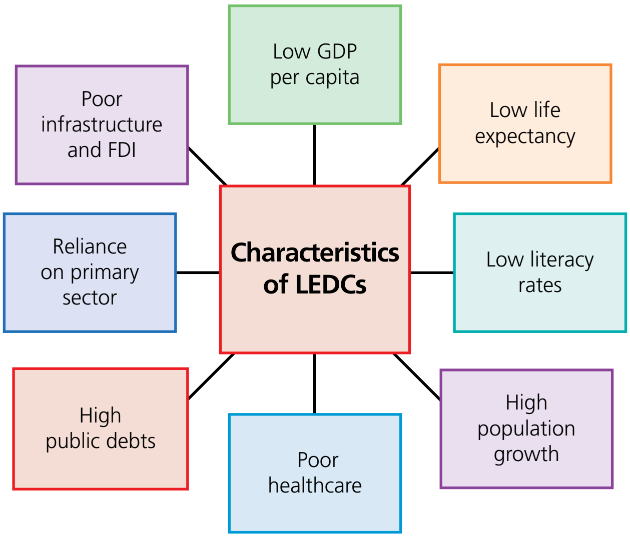
REVISED

Classification of countries

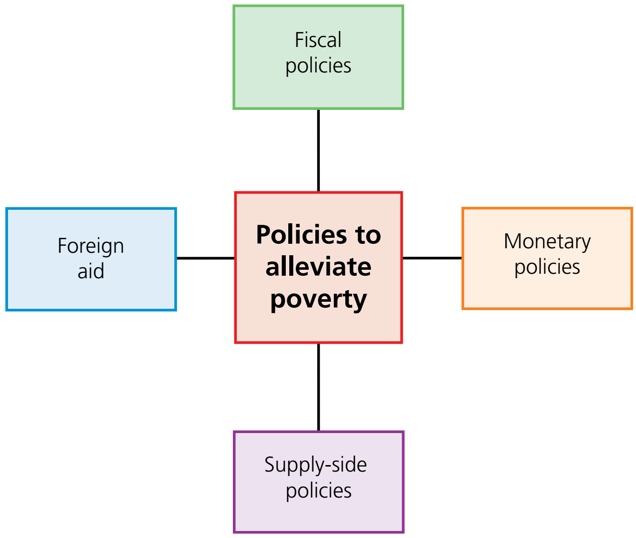


▲ **Figure 33.1** Classification of countries (GNI per capita)

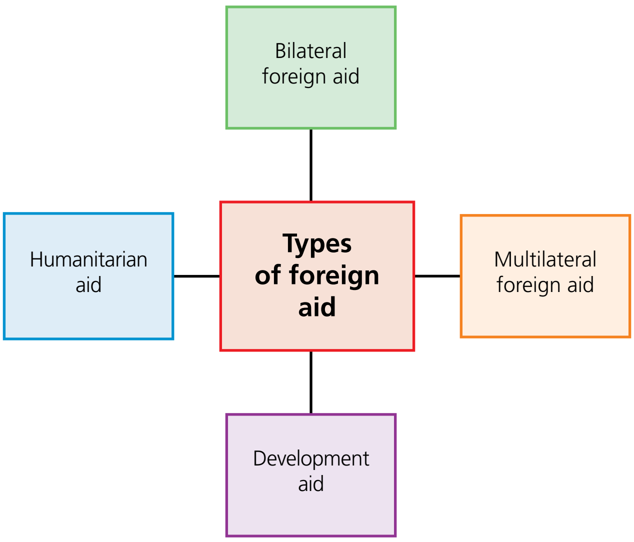
Characteristics of developing countries



▲ **Figure 33.2** Characteristics of developing countries (LEDCs)



▲ **Figure 33.3** Policies to alleviate poverty



▲ **Figure 33.4** Types of foreign aid

Common errors

REVISED

Error	Why it is wrong
'People in less developed countries have a low standard of living.'	Economists often disagree on the classification of countries because the definition and measurements of economic development and standards of living are rather subjective. Higher income does not necessarily mean better standards of living.
'Poverty exists in poor or low-income countries.'	Poverty exists in all countries, although it is more widespread in LEDCs, where there is mass poverty. Even in wealthy nations, inequalities exist. A recession or natural disaster can also cause extensive poverty in MEDCs.
'People who earn more than the average person in an economy do not suffer from absolute poverty.'	It is possible for people to be relatively well off (earning more than the average person) but still live in absolute poverty. If the GDP per capita is very low, even these people face financial difficulties in meeting their basic human needs.

Target your revision

REVISED

- Poverty is a condition that exists when people lack adequate income and wealth to sustain a basic standard of living.
- Poverty creates problems for society and the economy because it causes poor health (e.g. malnutrition and famine), deaths, crime, high unemployment, high welfare provision and lower national output.
- Absolute poverty exists when there is extreme outright poverty, i.e. income equal to or less than $1.25 per day.
- Those in absolute poverty (extreme poverty) suffer from malnutrition, i.e. they are unable to buy enough food to survive.
- Relative poverty is a comparative measure of poverty, referring to those who have a lower standard of living in comparison to the average member of society.
- Causes (and consequences) of poverty include: low GDP per capita, low life expectancy, low literacy rates, high population growth, poor infrastructure, low foreign direct investment, poor healthcare, low productivity, high public debt, overreliance on primary sector output, and corruption and instability in the economy.
- Policies to alleviate poverty and redistribute income include: policies to promote economic growth, improving education, using progressive taxation, and introducing (or increasing) a national minimum wage.

Test yourself

1 Complete the following sentence: Poverty is a condition that exists when people lack adequate ________________ and wealth to sustain a ________________ standard of living.
2 List **three** indicators of poverty in a country.
3 What is meant by the *poverty line* (or *poverty income threshold*)?
4 What is meant by the *UN Sustainable Development Goals*?
5 What are the main causes and consequences of poverty?
6 What are the main policies used to tackle poverty?

Answers on page 154

Tip

Poverty exists in all countries, although it is more visible in poorer countries that have mass poverty. Even in high-income countries, recessions or natural disasters can cause widespread poverty. It is therefore incorrect to assume that only low-income countries suffer from poverty.

Sample questions and answers

REVISED

1 Explain **two** ways in which a government could redistribute income in the economy. [4]

Student's answer

One way is to tax the rich by imposing progressive taxes [1]*. This means the relatively rich pay a larger proportion in tax based on their ability to pay* [1]*. Alternatively, the government can increase its spending to support the relatively poor* [1]*. For example, they can use tax revenues to fund the provision of free healthcare and/or state education for the poor* [1]*.*

Teacher's comments

This is a very good answer, with two methods clearly explained. Full marks are awarded.

2 Explain why poverty is a concern for the government. [4]

Student's answer

Poverty is a concern for the government because it creates many social problems [1]*, such as the consequences of poor health* [1]*, e.g. malnutrition. This creates negative impacts on the economy, such as productivity losses, social exclusion, homelessness, welfare provision and crime* [1]*. Poverty also creates economic problems* [1]*, such as high unemployment and lost national output* [1]*.*

Teacher's comments

This is a very good answer, with an explanation of both social and economic problems associated with poverty. There is also good use of relevant examples. Full marks are awarded.

Exam-style questions

1. Define the term *developed country*. [2]
2. Identify **four** characteristics of an economically developed country. [4]
3. Explain the difference between absolute poverty and relative poverty. [3]
4. Identify **four** reasons why developing countries often experience an emigration of workers. [4]
5. Analyse how a rise in tax rates could influence poverty within a country. [6]
6. Discuss whether a rise in a country's gross domestic product necessarily raises its citizens' standard of living. [8]

Answers on pages 154–55

34 Population

Key objectives

The objectives of this chapter are to revise:

- the factors that affect population growth
- reasons for the different rates of population growth in different countries
- the effects of changes in the size and structure of population on different countries.

Key definitions

REVISED

Term	Definition
Age distribution	The number of people within different age groups in the population.
Birth rate	This measures the number of live births per thousand of the population in a year.
Death rate	This measures the number of deaths per thousand of the population in a year.
Demographics	The study of population distribution and trends in a country.
Dependency ratio	A comparison of the number of people not in the labour force with the number of people in active paid employment. The dependency ratio = dependent population ÷ working population.
Fertility rate	This measures the average number of births per woman. It is also used to measure population growth in an economy.
Life expectancy	This measures the number of years an average person in the country is expected to live.
Malthusian growth theory	Thomas R. Malthus's theory that uncontrolled population growth would put pressure on the country's resources, thus negatively impacting living standards.
Net migration rate	This measures the difference between immigration and emigration rates. It shows the physical movement of people in and out of a country.
Optimum population	This exists when the output of goods and services is maximised per head of the population.
Over-population	This exists when the population is too large, given the available resources of the country, leading to negative economic consequences, e.g. famine, housing shortages, energy shortages and falling GDP per capita.
Population	The total number of inhabitants of a particular country.
Population distribution	The composition and size of the population.
Population growth	The rate of change in the size of a country's population.
Population pyramids	Graphical representations of the age and gender distribution of a country's population.
Replacement fertility rate	The number of children that the average woman must have to replace the existing population in order to maintain a stable population size.
Under-population	This exists in a country if it does not have sufficient labour resources to make the best use of the economy's resources, i.e. GDP per head could be further increased if the population was higher.
Working population	The active labour force of working age, i.e. those willing and able to work. It consists of those in paid employment, the self-employed and the unemployed.

Population

PAGES 243–53

REVISED

Population growth

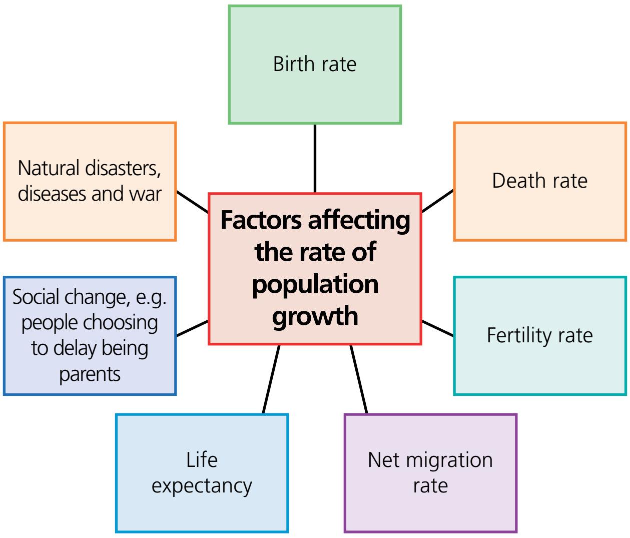


Figure 34.1 Factors affecting the rate of population growth

Population distribution

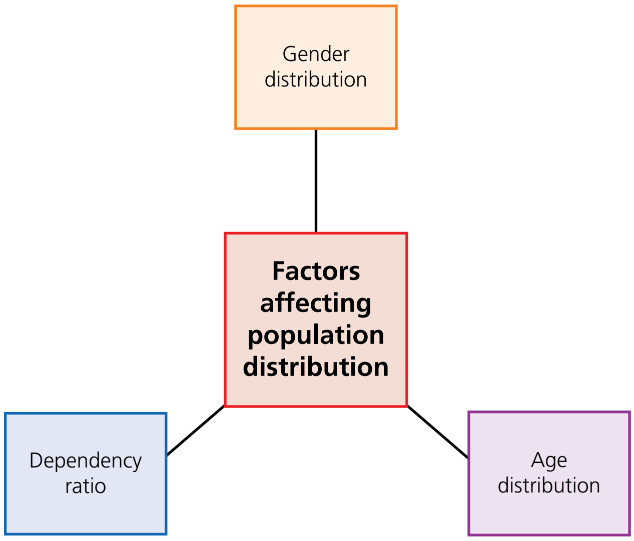


Figure 34.2 Factors affecting population distribution

Population changes

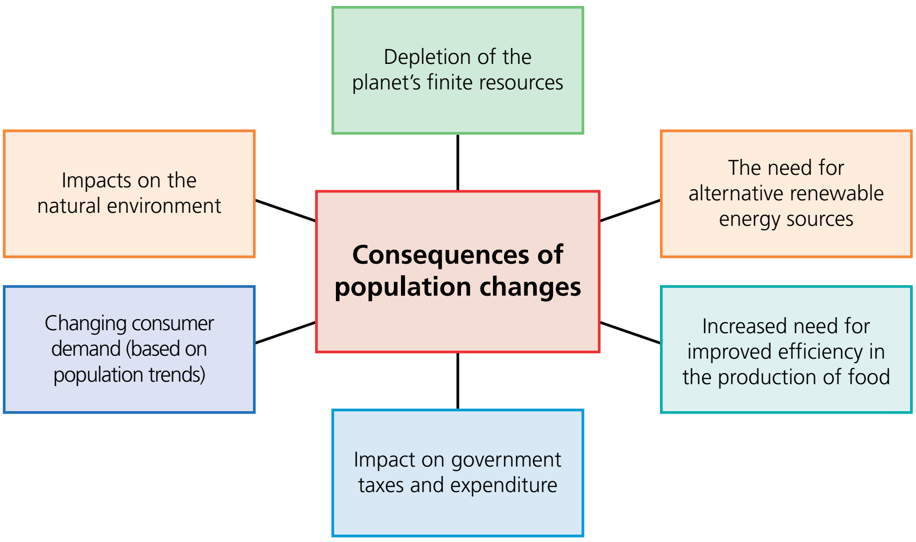


Figure 34.3 Consequences of population changes

Common error

REVISED

Error	Why it is wrong
'Net migration is the difference between the number of immigrant workers and the number of emigrant workers.'	The net migration rate measures the overall level of population change resulting from migrants. It does not distinguish between worker migrants, refugees and other lawful migrants, including children.

Target your revision

REVISED

- Population refers to the total number of inhabitants of a particular country. Population growth refers to the rate of change in the size of a country's population.
- Changes in three key factors affect the rate of population growth: birth rate, death rate and net migration rate.
- An optimum population exists when the output of goods and services per head of the population is maximised.
- A country is under-populated if it does not have sufficient labour to make the best use of its resources.
- A country that is over-populated has a population that is too large, given the available resources of the country.
- Demographics is the study of population distribution and trends.
- Population distribution refers to the composition and size of the population.
- Population pyramids are a graphical representation of the age and gender distribution of a country's population.
- Population changes have effects on consumers, firms, the government, the economy as a whole and the natural environment.

Test yourself

1 Complete the following sentences: Age ________________ refers to the number of people within different age groups in the population. Low-income countries tend to have a relatively ________________ proportion of their population in the younger age groups.
2 Why are economists interested in the study of population trends?
3 What are the **three** key factors that affect the rate of population growth?
4 What is meant by an *ageing population*?
5 What is the dependency ratio?

Answers on page 155

Tip

Thomas R Malthus's theory is not all doom and gloom. What he suggested is that population growth, if not controlled, can cause major social and economic problems. The theory has enabled governments and firms to deal with the potential problems of high population growth, e.g. by using GM technology (genetically modified) in food production.

Sample question and answer

REVISED

1 Analyse how the population structure of a less economically developed country (LEDC) is likely to differ from that of a more economically developed country (MEDC). [6]

Student's answer

The proportion of younger people is likely to be larger in an LEDC **[1]** *because the birth rate tends to be higher* **[1]**. *This might be due to a lack of education about birth control, the need for children to support their parents later in life or the lower cost of bring up children in LEDCs* **[1]**.

By contrast, the typical family in an MEDC will have fewer children due to the higher cost of living and different social attitudes, such as greater awareness of contraception **[1]**. *Additionally, an MEDC is much more likely to have an older population* **[1]** *due to better healthcare services so it will have a lower death rate* **[1]**.

Teacher's comments

This is a very detailed answer that considers several factors affecting population structures, such as birth rate, death rate, cost of living, education and healthcare. Full marks are awarded.

Exam-style questions

1 Define the term *demographics*. [2]
2 Explain what is meant by the *death rate*. [2]
3 Define the term *fertility rate*. [2]
4 Identify **three** factors that influence a country's birth rate. [3]
5 Describe the likely changes to a country's geographical distribution of its population as the economy develops. [3]
6 Explain **two** causes of a decline in a country's death rate. [4]
7 Explain **two** reasons why a country might have more females than males. [4]
8 Explain why people in MEDCs tend to have a longer life expectancy than people in LEDCs. [4]
9 Analyse how a government might attempt to reduce population growth in its country. [6]
10 Discuss the implications for a country that experiences an ageing population. [6]

Answers on pages 155–56

35 Differences in economic development between countries

Key objective

The objective of this chapter is to revise:

- the causes and impacts of differences in economic development between countries.

Key definitions

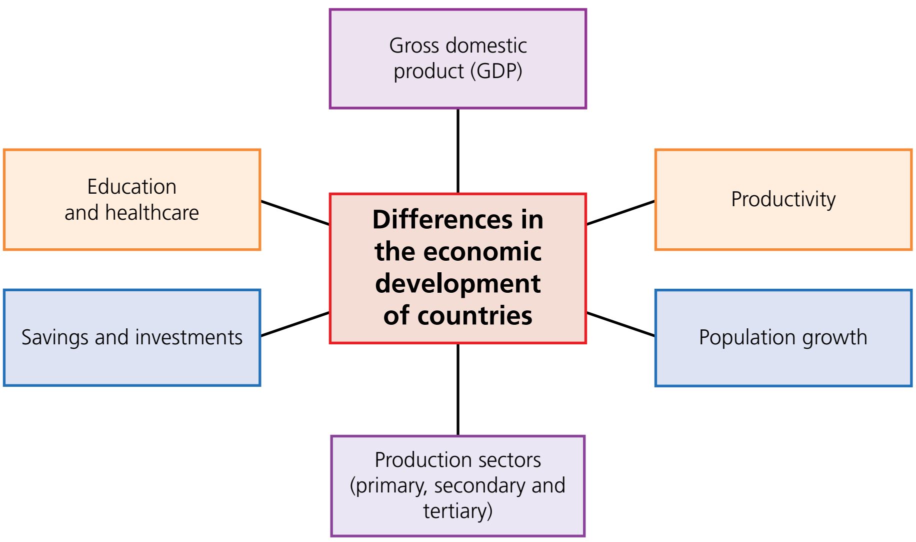
REVISED

Term	Definition
Economic development	An intangible concept that considers both quantitative and qualitative variables.
Investment	Business expenditure on fixed assets, e.g. machinery and production facilities, thus increasing the economy's productive capacity.
Primary sector	Employment sector where production is concerned with the extraction of raw materials and other natural resources, e.g. farming, fishing, mining and oil exploration.
Savings	The money that people or businesses do not spend but set aside for future expenditure.
Secondary sector	Employment sector where production is concerned with manufacturing, e.g. car manufacturing, textile production, chemical engineering and textbook publishing.
Tertiary sector	Employment sector where production is concerned with the provision of services, e.g. accountants, teachers, doctors, lawyers, financial advisers and retailers.

Differences in economic development between countries

PAGES 254–59

REVISED



▲ **Figure 35.1** Factors causing differences in the economic development of countries

Common error

REVISED

Error	Why it is wrong
'People working in the tertiary sector earn more than those in the primary sector.'	This is an over-generalisation. Those working in the primary sector (e.g. miners or offshore oil riggers) can certainly earn more than those working in the tertiary sector (e.g. supermarket cashiers or crew members at McDonald's).

Target your revision

REVISED

- Economic development is an intangible concept that considers both quantitative and qualitative variables that indicate an increase in the standard of living within a country.
- The main factors that account for differences in the economic development of countries are differences in: income (GDP), productivity, population growth, the relative size of the primary, secondary and tertiary sectors, saving and investment, education, and healthcare.
- Income is the most used single indicator of standards of living within a country. The wealthier a country is, the higher its standard of living tends to be.
- Differences in the productivity of factors of production can be explained by a country's ability to gain access to the latest technologies, differences in the quality and quantity of production resources, and the country's ability to attract foreign direct investment (FDI).
- Differences in population size and growth have a direct impact on real GDP per head. Economic development tends to be limited in countries with large and growing populations.
- As an economy develops, there tends to be a shift away from an over-reliance on primary production, towards secondary sector production and, even more, tertiary sector output.
- Savings are needed to enable banks to lend these funds to firms to finance their investment expenditure.
- In general, the greater the level of education in a country, the higher its standard of living tends to be.
- The better the healthcare in a country, the higher its social and economic wellbeing (and hence economic development) tends to be.

Test yourself

1 What are key indicators of economic development?
2 What are the main reasons for differences in economic development between countries?
3 Why does an increase in real GDP per head not necessarily lead to a higher standard of living for the majority of people?
4 How do differences in the national income of different countries affect their economic development?
5 What does a country's quality of healthcare indicate about its economic wellbeing?

Answers on page 156

Tip

There are a large number of reasons why countries' levels of economic development differ. To simplify things, you could consider the three indicators used in the Human Development Index (HDI): education, healthcare and income (gross domestic product). Revise Chapter 32 for more information about the HDI.

Sample question and answer

REVISED

1 Explain how foreign direct investment (FDI) can help to improve a country's economic development. [4]

Student's answer

FDI should lead to an increase in both the quantity and quality of physical capital [1] in the economy, thereby boosting its productive capacity [1]. Being more productive also means the economy becomes more competitive in the long run [1]. This should help to create economic growth and employment opportunities [1], thereby creating economic development [1].

Teacher's comments

This is a very good answer that explains how FDI can help facilitate economic development. There is relevant reference to the macroeconomic aims of economic growth and employment, both of which are essential for there to be economic development. Full marks are awarded.

Exam-style questions

1 Define the term *economic development*. [2]

2 Explain how productivity can affect the level of economic development. [2]

3 Explain why national income statistics are unlikely to be a good indicator of economic development. [2]

4 Explain how population growth rates are likely to affect the level of economic development. [2]

5 Explain how employment in different production sectors is likely to change as a country develops. [2]

Answers on page 156

36 International specialisation

Key objective

The objective of this chapter is to revise:

- the advantages and disadvantages of specialisation at regional and national levels.

Key definitions

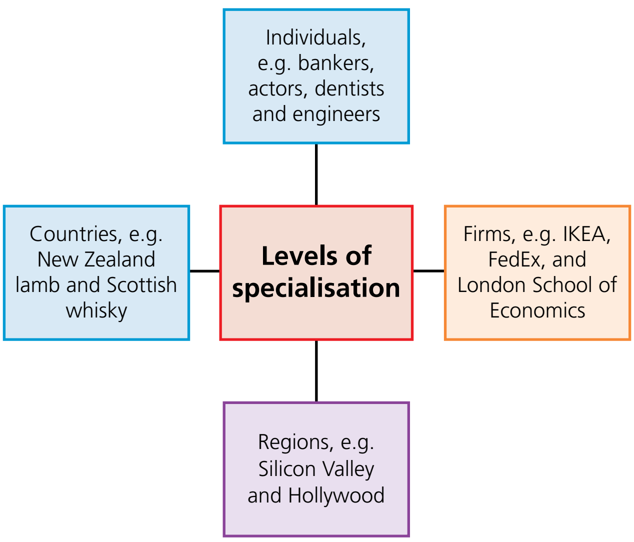
REVISED

Term	Definition
International specialisation	This occurs when certain countries concentrate on the production of certain goods or services due to cost advantages, e.g. their abundance of certain resources.
Over-specialisation	This occurs when a person, firm, region or country concentrates too much on producing a very limited number of goods and services. This exposes the economic agent to a far higher degree of risk in adverse circumstances.
Regional specialisation	This occurs when certain areas (regions) concentrate on the production of certain goods or services, e.g. Hollywood, in Los Angeles, is famous for its movie industry.
Specialisation	This occurs when individuals, firms, regions or countries concentrate on the production of a particular good or service.

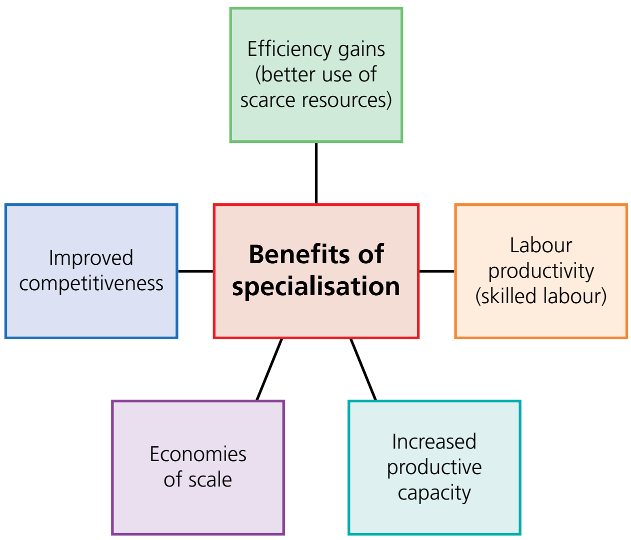
International specialisation

PAGES 262–66

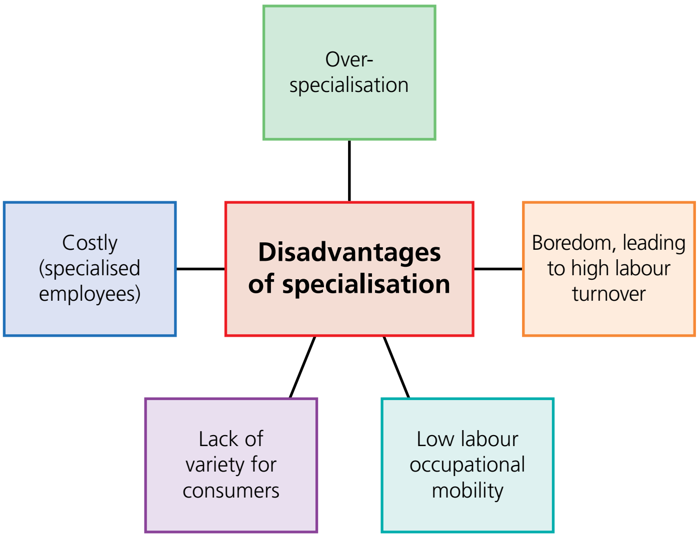
REVISED



▲ **Figure 36.1** Levels of specialisation



▲ **Figure 36.2** Benefits of specialisation



▲ **Figure 36.3** Disadvantages of specialisation

Common errors

REVISED

Error	Why it is wrong
'Specialisation is expensive due to the highly skilled labourers who need to be paid well.'	Specialisation can indeed be very expensive in some occupations (e.g. surgeons, professors, elite athletes and corporate lawyers) but not in all cases (e.g. supermarket cashiers, waiting staff in restaurants and hotel cleaning staff).
'Specialisation refers to the division of labour, which involves workers being experts in a particular job.'	This is not entirely correct – remember that specialisation also applies to machinery and technology (capital equipment), firms, regional areas and even countries.

Target your revision

REVISED

- Specialisation occurs when individuals, firms, regions or countries concentrate on the production of a particular good or service.
- International specialisation occurs when certain countries concentrate on the production of certain goods or services due to cost advantages, e.g. their abundant resources.
- Benefits of specialisation at a national level include: efficiency gains, higher labour productivity, increased productive capacity, economies of scale and improved competitiveness.
- Disadvantages of specialisation at a national level include: over-specialisation, lack of variety for consumers, high labour turnover, low labour mobility and higher labour costs.

Test yourself

1 Give **three** examples of specialisation at a regional level.
2 Give **three** examples of specialisation at a national level.
3 What is over-specialisation?
4 State **three** disadvantages of over-specialisation.
5 State **three** benefits of specialisation.

Answers on page 156

Tip

Remember that the concept of specialisation can refer to any factor of production, not just labour. Capital equipment can be highly specialised, e.g. machinery that makes horseshoes or combine harvesters that harvest corn (maize).

Sample question and answer

REVISED

1 Discuss whether it is in the best interest of workers to specialise. [8]

Student's answer

One argument for specialisation is that workers can be in high demand due to their level of expertise [1]. This can lead to good employment opportunities and high wages for them [1]. It allows workers to develop their skills [1] which can benefit employers from the increased labour productivity.

Another benefit is that specialisation can enable workers to focus on areas they most enjoy [1], e.g. Economics lecturers at university.

However, highly specialised workers have low occupational mobility [1] so will find it difficult should they wish to find alternative careers [1]. Also, doing the same job or tasks every day can be boring and demotivating [1].

Teacher's comments

This is a very good answer, with both advantages and disadvantages given. Relevant examples are also used, such as Economics lecturers. However, there are occasional lapses, such as stating that employers benefit from improved labour productivity (the question is about the benefits of specialisation for workers). Instead, the candidate could have developed the point by mentioning that improved labour productivity and efficiencies enable workers to be paid more for the value of their extra output. 7 marks are awarded.

Exam-style questions

1 Define the term *specialisation*. [2]
2 Describe **one** potential disadvantage of specialisation at a national level. [2]
3 Describe **two** benefits of specialisation at a regional level. [4]
4 Explain why engaging in division of labour may increase a firm's production costs. [4]
5 Using the concept of specialisation, explain why nations trade with each other. [4]

Answers on pages 156–57

37 Globalisation, free trade and protection

Key objectives

The objectives of this chapter are to revise:

- the definition of globalisation
- the role of multinational companies (MNCs)
- the costs and benefits of MNCs to their host and home countries
- the benefits of free trade for consumers, producers and the economy
- various methods of protection
- reasons for protection
- consequences of protection.

Key definitions

REVISED

Term	Definition
Barriers to trade	Obstructions to free trade, imposed by a government to safeguard national interests by reducing the competitiveness of foreign firms.
Dumping	The act of selling exports at artificially low prices, below those charged by domestic firms, and often at less than the costs of production.
Embargo	A type of trade protectionist measure banning the trade of a certain good, or banning trade with a particular country.
Free trade	International trade without any protectionist barriers between countries.
Globalisation	The process by which the world's economies become increasingly interdependent and interconnected.
Infant industries	New, unestablished businesses that need protection from foreign competitors.
International trade	The exchange of goods and services beyond national borders.
Multinational corporation (MNC)	An organisation that operates in two or more countries.
Protection	The use of trade barriers to safeguard a country from excessive international trade and foreign competition.
Quota	A type of protectionist measure that sets a numerical limit on the imports allowed into a country over a specified time period.
Subsidies	Financial support from the government to lower the production costs of domestic firms, thereby improving their competitiveness.
Tariffs	Import taxes imposed on foreign goods and services.

Globalisation, free trade and protection

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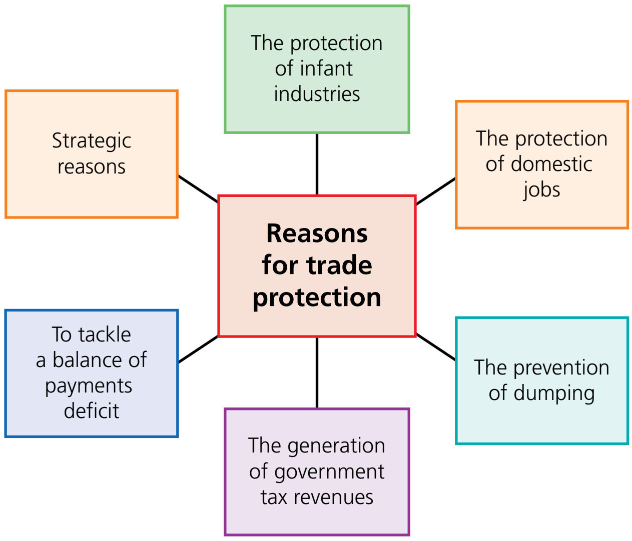
REVISED

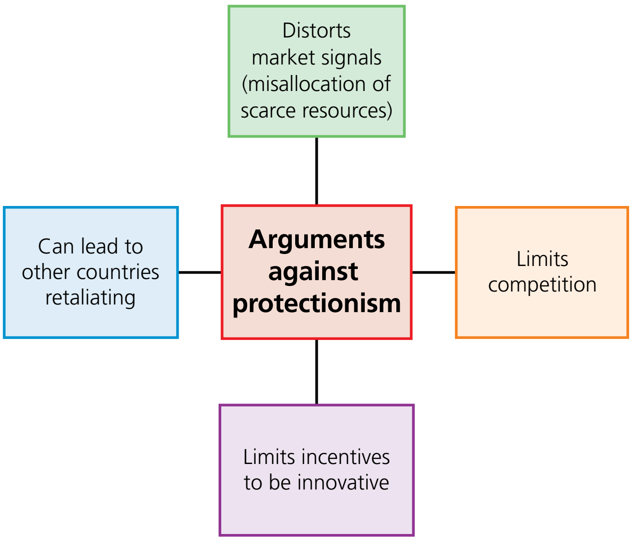
International trade

▲ **Figure 37.1** The merits of international trade

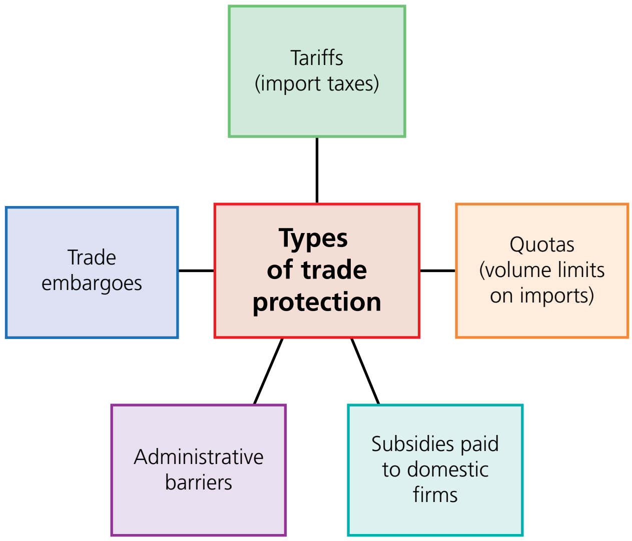
Trade protection



▲ **Figure 37.2** Reasons for trade protection



▲ **Figure 37.3** Arguments against protectionism



▲ **Figure 37.4** Types of trade protection

Common error

REVISED

Error	Why it is wrong
'International trade means trading without any barriers imposed on foreign countries.'	International trade and free trade are not quite the same – not all international trade entails free trade. The former can include barriers to trade (e.g. quotas and tariffs), whereas the latter is trade without any barriers.

Target your revision

REVISED

- Globalisation is the process by which the world's economies become increasingly interdependent and interconnected.
- A multinational corporation (MNC) is an organisation that operates in two or more countries.
- Advantages of MNCs include: job creation, economies of scale and spreading of risks.
- Disadvantages of MNCs include: unethical and cost-cutting practices, forcing domestic firms out of business, and potential to exploit foreign governments (especially those in low-income countries).
- International trade is the exchange of goods and services beyond national borders.
- Free trade means that international trade takes place without protectionist measures (barriers to international trade).
- Advantages of free trade include: access to resources (choice), lower prices, efficiency gains and improved international relations.
- Protection refers to the use of trade barriers to restrain foreign trade, thereby limiting overseas competition.
- Methods of protection include: tariffs and non-tariff barriers (import quotas, subsidies and embargoes).
- Reasons for protection include: to protect infant industries, and safeguard domestic jobs, to prevent dumping, to generate tax revenue, to tackle a balance of payments deficit and for strategic reasons.
- Arguments against protection include: market distortions and inefficiencies, higher production costs for domestic suppliers relying on imported supplies, and possible retaliation from foreign countries.

Test yourself

1 Complete the following sentence: Globalisation is the process by which the world's economies become increasingly ____________ and interconnected due to greater ____________ trade and cultural exchanges.
2 State **three** positive impacts of globalisation.
3 What are the characteristics of a multinational corporation?
4 What is the difference between free trade and international trade?
5 State **three** examples of protectionism.

Answers on page 157

Tip

Students often state that a multinational corporation operates in *more than two* countries; this means three or more countries, which is incorrect. The definition should refer to two or more countries.

Sample question and answer

REVISED

1 Discuss whether imposing tariffs will benefit the domestic economy. [8]

Student's answer

Imposing tariffs (taxes on imports) helps to raise tax revenues for the government [1]. This will benefit the economy as the money can be spent on healthcare and education etc. [1]. Also, tariffs raise the price of imports and so may reduce the demand for imports [1]. Tariffs can also be used to protect infant industries [1], allowing them to grow and become internationally competitive [1].

However, tariffs might not be effective as they simply cause other countries to retaliate and impose their own tariffs [1]. Also, for a country like Singapore that relies on imports, tariffs raise the costs of imported raw materials [1] and so can cause cost-push inflation in the economy [1].

Teacher's comments

This is a very good, balanced answer. It is always useful to use real-world examples in these extended response questions, so the candidate does well to include Singapore in the answer. The candidate mentions that tariffs can reduce the demand for imports, but does not explain why this might be of benefit to the economy, e.g. the impact on the balance of payments. Nevertheless, the answer is sufficiently detailed and balanced for full marks to be awarded.

Exam-style questions

1 Explain the difference between international trade and free trade. [3]
2 Identify **three** methods of trade protection that a country could use. [3]
3 Explain **two** benefits of free trade. [4]
4 Describe **two** disadvantages of international trade. [4]
5 Explain why countries may choose to specialise. [4]
6 Explain **two** benefits of trade protection. [4]
7 Explain **two** reasons why countries might decide to trade with each other. [4]

Answers on pages 157–58

38 Foreign exchange rates

Key objectives

The objectives of this chapter are to revise:

- the definition of exchange rates
- the determination of exchange rates in a floating system
- the determination of exchange rates in a fixed system
- the causes and consequences of exchange rate fluctuations.

Key definitions

REVISED

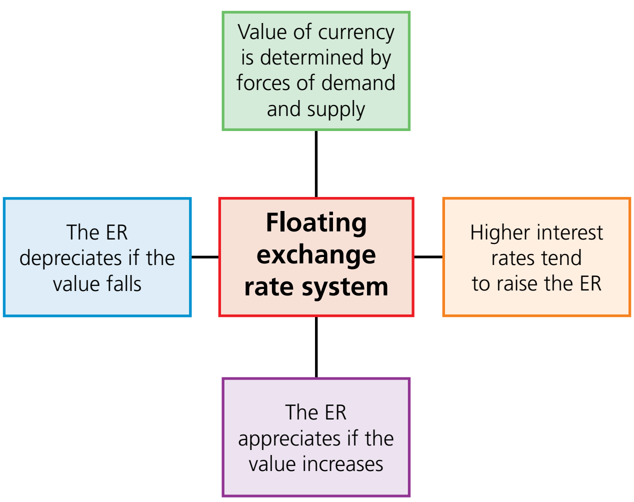
Term	Definition
Appreciation	This occurs when a currency increases in value relative to other currencies under a floating exchange rate system.
Depreciation	This occurs when a currency falls in value relative to other currencies under a floating exchange rate system.
Devaluation	This occurs when the value of a currency in a fixed exchange rate system is officially and deliberately reduced.
Exchange rate (ER)	The price of one currency measured in terms of other currencies.
Fixed exchange rate system	An exchange rate system involving the central bank or monetary authority intervening in foreign exchange markets to ensure the value of its currency stays at a pegged value.
Floating exchange rate system	An exchange rate system whereby the currency is allowed to fluctuate against other currencies according to market forces (of demand and supply) without the need for government intervention.
Foreign exchange market	The marketplace where foreign currencies can be bought and sold.
Revaluation	This occurs when the price of a currency operating in a fixed exchange rate system is officially and deliberately increased.

Foreign exchange rates

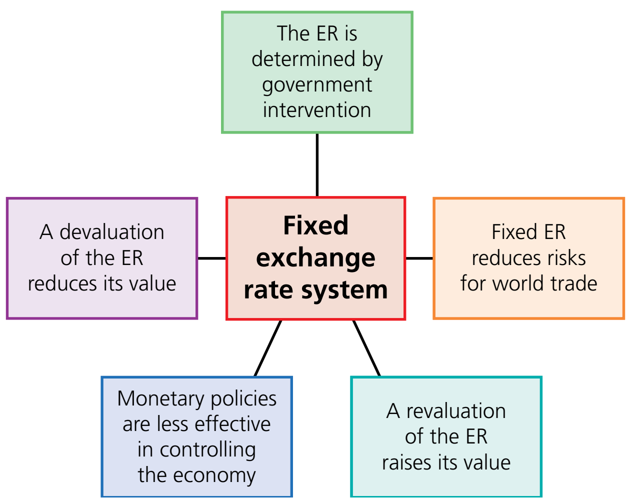
PAGES 276–83

REVISED

Floating and fixed exchange rate systems

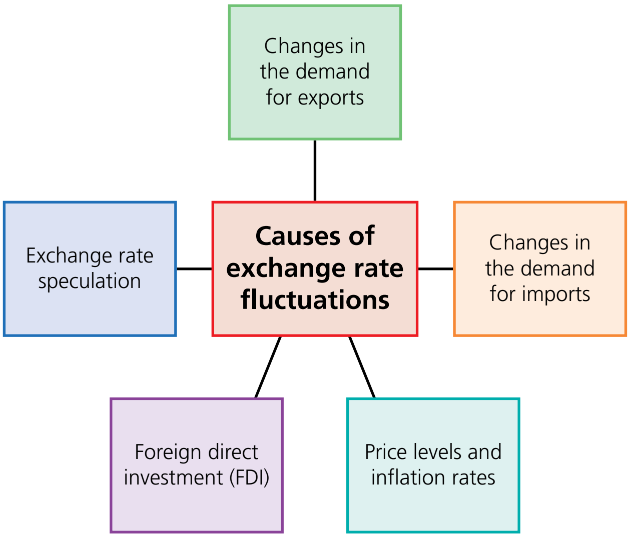


▲ **Figure 38.1** The floating exchange rate system

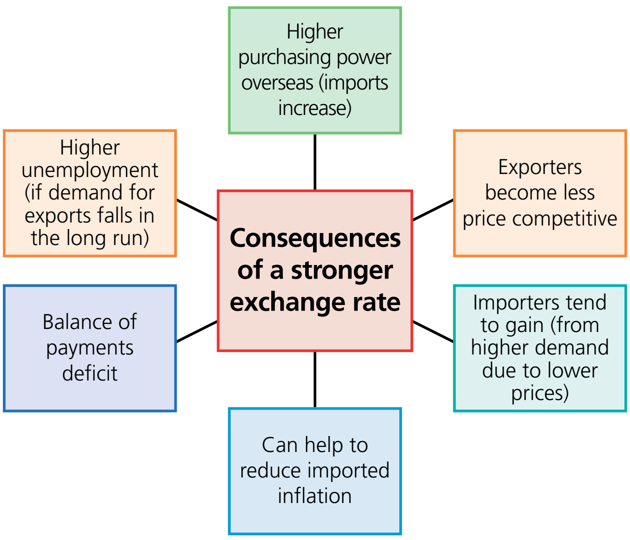


▲ **Figure 38.2** The fixed exchange rate system

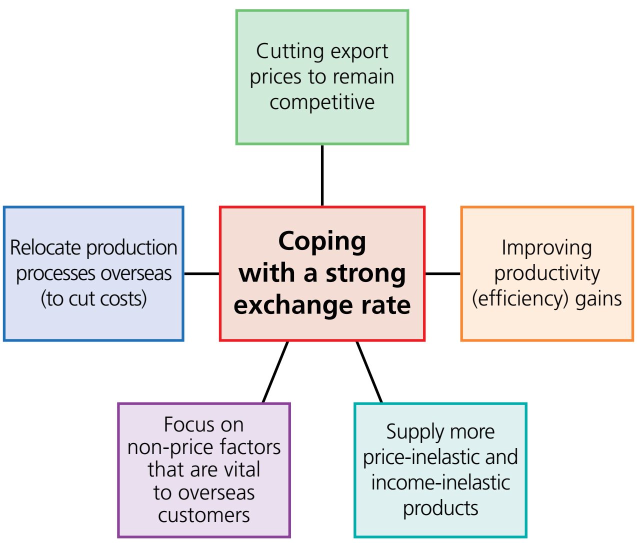
Exchange rate fluctuations



▲ **Figure 38.3** Causes of exchange rate fluctuations



▲ **Figure 38.4** Consequences of exchange rate fluctuations (stronger exchange rate)



▲ **Figure 38.5** Coping with a strong exchange rate

Common error

REVISED

Error	Why it is wrong
'Consumers and firms lose out from a stronger exchange rate.'	It is possible for some firms to gain from a stronger currency while others lose out. For example, firms selling price-inelastic products (e.g. petroleum) can gain from higher prices.

Target your revision

REVISED

- An exchange rate refers to the price of one currency measured in terms of other currencies.
- A foreign exchange market is the marketplace where different currencies can be bought and sold.
- In a floating exchange rate system, the currency is allowed to fluctuate against other currencies according to market forces, without any government intervention.
- In a fixed exchange rate system, the central bank or monetary authority buys and sells foreign currencies to ensure the value of its currency stays at the pegged value.
- The main advantage of a fixed exchange rate system is that it reduces uncertainties for international trade.
- An appreciation of the currency occurs in a floating exchange rate system when there is an increase in the currency's value. A depreciation of the currency occurs in a floating exchange rate system when there is a fall in the currency's value.
- A revaluation of the currency occurs in a fixed exchange rate system when the value of the currency is deliberately increased. A devaluation of the currency occurs in a fixed exchange rate system when the value of the currency is deliberately reduced.
- Causes of exchange rate fluctuations include: changes in the demand for imports and exports, price levels (inflation), the degree of foreign direct investment, speculation in the foreign exchange market and the degree of government intervention.
- Different stakeholders are affected by changes in the exchange rate in different ways. Exporters tend to lose out from a higher currency value. Customers and importers tend to gain, in the short term, as their purchasing power of foreign goods and services increases.
- Changes in the exchange rate have a direct impact on a country's balance of payments, employment levels, inflation rate and economic growth.

Test yourself

1 Complete the following sentence: In a floating exchange rate system, the value of a currency is determined by the __________ forces of demand for the currency and __________ of the currency.
2 What is the difference between an appreciation and a depreciation in the currency?
3 What is a fixed exchange rate system?
4 What are the potential advantages of having a weak currency?
5 How can a firm deal with rising exchange rates?

Answers on page 158

Tip

When calculating exchange rates, remember to round to 2 decimal places because the answer is always expressed in a currency, e.g. £1 = $1.25.

Sample questions and answers

REVISED

1 Suppose the exchange rate between the Australian dollar (AUD) and the Chinese yuan renminbi (CNY) is AUD1 = CNY6.5. Calculate the price for customers in China of buying textbooks priced at AUD65 from Australia. [2]

Student's answer

1 : 6.5 = 65 : 422.5 [1]

Hence, the price of the textbook = CNY422.5 [1]

2 Explain two advantages of a weak currency for the economy. [4]

Teacher's comments

Appropriate working out is shown and the correct answer given. Full marks are awarded.

Student's answer

Cheaper export prices due to the lower value of the currency [1] lead to rising export sales [1] and a larger trade surplus for the country [1], ceteris paribus. Exporters gain from the price advantage [1] over its American and other foreign rivals. This can therefore help to create income and wealth in the economy.

Teacher's comments

This is a very detailed answer for 4 marks. The candidate has shown a good level of understanding of the benefits of a lower exchange rate. Although the final sentence is correct, the candidate had already scored full marks beforehand.

Exam-style questions

1 Define the term *exchange rate*. [2]
2 Explain how a strong currency can benefit an economy. [2]
3 Suppose the exchange rate between the Australian dollar (AUD) and the Chinese yuan renminbi (CNY) is AUD1 = CNY6.5. Calculate the price for customers in China of buying wine priced at AUD65 from Australia. [2]
4 Suppose that the exchange rate between the Canadian dollar (CAD) and the British pound (GBP) is CAD1 = GBP0.65 and between the Canadian dollar and the euro (EUR) is CAD1 = EUR0.75. Calculate the exchange rate of the British pound against the euro. [2]
5 Explain **two** benefits of a floating exchange rate system. [4]
6 Explain **two** ways that a central bank can attempt to prevent a fall in the value of the country's currency. [4]
7 Discuss whether the exchange rate should be determined by market forces or by the government. [8]

Answers on pages 158–59

39 Current account of balance of payments

Key objectives

The objectives of this chapter are to revise:

- the structure of the current account of the balance of payments
- the causes of current account deficit and surplus
- the consequences of current account deficit and surplus
- policies to achieve balance of payments stability.

Key definitions

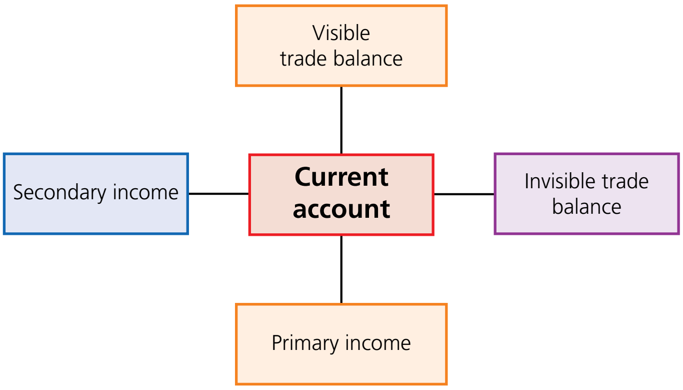
REVISED

Term	Definition
Balance of payments	An annual financial record of a country's transactions with the rest of the world.
Balance of trade (or trade balance)	The difference between a country's total export earnings and its total import expenditure.
Current account	Part of the balance of payments that records exports and imports of goods and services between a country and the rest of the world.
Current account deficit	This occurs when a country spends more money than it earns, i.e. import expenditure exceeds export earnings.
Current account surplus	This exists if a country's export earnings are greater than its import expenditure.
Invisible exports	Non-physical (intangible) services that are sold to foreign customers.
Invisible imports	Non-physical (intangible) services bought by domestic customers from foreign suppliers.
Invisible trade balance	A record of a country's trade in services, e.g. transportation and financial services.
Primary income (or investment income)	A record of a country's net income earned from investments abroad, e.g. profits earned by subsidiary companies based in overseas countries.
Secondary income	The final section of the current account which records net income transfers, i.e. income transfers between residents and non-residents.
Trade deficit	This exists if a country's import expenditure is greater than its export earnings, resulting in a negative trade balance.
Trade surplus	This exists if a country's export earnings are greater than its import expenditure, resulting in a positive trade balance.
Visible exports	These are physical (tangible) goods that are sold to foreign customers.
Visible imports	These are physical (tangible) goods bought by domestic customers from foreign sellers.
Visible trade balance	A financial record of a country's exports and imports of physical goods.

Current account of balance of payments

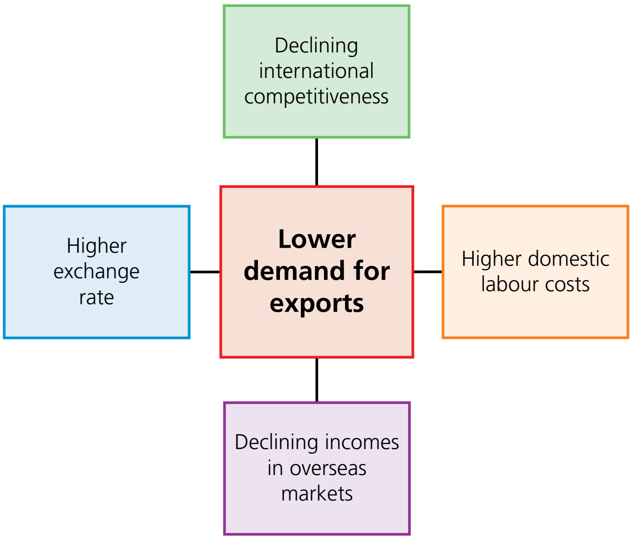
PAGES 284–92 REVISED

The current account



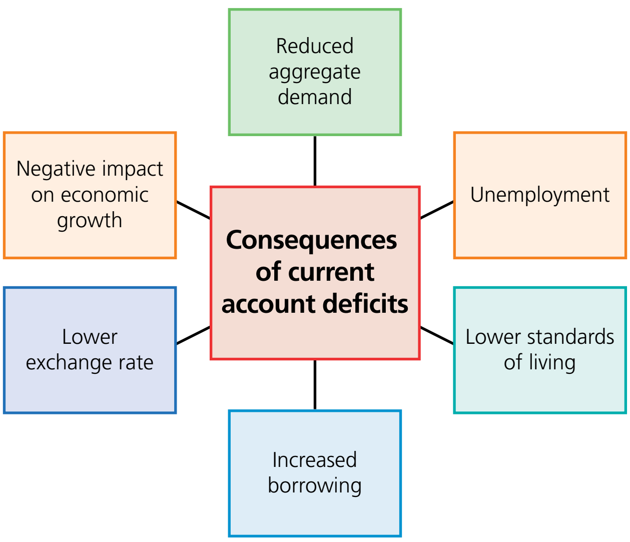
▲ **Figure 39.1** The current account on the balance of payments

Current account deficits

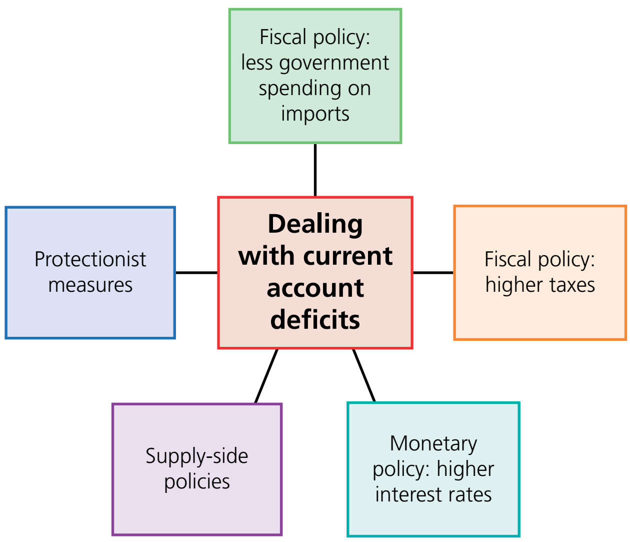


▲ **Figure 39.2** Causes of current account deficits (lower demand for exports)

▲ **Figure 39.3** Causes of current account deficits (higher demand for imports)

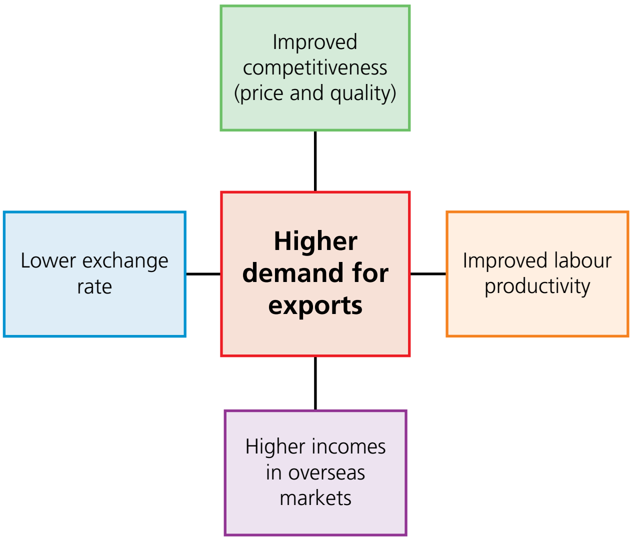


▲ **Figure 39.4** Consequences of current account deficits

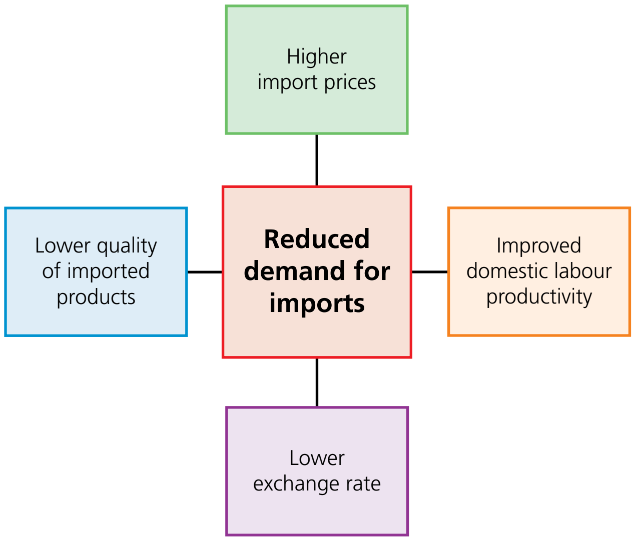


▲ **Figure 39.5** Dealing with current account deficits

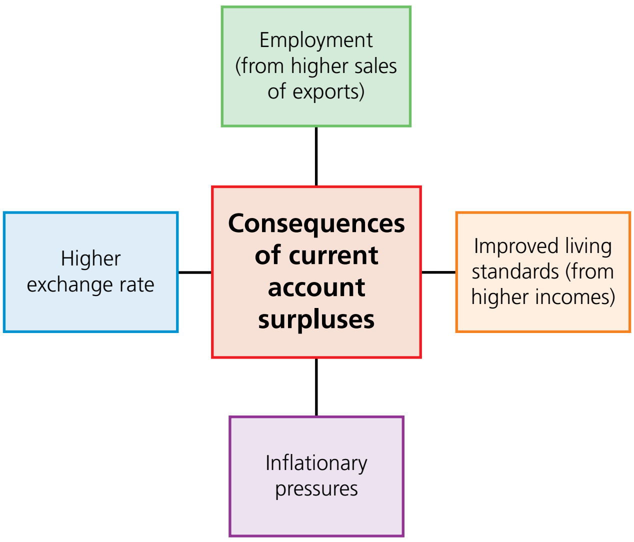
Current account surpluses



▲ **Figure 39.6** Causes of current account surpluses (higher demand for exports)



▲ **Figure 39.7** Causes of current account surpluses (reduced demand for imports)



▲ **Figure 39.8** Consequences of current account surpluses

Common errors

REVISED

Error	Why it is wrong
'Exports mean the selling of a good to an overseas buyer.'	Exports (and imports) are about flows of money, irrespective of whether a good is sold overseas. Furthermore, services are often consumed domestically by foreign tourists.
'It is bad for a country to have a deficit on its current account.'	A deficit on the current account that is manageable is not necessarily a bad thing. For example, the deficit may be the result of strong economic growth, so residents benefit from access to a range of good-quality imports.
'It is better for a country to aim for a surplus on its current account.'	A surplus on the current account is not necessarily a good thing. For example, a trade surplus can be gained by using trade protectionist measures. This limits access to foreign goods and services, thus causing living standards to be lower.
'A current account surplus can be used to pay for government spending.'	This common response suggests candidates need to learn the difference between a current account surplus and a (government) budget surplus.

Target your revision

REVISED

- The balance of payments is a financial record of a country's transactions with the rest of the world, per time period.
- Over time, the balance of payments must balance because a country can only spend what it earns.
- The current account is the largest component of the balance of payments, recording all exports and imports of goods and services between a country and its trading partners, plus net incomes from abroad.
- The current account is structured in four parts: trade in goods, trade in services, primary income and secondary income.
- The trade in goods (also known as the visible balance) records the balance of exports and imports of physical goods.
- The trade in services (also known as the invisible balance) is a record of the exports and imports of services (intangible products).
- The balance of trade is the sum of the trade in goods plus the trade in services, i.e. visible balance + invisible balance.
- As the balance of trade is the largest component of the current account, a deficit on the current account means that the value of imports is greater than the value of exports.
- By contrast, a surplus on the current account means that the value of imports is less than the value of exports.
- Primary income (also known as investment income) is a record of a country's net income earned from investments abroad.
- Secondary income is the final section of the current account, which records net income transfers between residents and non-residents of a country.
- The two key causes of current account deficits are lower demand for exports and higher demand for imports.
- Consequences of current account deficits include: reduced aggregate demand, unemployment, lower standards of living, increased borrowing and a lower exchange rate.
- The two key causes of current account surpluses are higher demand for exports and lower demand for imports.
- Consequences of current account surpluses include: more employment, improved standards of living, inflationary pressures and a higher exchange rate.
- There are four main macroeconomic policies that can be used to improve a country's current account balance: fiscal policy, monetary policy, supply-side policies and trade protection measures.

Tip

A surplus on the current account is not necessarily a good thing. For example, former communist nation Romania had a trade surplus by using trade protectionist policies. This limited access to foreign goods and services, thus causing living standards among its population to be lower.

Test yourself

1. Complete the following sentences: The balance of payments is a ______________ record of a country's transactions with the rest of the world for a given time period. The largest component of this account is called the ______________ account.
2. What is the balance of trade?
3. What is the difference between primary and secondary income?
4. What is the difference between a current account surplus and a current account deficit?
5. What are the consequences of current account deficits?
6. How might a government deal with a current account deficit?

Answers on page 159

Sample questions and answers

REVISED

1 Analyse how a government can improve the country's current account on the balance of payments. [6]

Student's answer

One way is to reduce the value of the currency [1] as this lowers export prices and raises import prices [1]. In theory, this should increase the demand for exports and decrease demand for imports [1], thereby improving the current account. Another way is to impose trade protection measures [1], e.g. tariffs would increase the price of imports [1] and quotas would reduce the availability of imports [1].

Teacher's comments

This answer is sufficient for 6 marks. The candidate shows a good level of understanding of how devaluation of the exchange rate and trade protectionism can help to improve the current account on the balance of payments.

2 Calculate the missing figures in the data below. [4]

Trade balance for Country D ($bn)	2018
Exports	285
Goods	157
Services	128
Imports	i
Goods	188
Services	115
Visible balance	ii
Invisible balance	iii
Trade balance	iv

Student's answer

i. *Imports = $188bn + $115bn = $303bn [1]*
ii. *Visible balance = $157bn – $188bn = –$31bn [1]*
iii. *Invisible balance = $128bn – $115bn = $13bn [1]*
iv. *Trade balance = –$31bn + $13bn = –$18bn [1]*

Teacher's comments

All calculations are correct, so full marks are awarded.

Exam-style questions

1 Explain why a country may have a visible trade deficit but have a current account surplus on its balance of payments. [2]
2 Explain the meaning of a current account deficit on the balance of payments. [2]
3 Identify **three** causes of a surplus on the current account of a country's balance of payments. [3]
4 Explain **two** consequences of a current account deficit. [4]
5 Explain how a fall in a country's exchange rate can reduce its current account deficit on its balance of payments. [4]
6 Explain why a current account surplus might not be desirable. [4]

Answers on page 159

Answers

Chapter 1

Test yourself

1 Examples of wants: toys, car, headphones, chewing gum, soft drinks, etc. Examples of needs: clothing, shelter, food and water.
2 Other IGCSE subjects, such as History, Geography or Business Studies.
3 Healthcare, education, public roads, motorways, street lighting, infrastructure, etc.
4 Haircuts, restaurant meals, massage, cinema, private education, etc.
5 Seawater, rain water, desert sand, air and daylight.

Exam-style questions

1 Finite resources, but infinite wants and needs [1], so the economy has to make choices about what, how and for whom production should take place [1]. These choices incur opportunity costs to the economy [1].
2 Scarcity means that resources are limited in supply [1], so it is not possible to meet everyone's wants and needs [1], so economic choices have to be made [1].
3 Economic activity in the private sector tends to focus on meeting the needs and wants of private individuals and firms [1]. Resource allocation is based on fulfilling the needs and wants of customers [1] in return for profit for the seller or supplier [1]. By contrast, economic activity in the public sector is determined by the government [1] in order to meet the needs and wants of society as a whole [1], such as education, healthcare, transportation networks, infrastructure and national defence [1].

Chapter 2

Test yourself

1 CELL: capital, enterprise, land and labour.
2 Interest, profit, rent and wages.
3 Geographical and occupational labour mobility.
4 For geographical mobility: family and friends, the cost of living, the presence of a good transportation network, immigration and emigration policies.
For occupational mobility: qualifications, skills, experience, cost and length of training, retraining programmes, the demand for specialised skills in a certain industry.
5 Changes in: the cost of factors of production; government policies; new technologies; net migration of labour; education and training; and healthcare provision.

Exam-style questions

1 The four categories of resources [1] that are needed to produce any good or supply any service [1], namely: land, labour, capital and enterprise [1].
2 Factors of production [1] used to produce goods and services [1]. Factor inputs [1] consisting of land (natural resource), labour (human resource), capital and entrepreneurship [1].
3 These are human-made goods [1] used to produce other goods and services [1] such as machinery [1], tools [1] or capital equipment [1].
4 Machinery, such as conveyor belts in a factory, might be used for different purposes [1]. Drinks manufacturers might be able to use their machinery to produce bottled water or soft drinks, for example [1].
5 Possible factors include:
   - The cost and availability of factors of production [1] – ceteris paribus, the higher the cost, the more likely the firm will use an alternative factor of production [1].
   - The relative cost and ease of substitution of factors of production [1] – if capital is relatively expensive, then labour-intensive production methods may be preferred [1].
   - The type of product being made [1], e.g. aircraft manufacturing will require more capital [1] whereas teaching will require more labour [1].
   - The size of the firm [1], e.g. large supermarkets can afford the latest technologies, so can be more capital-intensive [1] whereas small retailers may rely more on labour services [1].
   - The productivity of factors of production [1], e.g. having highly skilled workers means a firm can become more labour-intensive [1].

Chapter 3

Test yourself

1 forgone, decision
2 The lost opportunity of being able to choose another IGCSE subject to study, e.g. History, Geography or Business Studies.
3 The next best opportunity forgone for that household, e.g. a new Toyota Corolla motor car, or using the money towards a child's university fees.
4 The next best project that the government could have spent the $3 billion on, if the new airport terminal had not been built, e.g. new schools, hospitals or motorways.

5 Examples include consideration of: different wages and benefits offered by other employers; different career and promotional prospects; working conditions; travel time and cost for the workers.

Exam-style questions

1 Scarcity means that resources are finite in supply **[1]**, i.e. at any point in time, there is a limited amount of factors of production in the economy **[1]**.

2 Due to the scarcity of resources **[1]**, it is not possible to meet everyone's wants or desires **[1]**. Hence, choices have to be made about how best to allocate these scarce resources **[1]**.

3 Scarcity implies that there are insufficient resources **[1]** to satisfy the unlimited wants **[1]** of consumers. This creates the need for consumers and firms to make a choice **[1]**. Hence, choices generate an opportunity cost in terms of the (next) best alternative that is forgone **[1]** when making an economic decision **[1]**.

Chapter 4

Test yourself

1 productive, potential (or 'maximum')

2 Two – one on the y-axis, and the other on the x-axis.

3 There are unemployed factors of production and/or resources are being used inefficiently.

4 Given the current quantity and quality of resources, the economy is not able to produce beyond the current *PPC*.

5 Due to any factor that causes an increase in the quantity and/or quality of factors of production.

Exam-style questions

1 War, trade conflict, economic recession, natural disasters, widespread diseases, mass poverty, famine, droughts, etc. Award 1 mark for each.

2 Improvements in the quantity **[1]** and/or quality **[1]** of factors of production.

3 By producing more of one good or service as shown on a *PPC*, the economy automatically forgoes the production of the other good or service **[1]**. This demonstrates opportunity cost as it involves a forgone opportunity when an economic decision is made **[1]**.

4 a = A, b = E, c = B or C, d = F

Chapter 5

Test yourself

1 Microeconomics, Macroeconomics

2 Economic growth; inflation and deflation; employment and unemployment; balance of payments; redistribution of income; macroeconomic policies, etc.

3 Factors of production; demand and supply; price elasticity of demand; market failure; economies and diseconomies of scale; costs and revenues; market structures, etc.

4 Consumers, individual households and firms.

5 Governments and international organisations such as the International Monetary Fund (IMF), World Bank and United Nations.

Exam-style questions

1 The study of an individual market **[1]**, analysing particular parts of the economy in isolation **[1]**, instead of looking at the economy as a whole **[1]**.

2 All stakeholder groups are affected by macroeconomic decisions. Examples include:
- Consumers – tax rates affect their disposable income **[1]** and hence level of consumption **[1]**.
- Households – the state of the economy **[1]** such as a recession or economic boom affects employment levels **[1]** and hence household disposable incomes **[1]**.
- Firms – taxes or subsidies affect their costs of production **[1]** and hence level of output and profits **[1]**.
- Government – macroeconomic decision making will impact on the level of tax revenue **[1]** and government spending on items such as education, healthcare and national defence **[1]**.

Chapter 6

Test yourself

1 What, how and for whom production should take place.

2 surplus, shortage

3 higher, lower

4 No government interference in economic activities; resources are allocated on the basis of price; resources are allocated based on financial incentives; competition, which creates choices and opportunities; resources are allocated to individual firms and private consumers who are willing and able to pay.

Exam-style questions

1 The economic system of relying on the market forces of demand and supply **[1]** to allocate scarce resources in the economy **[1]**.

2 Advantages could include:
- Private firms and individuals have the economic freedom to allocate scarce resources **[1]** without interference from the government, which can sometimes be bureaucratic and inefficient **[1]**.
- It creates economic incentives for firms **[1]** as goods and services are produced for those who have the willingness and ability to pay **[1]**.
- The system promotes competition **[1]**, which creates greater choice **[1]** and opportunities for firms and potentially better quality and lower prices for individual consumers **[1]**.
- The allocation of factor resources is based on financial incentives **[1]**, such as incentives for people to work hard in return for monetary rewards **[1]**.

3 By the forces of demand and supply:
- If price is too low, there is excess demand **[1]**, so firms raise prices accordingly to tackle the shortage **[1]**.
- If price is too high, there is excess supply **[1]**, so firms reduce prices accordingly to get rid of the surplus **[1]**.

Chapter 7

Test yourself

1 willingness, ability
2 price, non-price
3 Individual demand refers to the demand for one person, whereas market demand refers to the sum of all individual demand for a product at each price level.
4 A leftward shift of the demand curve.
5 Extension of demand.

Exam-style questions

1 Demand refers to the willingness and the ability **[1]** of customers to pay a given price to buy a good or service **[1]**. The higher the price of a product, the lower its demand tends to be **[1]**.
2 The higher the price, the lower the quantity demanded **[1]**, ceteris paribus. This is because customers have greater ability to buy as the price falls **[1]**, so quantity demanded is likely to rise **[1]**.
3 A change in the price of a good or service **[1]** causes a movement along the demand or supply curve **[1]**.
Alternatively, a price rise will cause a contraction in demand **[1]** for the product and an expansion in supply **[1]**, and vice versa.
4 Award 1 mark for an acceptable factor and another mark for the explanation. Such factors could include:
- Lower price **[1]** due to more competition in the rice industry **[1]**.
- Higher consumer incomes **[1]**, thereby increasing their ability to buy rice **[1]**.
- A rise in population **[1]**, so more people to buy the rice **[1]**.
- Better quality **[1]** due to more skilled labour or improved technologies **[1]**.
- A rise in the price of other staple foods **[1]** such as wheat/bread or potatoes **[1]**.
- Fall in the value of the currency **[1]**, so rice exports become relatively cheap **[1]**.

Chapter 8

Test yourself

1 ability, willingness
2 higher, price
3 Taxes shift the supply curve to the left (due to higher costs) whereas subsidies shift supply to the right (due to lower production costs).
4 Price, costs of production, taxes, subsidies, time, technology and weather.

Exam-style questions

1 Supply is the ability and willingness of firms **[1]** to provide goods and services at given price levels **[1]**. In general, supply will tend to be higher at higher prices, ceteris paribus **[1]**.
2 There are two reasons for this:
- Existing firms in the market can earn greater profit margins **[1]** if they supply more at higher prices **[1]**.
- New firms are attracted to the market **[1]** as the higher price allows them to cover their production costs **[1]**.
3 Award 1 mark for an acceptable factor and another mark for the explanation, up to the maximum of 4 marks. Such factors could include:
- Higher price **[1]** due to higher levels of consumer demand, thereby increasing the incentive for rice producers to raise supply **[1]**.
- A rise in population **[1]**, so more people to buy the rice **[1]**.
- Better quality **[1]** due to more skilled labour or improved technologies **[1]**.
- A rise in the price of other staple foods **[1]** such as wheat/bread or potatoes **[1]**.
- A fall in the value of the currency **[1]**, so rice exports become relatively cheap **[1]**.
4 A shift in supply is caused by changes in non-price factors **[1]** that affect supply, e.g. taxes and adverse weather **[1]**. A movement in supply is caused only by changes in prices **[1]**, resulting in a contraction or extension in quantity demanded **[1]**.

Chapter 9

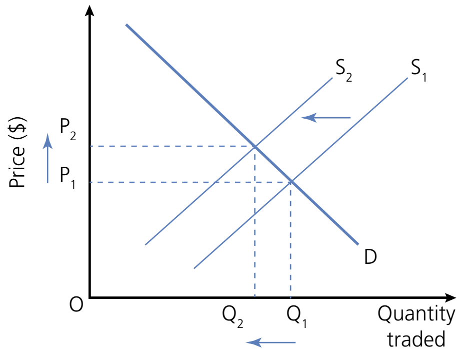
Test yourself

1 demand, supply
2 demand, supply
3 Disequilibrium is inefficient as it involves either shortages or surpluses.
4 Excess supply (surplus) of 200 units.
5 Excess demand (shortage) of 800 units.

Exam-style questions

1 When the price is set above the equilibrium **[1]**, resulting in supply exceeding demand **[1]**.
2 When the price is set below the equilibrium **[1]**, resulting in demand exceeding supply **[1]**.
3 The price established where the demand for a product equals the supply of the product **[1]**, avoiding a situation of shortages or surpluses **[1]**.
4 The imposition of a sales tax increases the costs of production, thereby shifting the firm's supply curve from S_1 to S_2 in the diagram below. This causes the equilibrium price to increase from P_1 to P_2 and the

equilibrium quantity traded to fall from Q_1 to Q_2, ceteris paribus.



Award up to 2 marks for the explanation and up to 2 marks for an appropriately drawn diagram.

5 If price is above its equilibrium level, there will be excess supply **[1]**; so equilibrium price falls to eliminate the surplus **[1]**.

In the same way, if price is above the equilibrium level, there will be excess demand **[1]**; so the equilibrium price increases to eliminate the deficit **[1]**. The price mechanism rations and allocates resources **[1]** to ensure shortages and surpluses are eliminated **[1]**.

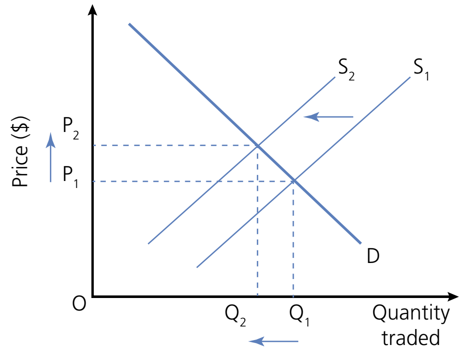
Chapter 10

Test yourself

1 non-price, equilibrium
2 supply, right
3 Higher disposable income; persuasive advertising; favourable changes in fashion and tastes; higher price of substitute products, such as tea, etc.
4 Price; wages of farmers and agricultural workers; costs of fertilisers and other direct production costs; government intervention (taxes or subsidies for banana growers); the weather, etc.

Exam-style questions

1 Explanation of any two factors, such as: lower consumer income and cheaper alternatives (e.g. smartphones or tablet computers). Award 1 mark for each factor and 1 mark for the explanation.
2 There is a leftward shift in the demand curve for Nike sports shoes **[1]**. This is because there is lower demand for Nike sports shoes **[1]**, ceteris paribus, due to the lower-priced rival sports shoes from Adidas **[1]**. This causes the market price of Nike sports shoes to fall **[1]**.
3 The sales tax will increase production costs, so shift the supply curve to the left **[1]**. This increases the market price from P_1 to P_2 and reduces the equilibrium quantity from Q_1 to Q_2 **[1]** in the diagram below.



Award up to 2 marks for a fully labelled and correctly drawn diagram.

Chapter 11

Test yourself

1 elastic, substitutes
2 increase, reduce
3 Whether there are close substitutes; the proportion of people's income spent on the product; the degree of necessity; time that consumers have available to search for alternative (rival) products.
4 Price inelastic (petrol is habit forming for drivers, whereas cigarettes are addictive products).
5 The ability or pricing strategy of firms with market power to charge different customers different prices for the same good or service because of different willingness and ability to pay (i.e. different PED values for different customers of the same product).

Exam-style questions

1 PED measures the extent to which the demand for a good or service changes due to a change in its price **[1]**. The formula is: percentage change in quantity demanded/percentage change in price **[1]**.
2 Award 1 mark for identification of a relevant factor, and another mark for the correct explanation. Factors can include: time, habits, addictions, taste, fashion, percentage of income spent on the good/service, whether good is a necessity, availability of substitutes, price of substitutes and degree of substitution, cost of switching, durability.
3 The product might lack substitutes **[1]**, such as private education or private healthcare **[1]**, so customers are less responsive to increases in price **[1]**. Additionally, the price of the product might account for only a small proportion of income **[1]**, such as the purchase of matches, candles or lightbulbs **[1]**, so higher prices might not have much of an impact on the level of demand **[1]**.
4 Price discrimination is the ability or strategy of firms to charge different customers different prices **[1]** for essentially the same product **[1]**. This is because of differences in their PED **[1]**, e.g. children and adult fares charged by airlines, cinemas, theatres and theme parks **[1]**.

5 Award 1 mark for defining PED or price inelastic demand [1]. Award up to 2 marks for each relevant factor that is explained, such as differences in:
- the availability and closeness of substitutes
- customs, habits and tastes
- the proportion of income spent on the product (average income is likely to vary in the two countries)
- what is considered to be a necessity
- what is considered to be a luxury product.

Chapter 12

Test yourself

1 supply, price

2 elastic, inelastic

3 Perfectly price inelastic.

4 Perfectly price elastic.

5 Supply has unitary price elasticity ($PES = 1$).

Exam-style questions

1 A measure of how responsive supply is to changes in price [1]. $PES = \%\Delta Q_S / \%\Delta P$. [1]

2 Explanation of how any two of the following can affect the value of PES: factor substitution, inventory (stock levels), rivalry in the industry, spare capacity, time, barriers to entry, etc. Award 1 mark for each determinant, and 1 mark for each correct explanation.

3 Possible answers include:
- If the production process is long [1], it is difficult to adjust supply quickly in response to an increase in price [1].
- It might not be possible to store the product [1], i.e. inventory (stock) cannot be used to meet a sudden increase in demand for the product [1].
- Supply is more price inelastic in the short run [1], so the time period under consideration has an implication for the value of PES [1].
- There might be a shortage of raw materials or components [1], so it becomes more difficult to increase supply in response to higher prices for the product [1].

4 The PES of smartphones will be relatively high due to the capital-intensive technologies used to mass produce computers [1]. Large manufacturers can produce millions of smartphones each year [1] in response to higher price. Using specialised machinery means they can change the level of output (supply) very easily [1]. By contrast, the PES for organic vegetables is low due to the time [1] needed to grow and harvest the crops. External factors such as climate, weather conditions and crop infestations can also prolong the supply of organic vegetables [1], so suppliers cannot easily respond to a change in price [1].

Chapter 13

Test yourself

1 demand, private

2 incentives, profit, earnings (accept 'wages' or 'salaries')

3 Reliance on the market forces of demand and supply to allocate resources; reliance on the private sector for economic activity; economic agents driven by incentives (e.g. wages, salaries and profits).

4 The private sector (accept 'the price mechanism').

Exam-style questions

1 Possible advantages include:
- Consumers have greater choice [1] in the goods and services that are produced.
- They can pursue their own career choices [1].
- Production is more likely to be efficient [1] due to competition [1].
- The existence of competition helps to reduce costs [1], so consumers benefit from lower prices [1].
- Incentives exist for people to work hard to earn high wages [1] and for firms to be productive and efficient in order to earn high profits [1].

2 Possible disadvantages include:
- The free market economy promotes income and wealth inequality [1], e.g. the rich get richer by having access to better education [1].
- Vulnerable groups [1], such as the uneducated, unskilled and sick, may find it very difficult to earn an income [1].
- Economic decision making is based on private costs and benefits only [1] without concern for external costs and benefits [1], so this can distort efficiency in resource allocation [1].
- There will be under-consumption and under-production of merit goods) [1] whereas there will be too many demerit goods [1] produced and consumed, from society's point of view.
- Similarly, public goods may not be produced [1] as it is extremely difficult to prevent non-buyers from being able to freely consume the product [1].
- Monopolies operating in the private sector [1] have the market power to charge higher prices [1], restrict choice [1] or reduce quality [1] as there is no competition or government intervention.

3 An economy with both a private sector and a public sector [1], where resources are allocated by both the price mechanism and government [1]. Households (consumers) and firms make some decisions based on free markets [1] while some are directives set by the government about what, how and for whom to produce [1].

Chapter 14

Test yourself

1. price, allocate
2. benefits, costs
3. National defence, law and order, street lighting, flood control systems, emergency services, public fireworks displays, lighthouses, public roads and public radio broadcasts.
4. Education, healthcare, training and development, public libraries, medicines, sports and recreation.
5. Smoking (tobacco), drinking (alcohol), recreational and hard drugs, gambling, junk food, sugary drinks, high-caffeine energy drinks, and (possibly) violent video games.

Exam-style questions

1. Possible answers include:
   - Over-production and/or over-consumption of demerit goods, such as tobacco, alcohol and gambling **[1]**.
   - Under-production and/or under-consumption of merit goods, such as education and healthcare services **[1]**.
   - The non-production and hence non-consumption of public goods, such as street lighting and public road signs **[1]**.
   - The existence of negative externalities, such as noise and air pollution that affect third parties **[1]**.
   - Imperfect information, such as trade secrets **[1]**.
   - The existence of private sector monopoly power **[1]**.
2. External costs or negative externalities **[1]** are the harmful effects of private transportation imposed on third parties **[1]**. External costs = social costs *minus* private costs **[1]**. Private vehicles burn fuel, creating air pollution, noise pollution, visual pollution **[1]**, congestion **[1]**, damage to natural habitats **[1]** and harm to the health of pedestrians and cyclists **[1]**.
3. Social costs include both external and private costs **[1]**. Alcohol generates external costs **[1]**, e.g. drink-driving (traffic accidents), disorderly behaviour and crime **[1]**. Hence, the social costs of alcohol consumption exceed the private costs **[1]**.
4. Possible causes include:
   - Abuse of market power **[1]** which results in output being less than the socially desirable level **[1]**, with higher prices being charged **[1]** and/or lower quality due to the lack of competition **[1]**.
   - It can also be caused by decisions being based only on private costs and benefits while ignoring external costs **[1]** and external benefits **[1]** of decisions, which results in under-consumption (merit goods) **[1]** or over-consumption (demerit goods) **[1]**.
   - Imperfect information – a lack of clear and transparent information – **[1]** causes consumers to make inefficient or irrational choices **[1]**, such as the dangers of smoking, gambling and alcohol **[1]**.
5. Possible discussion points include:
   - There is an opportunity cost **[1]** to subsidising university students; the money could have been used for alternative purposes, e.g. healthcare **[1]**.
   - The government has limited finance **[1]**, so might not be able to afford to pay for everyone's university education **[1]**.
   - Graduates learn new skills and gain qualifications **[1]**, so are likely to have greater employment opportunities **[1]** and higher earning potential **[1]**, so should pay for these private benefits of education **[1]**.
   - Subsidising people's university education may require higher taxes **[1]** and/or result in a budget deficit **[1]**.
   - Charging students the full cost of their university education may create greater incentives for them to consider the full opportunity cost of their studies **[1]**.
   - Not all students need financial assistance from the government as they come from relatively rich backgrounds **[1]**, so some form of means-tested assistance might be used instead of full payment from the government **[1]**.
   - Some people may emigrate upon or shortly after graduating **[1]**, so other countries receive the benefits of their education at the opportunity cost of the domestic government **[1]**.
   - However, government funding of university education leads to a more educated labour force **[1]**, thereby leading to higher national output **[1]** and reduced unemployment **[1]** and increasing income tax revenue in the long run **[1]**.
   - Education, including tertiary education, leads to improved standards of living **[1]**, generating external benefits **[1]**.
   - Students from relatively poor families may not be able to afford the cost of university education **[1]**, so without government funding the number of graduates would be much lower **[1]**, causing greater income inequality **[1]**.
   - The social benefits of university education create an argument for the government to pay part of the cost **[1]**, based on the principle of people's ability to pay **[1]**.

Chapter 15

Test yourself

1. market (or 'free market'), public
2. maximum, minimum
3. Minimum price.
4. Maximum price.
5. Both private sector and public sector allocation of resources.
6. Indirect tax, subsidies, rules and regulations, privatisation, nationalisation and direct provision.

Exam-style questions

1 A way of organising an economy with both private and public sector output [1] and decision making about what, how and for whom production should take place [1].

2 Privatisation is the transfer of ownership of assets [1] from the public sector to the private sector [1], i.e. transferring state-owned assets to private owners [1].

3 An economy with a private sector and a public sector [1]. Resources are therefore allocated by both the price mechanism and government [1]. Households and firms make some decisions based on the price mechanism [1] or market forces of demand and supply [1], while some economic decisions are made by the government about what, how and for whom to produce [1].

4 The government sets price below the equilibrium [1] in order to make certain goods and services more affordable [1], e.g. rent controls [1].

5 The government sets price above the equilibrium [1] in order to encourage more supply of a certain good or service [1], e.g. minimum wages to create incentives to work [1].

Chapter 16

Test yourself

1 medium, purchase

2 Any commodity that can be used as a medium of exchange that is widely accepted for the purchase of goods and services.

3 Medium of exchange, measure of value, store of value, and standard for deferred payment.

4 The act of swapping items in exchange for other items through a process of bargaining and negotiation.

5 The monetary authority that oversees and manages the money supply and the banking system of an economy.

Exam-style questions

1 A key characteristic of money [1] referring to anything that is generally acceptable to be used to facilitate the buying and selling of goods and services [1].

2 Central bank functions include:
- It issues notes and coins [1].
- It is the government's bank [1].
- It is the lender of last resort [1].
- Like any bank, it provides financial services to its customers – commercial banks and the government [1].
- It implements the country's monetary policy [1] *or* it sets interest rates to influence the level of total demand in the economy [1].
- It influences the exchange rate by buying and selling currencies in the foreign exchange market [1].

3 Points of explanation include:
- Notes and coins are considered as money because they carry out the functions of money [1], i.e. cash acts as a medium of exchange [1] and is generally accepted within a country as payment for goods and services [1].
- Notes and coins also act as a store of value [1] – people can save their notes and coins for use at a future date [1].
- Notes and coins also act as a unit of account [1], i.e. they measure the value (prices) of goods and services [1].

4 Functions of money are:
- Money acts as a medium of exchange [1], i.e. it is generally accepted in order to buy and sell products [1].
- It is a store of value [1], i.e. money can be saved for/used in the future [1].
- It is a unit of account [1], i.e. it is a measure of value [1], so can be used to compare the value of different products.
- It is a standard for deferred payments [1], i.e. money enables people and businesses to borrow and lend [1].

5 Analysis could include:
- It is the sole issuer of banknotes and coins [1], so is vital to the functioning of the country's banking sector [1].
- Through manipulating interest rates, the central bank (or government) influences the level of savings and expenditure in the economy [1].
- The central bank operates the country's monetary policy [1], overseeing its money supply and interest rate policy [1].
- As it oversees interest rates in the country, the central bank has a key role in maintaining price stability/controlling inflation [1].
- It acts as a lender of last resort [1], which is vital in order to prevent commercial banks going out of business [1].
- Controlling inflation is vital to maintaining or improving the country's international competitiveness [1].
- Overall, the central bank is critical to establishing and maintaining a strong banking sector [1], which helps to promote financial stability and investment [1].
- It oversees the national debt [1] by issuing (selling) government bonds [1], and paying interest on these government bonds [1].

Chapter 17

Test yourself

1 wages (accept 'salaries'), Disposable

2 The difference between the value of a person's assets (what they own) and their liabilities (the amount they owe).

3 The cost of borrowing money or the return on saving money.
4 A financial product offered by banks enabling customers to purchase goods and services with deferred payment, i.e. they buy now and pay later.
5 The level of disposable income, interest charges, business and consumer confidence levels, the availability of funds (i.e. the money supply), availability and cost of credit, and level of household wealth.

Exam-style questions

1 Award 1 mark for each valid factor identified, including:
   - The amount of disposable income.
   - The amount of wealth.
   - The level of interest rates.
   - The proportion of income that is spent on the product.
   - Consumer confidence levels.
   - The rate of income tax, sales taxes and incentives to save.
   - The age structure of the population.
   - Social attitudes towards saving.

2 Possible reasons include:
   - The government might want people to increase their spending **[1]**, perhaps to stimulate economic growth **[1]** and/or to lower unemployment **[1]**.
   - Borrowing, if affordable, can enable people to enjoy a higher standard of living **[1]** as they can purchase products, such as cars or furniture, beyond their income **[1]**.
   - People may be encouraged to borrow for their future benefit **[1]**, such as university students borrowing to spend on their education **[1]** to increase their future earning potential **[1]**.

3 Possible reasons include:
   - People may get into debt that they cannot afford **[1]**, resulting in repossessions of property **[1]**.
   - Borrowing money to fund current expenditure **[1]** could result in demand-pull inflation in the economy **[1]**.
   - The funds could be used to purchase more imports **[1]**, thus causing a current account deficit **[1]**.
   - An increase in demand for loans can result in higher interest rates **[1]**, which makes it more difficult for those on low incomes to borrow money **[1]**.

4 Possible effects include:
   - An increase in bank lending to consumers increases spending by households **[1]**, thus raising the level of total (aggregate) demand and hence economic growth **[1]**.
   - An increase in bank lending to businesses encourages firms to produce more output **[1]** and/or new businesses to set up **[1]**, thus raising economic growth in the country **[1]**.
   - An increase in investment expenditure, funded by bank loans, can help to raise the country's productive capacity **[1]**, which will increase its GDP in the long term **[1]**.
   - However, an increase in bank lending can lead to inflation **[1]**, which could damage the country's long-term economic growth **[1]**.
   - Although consumers borrow more from banks, the funds could be used to purchase more imports **[1]**, which reduces economic growth **[1]**.

5 Discussion points could include:
   - Those on low incomes may have to borrow more in order to buy basic necessities **[1]**, such as borrowing to fund the healthcare and educational expenses of their children **[1]**.
   - The poor may also need to borrow more in order to purchase expensive items for their household **[1]**, e.g. furniture and beds **[1]**.
   - They may therefore be more likely to get into debt **[1]**.
   - The poor may need to borrow more to cover their debt repayments **[1]**, thus fuelling increasing levels of debts **[1]**.
   - The poor are unlikely to have much, if any, savings to fund their purchases **[1]**, so will need to borrow more **[1]**.
   - They are therefore likely to borrow more as a proportion of their income **[1]**, even though those on high incomes are likely to borrow more in absolute terms **[1]**.
   - However, banks may be reluctant to lend money to those on low incomes **[1]** because they represent high risk, i.e. banks are concerned that the poor may not be able to repay their debts **[1]**.
   - Since banks charge a higher interest rate to customers representing a higher level of risk **[1]**, the poor may be unable to afford debt financing **[1]**.
   - While the rich may not need to borrow money to finance their purchases of necessities **[1]**, they are more likely to borrow greater sums of money to finance the purchase of expensive items such as cars and property **[1]**.

   Award up to 5 marks for a one-sided, unbalanced answer.

Chapter 18

Test yourself

1 derived, cost
2 geographically, occupationally
3 Wages (or salaries), piece rate, commission, bonuses, profit-related pay, share option schemes and fringe benefits (financial perks).
4 Challenge, career prospects, length of training, education and qualifications, level and breadth of experience, personal satisfaction, etc.
5 Wages are paid per time period (usually per hour worked), whereas salaries are a fixed payment (usually paid per month) irrespective of the number of hours worked.

Exam-style questions

1 Differences in earning between workers [1] due to differences in the demand for and supply of labour [1], e.g. skilled workers are in higher demand and lower supply so they tend to earn higher wages [1].

2 Possible reasons include:
- The person may not be experienced or skilled [1].
- The job could offer attractive fringe benefits [1], e.g. bonuses or good facilities [1].
- There could be opportunities for overtime [1].
- To keep busy as working might be better/more productive than being unemployed [1].
- A lack of employment opportunities [1].
- Working for a charity may entail working for a low wage [1].

3 Possible factors include:
- Wage/salary payments [1].
- Skills and training/qualifications required [1].
- Working hours [1].
- Fringe benefits such as bonuses, holiday entitlement, pension schemes and housing allowance [1].
- Job security [1].
- Job satisfaction [1].
- Prospects for professional development and career growth [1].
- Travelling time to/from work [1].

4 Possible reasons include:
- Skilled workers are more likely to be in demand [1], as they are more productive and valuable to the firm [1].
- Unskilled workers are in lower demand [1] due to their lower level of skills and qualifications [1], so tend to be paid less.
- Skilled workers are in shorter supply [1], so can demand higher average wages [1].
- Unskilled workers do not tend to belong to strong professional associations and trade unions [1], unlike skilled professionals, so they tend to have weaker bargaining power to advocate for higher earnings [1].

5 Possible reasons include:
- Higher wages and better fringe benefits in overseas countries [1], leading to improved living standards [1].
- Better working conditions [1], such as a better working environment, more public/statutory holidays and/or a safer environment [1].
- Greater career opportunities for promotion [1], leading to greater motivation, higher income and sense of achievement [1].
- Opportunities to gain experience working in another country [1] and to gain a broader set of skills, thus improving employability and earnings when returning to the home country [1].

Chapter 19

Test yourself

1 welfare (or 'benefit'), members

2 Number of members, unity of purpose of members, willingness of members to take appropriate industrial action.

3 Pay negotiations, improved terms and conditions for its members, legal services and advice, support during employment disputes (e.g. unfair treatment at work, legal disputes and redundancies).

4 Work-to-rule, go-slow, sit-in, overtime ban and strike action.

5 Negotiations on their behalf for better basic pay, improved bargaining power to discuss terms and conditions of work, trade unions have more power than an individual worker trying to negotiate with the employer, trade unions exist to support the demands of their members.

Exam-style questions

1 Collective bargaining is the process of trade union representatives negotiating [1] on behalf of their worker members with employer representatives [1], usually for better pay and terms and conditions of employment [1].

2 Industrial action refers to measures taken by trade unions and their members during major disagreements or disputes with their employers [1], such as work-to-rule, go-slow, sit-in or strike action [1].

3 A trade union is an organisation that operates for the welfare and benefit of its worker members [1]. It engages in the collective bargaining process with employer representatives [1] to negotiate for better wages/salaries [1].

As the employee representative body, it strives to protect and promote other interests of its members [1], e.g. enhanced terms and conditions of employment, better working conditions, and improved health and safety at work [1]. The trade union will often negotiate with governments on behalf of its members [1] for new or improved employment laws such as minimum wages and/or maximum working hours [1].

4 Possible reasons include:
- It eliminates the need to negotiate with individual workers [1] as negotiations take place with union representatives [1].
- It may attract more people to apply for jobs at the firm [1], as they can expect better working conditions and job security [1].
- Unions help to provide an additional channel of communication with workers [1], such as passing on information about new working practices [1].
- Unions can help to reduce conflict and develop improved industrial relations [1], which ultimately benefits the firm in terms of higher labour productivity and employee motivation/loyalty [1].

5 Discussion points include:
- Members will benefit from the union being able to negotiate better basic pay [1].
- Trade unions are only as strong as the number of united members who join the union [1]; a union will also have more power than an individual worker trying to negotiate better pay and conditions [1].
- There is bargaining strength in large numbers [1] because a union can threaten employers with industrial action in order to support their demands [1].
- However, members have to pay a fee to join the union [1] but, as individuals, may never need to call upon the services of the union [1].
- The union might vote/require the workers to take strike action [1], which results in members losing potential earnings [1] or even redundancies [1]; prolonged strike action could even force the firm to go out of business [1], causing unemployment.

Award up to 4 marks for an unbalanced, one-sided answer.

Chapter 20

Test yourself

1 Number of employees, market share, value of capital employed, and sales revenue.

2 Internal growth, franchising, external growth (mergers and takeovers).

3 Proximity to related firms, availability of skilled labour, reputation of the geographical area, access to transportation networks, R&D facilities and location of suppliers.

4 Purchasing economies, technical economies, financial economies, managerial economies, marketing economies, research and development economies and risk-bearing economies of scale.

5 Communication problems, culture clashes, alienation of the workforce, reduced command and control, management inefficiencies, compliance and regulatory costs, and industrial relations (office politics).

Exam-style questions

1 Factors could include:
- The level of demand [1] – if demand is low, the size of the firm is likely to be small [1].
- Availability of finance [1] – a small firm may not be able to expand due to a lack of finance [1], whereas large firms can benefit from financial economies of scale [1].
- Some entrepreneurs choose to keep their firm small [1] in order to maintain control [1] or to avoid the stress associated with operating on a larger scale [1].

2 Possible reasons include:
- Ineffective management [1] as the firm becomes too large to control and manage [1].
- Poor industrial relations [1] due to the large size of the business, causing a greater chance of industrial unrest [1].
- Operating at such a large scale can put pressure on the firm's infrastructure [1], causing inefficiencies and hence higher average costs of production [1].
- External diseconomies of scale may arise due to congestion [1] and pollution [1], thereby increasing unit costs of production [1].

3 Possible reasons include:
- There are high start-up costs [1] in the aircraft manufacturing industry as the production process is capital intensive [1].
- Large aircraft manufacturers can take advantage of economies of scale [1], such as technical and financial economies, so that the average cost of each aircraft is lower than otherwise [1].
- Generally, only large firms can afford to invest in research and development [1] in order to improve the design, features, safety and overall quality [1].

4 A merger is usually agreed upon [1], with the owners of two or more firms voting for the organisations to form a new company [1]. By contrast, a takeover occurs when a firm buys a controlling stake [1] in another firm, i.e. it owns the majority of shares in the target company [1]. While mergers are usually mutually beneficial [1], takeovers are often hostile and against the wishes of the target firm [1].

5 Analysis could include:
- Firms grow organically by selling more goods and services [1], so this usually increases the firm's level of profit [1] if its sales revenue rises by more than its costs [1].
- Firms can also grow inorganically by merging with or taking over rival firms [1], which eliminates competition and helps the firm to increase its profit [1].
- Larger firms are able to take advantage of economies of scale [1], cutting their average costs of production, which increases profits, ceteris paribus [1].
- Larger firms have greater market power [1], such as marketing budgets used to establish brand loyalty, or the ability to create barriers to entry [1], which both help to increase the firm's profits [1].
- Greater market power also allows larger firms to push up prices [1], thereby improving their profit margins [1].

Chapter 21

Test yourself

1 capital, derived

2 Derived demand, costs of the various factors of production, quantity and availability of resources, quality of the factors of production, etc.

3 Investment expenditure, innovations and state of technology, skills and experience of the workforce, degree of entrepreneurial spirit, intensity of competition in the industry, etc.
4 High set-up costs, machinery can break down, training costs (so workers can operate the machines), maintenance costs, machines lack initiative and creativity, individual customer requirements cannot be met, etc.
5 Expensive in the long run, workers can be sick or leave the firm, relatively inefficient and inconsistent levels of effort, labour relations problems (leading to industrial action such as go-slows or strike action), potential shortage of skilled labour, costs of recruiting and training new employees, workers can become tired and bored with repetitive tasks, etc.

Exam-style questions

1 Labour productivity measures the efficiency of the workforce **[1]** in terms of output per worker **[1]**.
2 Firms that operate on a larger scale can suffer from diseconomies of scale **[1]**, so hiring workers could be inefficient **[1]**, e.g. miscommunications which cause unproductive output **[1]**.
3 Firm B is more labour intensive **[1]**, because its labour costs of $60,000 account for 55% **[1]** of its overall costs. Although Firm A spends more on its labour costs ($80,000 vs $60,000), this only accounts for 50% **[1]** of its overall costs of $160,000 **[1]**.

Firm	Labour costs ($)	Capital costs ($)	Other costs ($)	Total	Labour intensity (%)
A	80,000	50,000	30,000	160,000	0.50
B	60,000	30,000	20,000	110,000	0.55

The table here is shown for illustrative purposes only.

4 Higher labour costs **[1]**, especially for highly skilled labour **[1]**. Labour intensity may also require more workers to be hired **[1]**, again raising the overall costs of production **[1]**. The production process also tends to be longer **[1]**.
5 Explanations could include: the importance of higher productivity for economic growth **[1]**, improved international competitiveness **[1]**, economies of scale and lower average production costs **[1]**, higher profits **[1]**, more employment **[1]** and improved pay for workers **[1]**.

Chapter 22

Test yourself

1 Wages and salaries, rent, advertising and marketing, purchases (from suppliers), utility bills, dividends (to shareholders), insurance, taxes, etc.
2 Management salaries, insurance payments, administrative costs, bank loan repayments and rent payments.
3 Total costs = Fixed costs + Variable costs
4 Total revenue = Price × Quantity
5 Survival, social welfare, growth, profit maximisation, sales revenue maximisation.

Exam-style questions

1 A type of cost that does not change with the level of output **[1]** in the short run **[1]**, e.g. rent and management salaries **[1]**.
2 Variable costs are production costs that change when the level of output changes **[1]**, i.e. the costs are directly related to the level of production **[1]**. Examples include wages paid to the car production workers and the cost of components/parts needed to produce the cars **[1]**.
3 Profit maximisation provides an incentive (financial reward) for entrepreneurs **[1]** to bear risks and to organise the other factors of production in the production process **[1]**. It helps to provide finance for the firm's investment **[1]**, enabling it to purchase the latest capital equipment to remain competitive **[1]** and/or to reduce costs of production **[1]**. The proceeds from the firm's profits can enable it to grow organically **[1]** or inorganically by mergers and/or takeovers of other firms **[1]**. Profit maximisation is also important for the firm's owners **[1]**, such as dividend payments paid from the profits to the company's shareholders **[1]**. Profits enable a firm to gain greater market power **[1]**, thus helping to maintain its competitiveness **[1]**.
4 Fixed costs, such as rent, will remain unchanged **[1]** as these costs do not change with the level of output in the short run **[1]**. Variable costs, such as raw material costs, will rise **[1]** as these increase with the level of output **[1]**. The effect on average costs is less certain as this depends on whether the firm experiences economies of scale, in which case *AC* falls **[1]**, or diseconomies of scale, in which case *AC* rises **[1]**.
5 From the table:
   a Total costs increase by $30,000 for every 1000 units produced. Hence, *AVC* = $30,000 ÷ 1000 **[1]** = $30 per unit **[1]**.
   b Since *TC* increases by $30,000 for each extra 1000 units produced, at 1000 units, *TFC* = $40,000 – $30,000 **[1]** = $10,000 **[1]**.
   c

Output level (units)	Total costs ($)	Average costs ($) = *TC/Q*
1000	40,000	40.00 **[1]**
2000	70,000	35.00
3000	100,000	33.33 **[1]**

The *AC* falls from $40 per unit to $33.33 **[1]** as the company experiences economies of scale **[1]**, falling unit costs of production following increased output **[1]**.

Chapter 23

Test yourself

1 one, supply
2 The key characteristics of a particular market (or industry), e.g. number and size of firms in the market, and the nature of barriers to entry.
3 Single supplier, price maker (price setter), imperfect knowledge and high barriers to entry.

4 Ability to supply large quantities at lower prices, financial resources for research and development, the elimination of wasteful competition, and ability to compete with large foreign competitors.
5 Ability to exploit customers (higher prices and/or limited supply), inefficient resource allocation, high entry barriers (limited competition), imperfect knowledge (possibly causing irrational decision making), and a lack of innovation (absence of competition).

Exam-style questions

1 Possible advantages include:
- To prevent a private sector monopoly abusing its market power [1], governments may choose to regulate or limit monopoly power [1].
- This would introduce some competition for the monopolist [1], which may lower prices and/or create choice for consumers [1].
- It could create greater incentives [1], e.g. to be more efficient (due to the exposure of competition), to encourage firms to concentrate on producing what consumers want [1] and/or to lower their costs of production [1].
- Competition can stimulate the need to increase investment [1] and/or research and development, which ultimately leads to an improvement in the quality of products [1].

2 Possible discussion points include:
- More competition can lead to greater efficiency in the industry [1] and may lower prices of flights, thus benefiting consumers [1].
- More competition can also lead to improved quality of flight services [1], such as in-flight entertainment [1].
- It can create more choices for consumers [1] such as choice of flight destinations and timing of flights [1].
- However, increased competition can limit the ability of individual airlines to benefit from economies of scale [1], leading to higher costs and prices [1].
- Increased competition can also lead to lower profits [1], so there is less to reinvest in the industry in terms of research and development expenditure [1], negatively impacting on the service to customers in the future.
- More competition can lead to increased congestion at airports [1], creating longer queuing and check-in times for customers [1].
- More, and unnecessary, competition creates spare capacity on some airlines [1], causing inefficiencies and higher costs and prices [1].
- The social and environmental costs of increased air traffic [1] have negative impacts on consumers in the long run [1].

Award up to 5 marks for an unbalanced, one-sided answer.

3 Possible discussion points include:
- Prices may be higher under monopoly due to the lack of competition [1] and ability of monopolies to set higher prices [1].
- Profit-maximising monopolists can force prices higher [1] by restricting market supply [1].
- By contrast, prices may be lower under perfectly competitive markets [1] due to consumer sovereignty [1].
- However, monopolies operate on a large scale so benefit from economies of scale [1], which can be passed on to customers in the form of lower prices [1]; with lower average costs, the monopolist can still enjoy high profits [1] despite lower prices if it so chooses.
- Firms in perfect competition do not benefit from economies of scale [1], so lower prices may not be possible [1].
- A monopolist can spend more on research and development/new technologies [1] which can reduce costs of production in the long run [1], enabling it to charge lower prices [1].
- State-owned monopolists [1] may choose to charge low prices, in the best interest of the general public, to ensure everyone can afford their services [1].
- Private sector monopolies may still face overseas competition [1], so may still need to keep prices down [1].

Award up to 5 marks for an unbalanced, one-sided answer.

Chapter 24

Test yourself

1 To improve the general welfare of society as a whole.
2 The rules and laws that govern business behaviour in the economy, e.g. environmental protection laws.
3 To fund local services, e.g. refuse (rubbish) collection, street lighting, libraries, schools, hospitals and public parks.
4 Economic growth, stable prices, low unemployment, a healthy balance of payments, and a fairer distribution of income and wealth.

Exam-style questions

1 The government is responsible for economic activity in the public sector [1], such as state education and healthcare [1] where teachers, doctors and nurses are employed [1]. Many governments operate state-owned enterprises [1], such as transportation, telecommunications and postal services [1]. A significant number of people may be employed in the emergency services [1], such as the police force and fire services [1], and national defence such as the military [1].
2 The subsidies help to reduce the costs of production for farmers [1], so enable prices to fall [1], thereby potentially leading to greater consumption of food [1]. Similarly, subsidies cause an increase in

agricultural supply [1], thereby reducing the price of agricultural products [1]. Alternatively, as subsidies cut production costs, this can lead to higher profits [1] for the farmers. Subsidies can also reduce the cost of capital investment for farmers [1], thereby helping to raise productivity in the agricultural sector [1].

3 It is more likely to take into account the social costs and benefits of such projects [1], such as the lowering of air and noise pollution levels [1], whereas a private firm would only consider private costs and benefits [1]. The government might set prices relatively low [1] in comparison with a private firm in order to allow more people to use the airport facilities [1]. The government may have the necessary finances available [1] for such a large and expensive project, from its tax revenues [1].

Chapter 25

Test yourself

1. Economic growth, stable prices (low inflation), employment (low unemployment), balance of payments stability, and redistribution of income and wealth.
2. Outward shift of the production possibility curve.
3. (Number of unemployed people / Number in the labour force) × 100
4. A weighted index that measures the change in prices of a representative basket of goods and services, in order to measure the rate of inflation in the economy.
5. Credit items are records of all payments received from other countries, whereas debit items are records of all payments made to other countries.

Exam-style questions

1. Economic growth is an increase in the level of economic activity over time [1], as measured by changes in real GDP [1].
2. The non-use of labour resources [1]. It is measured by the number of unemployed people as a proportion of the total labour force [1].
3. The sustained increase [1] in the general price level over time [1], as measured by a consumer price index [1].
4. A balance of payments deficit occurs if a country's debits exceed the credits [1], but a country cannot continually spend more than it earns [1] in the long run.
5. Redistributing income from the rich to the poor can help to achieve a fairer or more equitable distribution [1] of income and wealth in the economy, which improves the nation's overall standard of living [1].

Chapter 26

Test yourself

1. Housing, national defence, education, healthcare, environmental protection, infrastructure, law and order, transport networks, welfare benefits, etc.
2. A budget deficit occurs when government spending > government revenue, whereas a budget surplus exists when government revenue > government spending.
3. Equity, economy, convenience, certainty, efficiency and flexibility.
4. Tax evasion is illegal as there is a deliberate attempt to pay the incorrect amount of tax; tax avoidance is the legal attempt to reduce tax liability.
5. Expansionary fiscal policy is used to stimulate the economy, by increasing government spending and/or lowering taxes, whereas contractionary fiscal policy is used to reduce the level of economic activity by decreasing government spending and/or raising taxes.

Exam-style questions

1. A progressive tax takes a higher proportion of income [1] from those on high incomes [1], e.g. income taxes. By contrast, regressive taxes take a larger proportion of income from low-income earners [1], e.g. sales taxes [1].
2. Possible reasons include:
   - To raise tax revenue [1], in order to provide finance for government expenditure such as on education or national defence [1].
   - Taxes can be required to pay for government debts [1] in order to reduce a public deficit [1].
   - Tax revenues are needed to redistribute income and wealth [1] in order to reduce the gap between the rich and poor [1].
   - Taxes can be imposed to reduce or limit the rate of inflation [1].
   - Taxes can raise the price of certain products [1], such as alcohol or tobacco, in order to discourage their consumption [1].
   - Import taxes may be imposed to raise the price of imports [1] to improve the country's balance of payments [1].
3. Possible reasons include:
   - An increase in economic activity leads to higher national incomes [1], which is likely to lead to an increase in income tax revenues [1], especially if the country uses a progressive tax system [1].
   - Sales tax revenues will also increase from increased spending [1] in the economy, assuming people do not save all of their extra income [1].
   - An increase in economic activity also helps to increase profits of businesses [1], resulting in more corporation tax revenue [1].
   - Higher incomes can also lead to more imports being bought [1], thus increasing tax revenues from tariffs [1].
4. Possible advantages include:
   - A change in taxes [1] can have a more immediate effect [1] on households and firms than the use of monetary policy, e.g. cutting taxes during a recession or raising taxes to combat demand-pull inflation [1].

- Government spending [1] can have a huge impact on the country's GDP [1] and hence the level of employment and economic growth [1].

5 Possible disadvantages include:
  - There could be side-effects of using taxation policy to control the economy [1], e.g. an increase in income tax could cause disincentives to work [1], leading to lower GDP [1], while a cut in taxation could be inflationary [1].
  - There could be time lags [1] between changing taxes and this having an impact on the level of GDP or unemployment [1].
  - Government spending is financed mainly through taxation [1] but an increase in government expenditure may need to be financed through public sector debt [1].

Chapter 27

Test yourself

1 coins, deposits

2 The use of interest rates, exchange rates and the money supply to influence the level of economic activity, and to achieve the government's macroeconomic objectives.

3 Expansionary monetary policy aims to boost economic activity, mainly by reducing interest rates, whereas contractionary monetary policy aims to reduce overspending and limit investment, mainly by increasing interest rates.

4 Time lags, ignores other factors that affect the level of economic activity (such as consumer and business confidence levels), high interest rates can discourage foreign direct investment (resulting in long-term consequences for the economy, e.g. negative impacts on profits, job creation, research and development expenditure, and innovation).

Exam-style questions

1 The use of interest rates, exchange rates and the money supply [1] to control macroeconomic objectives [1] and to affect the level of economic activity [1].

2 Possible answers include:
  - Increasing interest rates as part of tight monetary policy [1] to contract the economy if there are inflationary pressures [1], and vice versa.
  - Currency appreciation to deflate the economy [1] during times of rapid economic boom and overspending on exports [1].
  - Increasing the money supply during times of economic downturn [1] to improve liquidity in the economy [1] and to encourage spending.

3 Households and firms with outstanding mortgages and loans have higher interest payments to make [1], and thus are left with less disposable income to spend or invest [1]. Savers have more of an incentive to deposit their money in banks [1], so are more likely to save their money. This reduces the level of consumption in the economy, thus easing its inflation rate [1]. Higher interest rates also tend to lead to a higher exchange rate [1], thus causing a reduction in the demand for the country's exports [1].

4 Possible points for analysis include:
  - Deflationary (contractionary) monetary policy can be used [1] by increasing the rate of interest [1].
  - This helps to reduce consumer expenditure [1] as higher interest rates reduce borrowing, increase the cost of existing loans and create more incentives to save [1].
  - It also reduces investment expenditure [1] as higher interest rates raise the cost of new loans (so deterring firms from investing) and raise the cost of the firm's existing loans [1].
  - The combination of reduced consumer expenditure and investment expenditure helps to reduce demand-pull inflation [1].
  - Deflationary (contractionary) monetary policy can be used by reducing the money supply [1], which helps to reduce aggregate (total) demand in the economy [1], again helping to lower demand-pull inflation [1].
  - Deflationary (contractionary) monetary policy can be used by raising the exchange rate [1], which reduces costs of imported raw materials [1] and helps to put pressure on domestic firms to lower their own costs [1]; this reduces cost-push inflation [1].

Chapter 28

Test yourself

1 long, capacity, production

2 Education, training and development, labour market reforms, lower direct taxes, deregulation, improving incentives to work and invest, and privatisation.

3 Policies that make labour markets more flexible, resulting in greater productivity, e.g. reducing the power of trade unions, reducing unemployment benefits or removing the national minimum wage.

4 People will have larger disposable incomes, due to the tax cuts, so will have more of an incentive to work.

5 It can help to create more flexible labour markets and focus on incentives to work.

Exam-style questions

1 Supply-side policies are the long-term macroeconomic policies [1] used by a government to increase the economy's productive capacity [1], e.g. education, training, tax reforms, deregulation and privatisation [1].

2 Privatisation is the selling of government-owned assets [1] in order to increase competition, productivity and efficiency [1] in the economy.

3 Supply-side policies, such as improved education and training [1], help to increase the international competitiveness of an economy [1]. Hence, there is likely to be a boost in export sales and earnings [1]. This helps to improve the country's balance of payments [1].

4 Lower taxes create incentives to work as people can earn higher real disposable income [1], which enables them to consume more goods and services [1]. Lower taxes can also promote competition in the economy [1], thereby increasing output in the economy [1], and hence the economy's productive capacity [1].
5 Possible points for analysis include:
   - Privatisation [1] introduces competition [1] to the industry, creating incentives [1] to become more efficient in order to increase profit [1].
   - A cut in corporation tax [1] creates incentives for the industry to increase its profits [1] and/or to increase funds available for research and development [1] and investment [1], which in the long term helps to raise productivity levels [1] and to lower costs of production [1].
   - Cuts in income tax [1] help to increase the incentive to work [1], so can raise people's level of motivation [1] and productivity [1].
   - Subsidies [1] encourage firms in an industry to invest in advanced technologies, engage in research and development and/or to train their workers [1], thus improving the industry's productive capacity [1] and/or cutting its average costs of production [1].
   - Improved education and training [1] help to raise the skills and productivity of workers [1], increasing productivity [1].
   - Deregulation [1] – removing rules, regulations and laws helps to reduce administrative and operational costs [1], enabling the industry to invest more money to improve performance and profits [1].

Chapter 29

Test yourself

1 output, domestic
2 Consumption is the value of all private household consumption within a country (household expenditure), whereas investment expenditure is the capital spending of firms used to further production and to expand the economy's productive capacity (business expenditure).
3 The monetary value of the difference between a country's export earnings and its import expenditure.
4 An economic model that describes the fluctuations in economic activity in a country over time.
5 Improved standards of living, employment and tax revenues.
6 Environmental consequences, inflationary pressures, income and wealth inequalities, and resource depletion.
7 Fiscal policy, monetary policy and supply-side policies.

Exam-style questions

1 Economic growth is the increase in the level of national output [1], as measured by the annual percentage change in real gross domestic product [1].
2 Real GDP refers to the value of national income [1] that is adjusted for inflation [1], per time period.
3 The business cycle describes the fluctuations in economic activity [1] in a country over time. The typical cycle includes: boom, recession, slump and recovery [1].
4 Positive consequences include: improved standards of living [1], decreased unemployment [1] and increased tax revenues [1]. Award 1 mark for each relevant factor, and 1 mark for the correct explanation.
5 Possible causes include: the quality and quantity of a country's factors of production [1], e.g. factor endowments [1], the labour force [1], labour productivity [1], education [1], training [1] and investment expenditure [1]. Award 1 mark for each relevant factor, and 1 mark for the correct explanation.

Chapter 30

Test yourself

1 working, able
2 Raises standards of living, promotes economic growth, increases tax revenues for government spending, reduces financial burden on the government (less unemployment and welfare benefits to pay), prevents brain drain, reduces income and wealth inequalities in the economy, etc.
3 An ideal economic situation when everyone in a country who is willing and able to work has a job.
4 The claimant count measures the number of people who are out of work and claiming unemployment benefits.
5 The unemployment rate is a measure of the percentage of a country's workforce that is out of employment.

Exam-style questions

1 Unemployment rate = (4m/(36m + 4m)) × 100 = 10%.

   Award 1 mark for the working out and 1 mark for the correct answer.
2 The rate of unemployment is the percentage of people out of work as a proportion of the workforce [1], whereas the level of unemployment is the actual number of unemployed people [1].
3 Opportunity cost refers to cost measured in terms of the next best alternative forgone [1]. Spending on unemployment benefits means that the government cannot use this money for other purposes [1] such as education or healthcare [1].
4 Possible reasons include:
   - It represents a more efficient use of scarce resources [1], producing near or on the economy's production possibility curve [1].
   - Employment opportunities bring about higher GDP per head [1], thereby raising living standards [1].

- It means more people are able to access more goods and services [1], so employment helps to reduce poverty [1].
- It reduces the need for governments to spend so much on unemployment benefits [1] and to raise taxes to fund such spending [1].
- It frees up government funds [1] to spend on other areas such as healthcare and education [1].

5 Possible causes include (an explanation of):
- A fall in the death rate.
- A rise in the birth rate (a couple of decades before).
- A fall in the school leaving age.
- A rise in the retirement age.
- Greater acceptance of women in the workforce.
- An increase in the number of immigrants.

6 Cyclical unemployment is mass-scale unemployment caused by an economic downturn [1], so can be a medium- to long-term type of unemployment [1]. Also called demand-deficient unemployment [1], cyclical unemployment occurs when the level of aggregate (total) demand falls, i.e. during a recession or slump [1]. Frictional unemployment occurs when people are in between jobs [1], so is a short-term type of unemployment [1]. It occurs when there is a disequilibrium (or mismatch) between the demand for and the supply of labour [1], such as seasonal unemployment [1].

7 Analysis could include:
- A rise in unemployment reduces national income [1] with the unemployed not being able to purchase as many goods and services [1], which reduces their standard of living [1].
- The rise in unemployment involves an opportunity cost [1] because the fall in GDP results in the unemployed experiencing poverty and health problems [1], which increases the burden on the country's health services [1].
- The rise in unemployment might also lead to an increase in crime [1], thus lowering the quality of people's lives in the country.
- The government is also likely to need to spend more on unemployment benefits [1], which results in a budget deficit and/or less money being spent on education and healthcare services [1].

8 Analysis could include:
- Changes in government policies [1], e.g. the government may choose to subsidise certain industries, which positively impacts on employment in these industries [1].
- Changes in the pattern of demand [1] due to changing tastes in the economy [1].
- Advances in technology [1] creating new jobs opportunities [1].
- The emergence of new or rival industries in other countries [1], leading to some domestic industries declining [1].
- Improvements in education [1] creating new skills and job opportunities for younger people [1].
- Changing social attitudes [1] resulting in more females in the workforce [1] and encouraging more people with disabilities to work [1].
- An increase in the retirement age [1] resulting in more workers in the labour force [1].
- Firms adopting greater flexibility [1], such as 24-hour operations, resulting in more part-time job opportunities [1].
- Greater employment opportunities and job prospects [1], which help to attract more migrant workers [1].
- Improved business opportunities [1], such as government grants for business start-ups, creating incentives for more people to become self-employed [1].
- As countries become more economically developed [1], there are greater employment opportunities in the secondary and tertiary sectors [1].

Chapter 31

Test yourself

1 sustained, general (or 'average')

2 weighted, cost

3 Very high rates of inflation that are out of control, causing average prices in the economy to rise very rapidly.

4 Demand-pull and cost-push inflation.

5 Menu costs, shoe-leather costs, savers lose, borrowers gain, lenders lose, fixed income earners lose, the economy as a whole tends to lose (being less internationally competitive), low income earners lose, exporters lose, importers gain, and employers tend to lose (higher costs of production, including wage costs).

6 Unemployment, bankruptcies, wealth (reduction) effect, debt (increasing) effect, government debt, and falling business and consumer confidence levels.

7 Fiscal, monetary and supply-side policies.

Exam-style questions

1 Deflation occurs when there is a fall in the general price level [1]. It results in a rise in the value of money [1] and hence a rise in the purchasing power of money [1].

2 An increase in the money supply can increase spending in the economy [1]. People might spend more than previously due to the increased money supply, which subsequently pushes up prices [1]. Too much money chasing too few goods [1] causes demand-pull inflation [1].

3 The CPI is a measure of the change in the general price level [1], so essentially measures an economy's rate of inflation [1]. It is a weighted identification of the price level in an economy [1] based on prices paid by the average household purchasing

a representative basket of goods and services [1], compared with a base year [1].

4 Demand could fall if consumers expect that prices will be lower in the future [1], so this could reduce the output of firms [1], lower their investment [1] and increase unemployment in the economy [1].

  Alternatively, the country's exports become more internationally competitive [1], so it may sell more exports [1] which improves the country's current account position [1] and could raise employment in the long run [1].

5 Cost-push inflation refers to inflation caused by higher costs of production [1], e.g. higher wages or raw materials costs [1]. Firms raise their prices in order to maintain profit margins [1]. Demand-pull inflation refers to higher prices caused by higher levels of total (aggregate) demand in the economy [1], pulling up the general price level in the economy [1]. It is associated with an increase in GDP, mainly due to higher consumer spending [1].

6 Possible reasons include:
   - Inflation increases the cost of living [1], so people become worse off in real terms unless their incomes rise by at least the rate of inflation [1].
   - People on fixed incomes lose out [1] because of the decline in the purchasing power of their money [1].
   - Inflation causes the price of exports to go up, so the economy becomes less internationally competitive [1], which leads to other macroeconomic issues such as higher unemployment and a current account deficit [1].
   - Inflation creates uncertainty in the economy [1] and causes a lack of consumer and producer confidence which leads to a fall in consumer spending and investment expenditure [1].
   - Banks become more reluctant to lend money [1] as the real value of the loan falls due to inflation, so this can reduce the liquidity and investment in the economy [1].

7 Analysis of reasons could include:
   - Price stability reduces menu costs [1], so firms save by not having to change prices so frequently [1].
   - It also lowers shoe-leather costs [1] as firms do not need to move their money in search of the highest interest rate [1] and consumers do not need to 'shop around' for the best prices [1].
   - Price stability preserves people's purchasing power [1].
   - Inflation reduces the value of money, meaning people can only buy fewer goods and services with the same amount of money [1], thus lowering their living standards [1].
   - It can increase consumer confidence [1], helping to make economic growth more likely [1].
   - It can also increase producer confidence [1], which encourages them to invest [1] in the economy.
   - Price stability improves a country's international competitiveness [1], thereby improving its current account position [1].
   - Similarly, it encourages MNCs to set up in the country [1], thus increasing GDP [1] and creating employment opportunities [1].

Chapter 32

Test yourself

1 GDP per head of the population, adjusted for inflation.

2 A composite indicator of living standards in a country obtained by measuring three dimensions of human development: education, healthcare and income.

3 The HDI ignores: qualitative factors that influence standards of living, income distribution in the economy, environmental impacts of economic activity, and cultural differences and interpretations of the meaning of standards of living.

Exam-style questions

1 The social and economic wellbeing [1] of individuals in a country at a particular point in time [1], based on factors such as access to education and healthcare, and income level [1].

2 Absolute poverty exists when people cannot access or afford basic necessities [1], such as food, housing and clothing [1]. Absolute poverty occurs in cases of people earning less than $1.25 per day [1]. Relative poverty exists when people have less income than the average person in the country [1], so is a less serious problem.

3 Possible reasons include:
   - The country might lack natural resources [1], resulting in low national output and income [1].
   - There is a very large population and/or high population growth rate [1] relative to the country's GDP [1].
   - It has a low level of investment expenditure [1], resulting in low national output and higher costs of production [1].
   - The country suffers from poor education [1], so has unskilled workers with low productivity [1].
   - There is a high level of unemployment [1], so GDP is low [1].
   - A large proportion of the workforce might be engaged in agriculture [1] with low value added and output, highly dependent on weather conditions beyond the control of workers and entrepreneurs [1].

4 Discussion points could include:
   - Higher GDP means the average citizen can purchase more goods and services [1], thus increasing their material living standards [1].
   - A rise in GDP may indicate higher employment [1], so with rising incomes, living standards should improve [1].

- Higher GDP helps to increase tax revenues [1], increasing the availability and quality of public services [1], such as education and healthcare services.
- However, if GDP rises but the population size increases at a faster rate, GDP per head will fall [1], so living standards will not rise [1].
- Similarly, if GDP rises but the rate of inflation increases at a faster rate [1], real GDP per head will fall [1].
- While national income may rise, this might be at the opportunity cost of poor working conditions [1] or longer working hours [1].
- There needs to be consideration of how the higher GDP is distributed [1] – if it is simply a case of the rich getting richer, then living standards of many people will not rise [1].
- Similarly, there needs to be consideration of potential environmental damage [1] as a result of greater economic activity, such as the depletion of the earth's scarce resources [1].

Award up to 5 marks for an unbalanced, one-sided answer.

Chapter 33

Test yourself

1 income, basic

2 Hunger and malnutrition, ill health and mortality from illness, limited or lack of access to education and other basic services, homelessness and inadequate housing, unsafe environments, and social discrimination and exclusion.

3 The minimum daily amount of money that a person must earn to avoid being in absolute poverty, deemed by the World Bank to be $1.25 per day.

4 International development goals set by the United Nations, to be achieved by 2030, to end poverty, protect the planet and ensure prosperity for all.

5 Low GDP per capita, low life expectancy, low literacy rates, high population growth, poor infrastructure, low FDI (foreign direct investment), low labour productivity, high public debt, over-reliance on primary sector output, and a high degree of instability and corruption.

6 Progressive taxes to redistribute income, economic growth, improved education, better healthcare provision, welfare benefits and introducing/increasing the national minimum wage.

Exam-style questions

1 A country with a high real GDP per head [1] and high living standards [1]. Indicators of this include long life expectancy, high levels of education, access to high levels of healthcare and a high savings ratio [1].

2 Award 1 mark for each correct characteristic, such as:
- high GDP per head (high average income)
- high standards of living
- high life expectancy
- low death rate
- low birth rate
- low infant mortality rate
- high proportion of the labour force employed in the tertiary sector (low proportion employed in the primary sector)
- high labour productivity
- high level of saving
- high level of investment expenditure
- high adult literacy rate
- good infrastructure
- provision of and access to good healthcare
- provision of and access to good education.

3 Absolute poverty exists when people cannot access or afford basic necessities [1], such as food, housing and clothing [1]. Absolute poverty occurs in cases of people earning less than $1.25 per day [1]. Relative poverty exists when people have less income than the average person in the country [1], so is a less serious problem.

4 Award 1 mark for each suitable reason, such as:
- better wages/salaries abroad
- better employment prospects overseas
- better working conditions
- to avoid famine and absolute poverty in the domestic economy
- prospects of job security
- political/human rights (civil liberties)
- to evade war and/or political conflicts.

5 Possible points for analysis include:
- A rise in progressive taxes [1], such as income tax, takes a higher proportion of the income from the rich [1], thereby helping to redistribute income to the poor [1].
- Tax revenues can be used to help the poor [1], such as by providing welfare benefits, housing, education and healthcare services [1], all of which help to lower absolute poverty [1].
- A rise in the rate of direct taxes could reduce incentives to work [1], thus increasing unemployment [1] and contributing to greater poverty [1].
- A rise in sales taxes is regressive [1] as it takes a higher proportion of the income of the poor [1], so could result in more poverty [1].
- While it can be used to reduce relative poverty [1] by redistributing income, a rise in tax rates could increase absolute poverty [1] if it reduces the incomes of the poor [1].

6 Possible discussion points include:
- Higher GDP means the average citizen can purchase more goods and services [1], thus increasing their material living standards [1].
- A rise in GDP may indicate higher employment [1], so with rising incomes, living standards should improve [1].

- Higher GDP helps to increase tax revenues [1], increasing the availability and quality of public services [1], such as education and healthcare services.
- However, if GDP rises but the population size increases at a faster rate, GDP per head will fall [1], so living standards will not rise [1].
- Similarly, if GDP rises but the rate of inflation increases at a faster rate [1], real GDP per head will fall [1].
- While national income may rise, this might be at the opportunity cost of poor working conditions [1] or longer working hours [1].
- There needs to be consideration of how the higher GDP is distributed [1] – if it is simply a case of the rich getting richer, then living standards of many people will not rise [1].
- Similarly, there needs to be consideration of potential environmental damage [1] as a result of greater economic activity, such as the depletion of the earth's scarce resources [1].

Award up to 5 marks for an unbalanced, one-sided answer.

Chapter 34

Test yourself

1. distribution, large
2. People (workers and consumers) are essential for the economic prosperity of a country and also responsible for the depletion of the earth's scarce resources.
3. Birth rate, death rate and net migration rate.
4. An increase in the average age of the population.
5. A comparison of the number of people who are not in the labour force with the number of people in active paid employment.

Exam-style questions

1. Demographics is the study of population distribution and trends [1], such as the birth rate, death rate and net migration rate [1].
2. The number of deaths per 1000 of the country's population [1] per year [1].
3. The average number of children [1] that a woman gives birth to [1]. It can also refer to the number of children born per 1000 women [1] who are of child-bearing age [1].
4. Possible factors include:
   - The social status of and attitude towards women.
   - The cost of bringing up children in the country.
   - The average age at which women in the country marry.
   - Access to the availability of family planning services.
   - The level of women's education and the proportion of women in higher education.
   - Infant mortality rates.

   Award 1 mark for each relevant factor, up to 3 marks.
5. There is likely to be noticeable migration of workers away from rural to urban regions of the country [1] in search of employment opportunities, higher incomes and better standards of living [1]. However, there is likely to be overcrowding of people in urban areas [1] and a deterioration in some rural areas due to a lack of people to sustain economic development [1].
6. Possible causes include:
   - An improvement in nutrition [1] thereby improving the general health of the population [1].
   - Improvements in healthcare services [1], enabling people to live longer [1].
   - Improvements in health education [1], helping people to make more informed choices about diet, sleep and exercise [1], and giving up smoking [1].
   - Improved housing [1], thereby reducing the number of people suffering from illnesses [1].
   - A fall in political and military conflicts [1], which reduces the number of casualties of conflicts and wars [1].
   - Improved sanitation and water quality [1], thereby reducing the risks of disease [1].
7. Possible reasons include:
   - Higher immigration of females [1] perhaps due to them fleeing war-torn countries [1].
   - Higher emigration of males [1] in search of employment in other countries [1].
   - Longer life expectancy of females [1], e.g. males may go to war [1].
   - More girls are born than boys [1] with boys having a higher infant mortality rate [1].
8. In MEDCs, people are more likely to be able to afford more/better-quality healthcare [1]. In MEDCs, GDP per capita is higher [1], so higher income means there is generally better nutrition [1]. Higher income also means a better standard of living [1], e.g. access to better education and housing [1]. MEDCs also have better sanitation [1]. Governments in MEDCs tend to have higher tax revenues [1], so have greater ability to provide basic essentials such as housing, education, healthcare and infrastructure [1] for the benefit of everyone in the economy.
9. Points for analysis could include:
   - Improved education to raise awareness of the cost of having children [1], resulting in women having fewer children [1].
   - Increased government spending on education [1], with a focus on women's education and careers – more educated women tend to delay having children [1].
   - Increased information about contraception [1], leading to a lower birth rate [1].
   - In LEDCs, improved healthcare can lower the birth rate [1], resulting in fewer children being born [1].
   - Tighter immigration restrictions and control measures [1], making it harder for immigrants to enter the country [1].

- Reducing or removing state welfare benefits [1] to those having children.
- Adopting regulatory population control measures, e.g. China's previous 'one child policy' [1].

10 Discussion points could include:
- An ageing population increases the dependency ratio [1], with fewer people working (and paying taxes) to support more elderly people [1].
- It is likely to lead to increased government spending on healthcare [1] and pensions [1], which creates an opportunity cost [1].
- In the longer term, taxes may need to be raised for those in employment [1]; higher taxes can cause disincentives to work [1].
- With more elderly people in the country, there may be a shortage of workers [1], thereby pushing up wage rates [1].
- With a shortage of workers, firms could be forced/encouraged to give jobs to older people [1] or to retain the workers beyond retirement age [1].
- Nevertheless, elderly people can be economic assets [1], due to their wealth of knowledge and work experience [1].
- To control the issues caused by an ageing population, the government could increase the retirement age [1], thereby maintaining the size of the workforce.
- Alternatively, the government may create incentives to attract migrant workers [1] to overcome the potential decline in the workforce [1].

Award up to 4 marks for an unbalanced, one-sided answer.

Chapter 35

Test yourself

1. A reduction in poverty, reduced income inequalities, greater self-esteem, gender equality and political freedom.
2. Differences in: income (GDP), productivity, population growth, the relative size of the primary, secondary and tertiary sectors, saving and investment, education and healthcare.
3. Due to inequalities in the distribution of income.
4. In general, the higher the national income in a country, the more likely it is to develop economically.
5. Economic wellbeing is positively impacted by healthcare provision.

Exam-style questions

1. An intangible concept [1] that considers both quantitative and qualitative variables [1] that indicate an increase in the standard of living within a country [1].
2. Productivity refers to how well (efficiently) production takes place [1]. The more productive a country's resources, the more likely it is to develop economically [1].
3. Other factors, qualitative and quantitative, that affect development are ignored [1], e.g. population size and environmental factors [1].
4. All things being equal, the greater a country's population growth rate [1], the more likely it is to cause negative impacts on economic development [1] as the economy's scarce resources need to be shared by a larger population [1].
5. As an economy develops, there tends to be a shift away from an over-reliance on primary production [1], towards secondary sector production [1] and even more towards tertiary sector output in the long run [1].

Chapter 36

Test yourself

1. Silicon Valley (hi-tech industry), Hollywood (movies), Milan (fashion), Scottish whisky, Champagne (French sparkling wine region), etc.
2. Hong Kong – financial services, China – aluminium, Brazil – coffee, Saudi Arabia – oil, Thailand – rice, USA – copper, etc.
3. Situation that occurs when an individual, firm, region or country concentrates too much on producing a very limited number of goods and services.
4. Lack of choice for consumers, high labour turnover (unchallenging and boring jobs), low labour mobility, high labour costs, etc.
5. Efficiency gains, economies of scale, high labour productivity, increased productive capacity, improved competitiveness, etc.

Exam-style questions

1. Specialisation can refer to the division of labour [1], which involves workers concentrating on and becoming experts in particular tasks and activities [1]. It can also refer to firms or countries concentrating on what they can do best [1], thereby achieving greater efficiency, output and quality production [1].
2. Possible disadvantages include:
   - Specialisation or over-specialisation can lead to a depletion of the nation's factor endowments [1], creating economic problems such as unemployment in the long run [1].
   - The country could be vulnerable [1] if demand for its (specialised) product suddenly falls due to changing trends [1] or if new and alternative products become available at a lower price and/or better quality elsewhere [1].
3. Possible benefits include:
   - Certain regions of the country can concentrate on or specialise in what they are best at [1], leading to an increase in output [1].

- It is efficient as specialisation at a regional level involves making the best use of the region's factor endowments [1], such as its resources and natural climate [1].
- Specialisation can lead to an increase in the income of workers in the region [1], thereby raising standards of living in the area [1].
- Specialisation can enable the region to develop a good reputation for providing the good or service it specialises in [1], which can lead to increased demand for the product generated in the region [1].

4 Possible reasons include:
- Division of labour involves repetitive tasks, so workers may become bored [1], so productivity may fall [1] as workers are demotivated and make mistakes [1].
- It can also lead to higher labour turnover [1] if workers become bored and look for alternative jobs; this increases the cost of hiring new workers [1].
- Division of labour also relies on key workers being present – if they are sick or leave [1] it can disrupt the production process [1], thus proving costly for the firm.
- The division of labour and specialisation of workers often means they can demand higher wages [1], thus increasing production costs [1].

5 Possible reasons include:
- There are cost advantages [1], perhaps due to a country's abundant resources [1]. As a result, productivity increases, thereby increasing the country's gross domestic product and standard of living [1].
- International specialisation makes better use of scarce resources [1]; no country can produce everything it wants or needs efficiently [1], i.e. it cannot be self-sufficient.
- International specialisation increases national output and global trade [1]. Therefore, firms are able to enjoy cost-saving benefits from large-scale operations [1].

Chapter 37

Test yourself

1 interdependent, international

2 Increased international trade; greater wealth and jobs throughout the world; freer movement of labour, capital, goods and services; firms can enjoy greater economies of scale when operating on a larger scale; greater choice of goods and services for customers around the world; greater cultural understanding and appreciation.

3 Headquarters in one country and branches/shops or offices in more than one country; often an internationally recognised brand name; firm is usually large in size; benefits from economies of scale.

4 International trade refers to the exchange of goods and services beyond national borders, although there could be barriers to trade (protectionism) imposed, such as tariffs and quotas, whereas with free trade protectionist measures do not exist between trading countries.

5 Tariffs, import quotas, embargoes and subsidies.

Exam-style questions

1 International trade refers to the exchange of goods and services beyond national borders [1]. It entails the sale of exports (goods and services sold to overseas buyers) and imports (foreign goods and services bought by domestic households and firms) [1]. Free trade means that international trade can take place without any forms of protection, i.e. barriers to international trade [1], such as quantitative limits or taxes being imposed on exports [1].

2 Award 1 mark for any of the following: tariffs, quotas, subsidies for domestic firms, administrative restrictions and boycotts (bans or embargoes).

3 Possible benefits include:
- Allows a country to specialise in what it is best at producing [1], thus improving economic efficiency [1].
- No tariffs charged or quotas imposed on exports/imports [1], so encourages international trade and cooperation [1].
- Increased competition [1] can force firms to reduce costs (lower price) and/or increase their productivity [1].
- Access to larger global markets [1] enables firms to take advantage of economies of scale [1].
- Employment opportunities from higher export sales [1] and/or from multinational companies operating in the domestic country [1].
- Firms have access to more raw materials and capital goods [1], which improves their operational efficiency [1].
- Consumers have greater access to better-quality goods and services [1], which can help to improve their standard of living [1].

4 Possible disadvantages include:
- Domestic firms can go out of business [1] if products from foreign firms are more competitively priced and/or of better quality [1], which can lead to domestic unemployment [1].
- International trade may allow the import of harmful products [1], which adversely affects the economy and the wellbeing of a country's people [1].
- Economic dependence on other countries [1], which can put the country in a vulnerable position if there is political/economic conflict [1].
- Trade rivalry between countries can lead to friction and even war between countries [1], especially in the case of unfair tactics such as dumping [1].

5 Possible reasons include:
- Specialisation allows countries to concentrate on what they are best at producing [1], so this improves economic efficiency [1].
- Countries are able to take advantage of their factor endowments [1] in order to produce and trade a greater volume of output [1].
- Specialisation can help to reduce the average costs of production [1] due to higher productivity [1] and economies of scale [1].
- Being more efficient and exploiting economies of scale also enable prices to be lower [1].
- Specialisation improves quality [1], so can help to increase export revenue [1].

6 Possible benefits include:
- It can help to protect infant industries [1] from larger, more established foreign competitors [1].
- It may help to protect declining industries from going out of business too quickly [1], giving people more time to find alternative employment [1].
- It can help to prevent dumping [1], which involves foreign firms selling their products below cost price [1] in order to gain an unfair price advantage [1] and possibly drive domestic firms out of business [1].
- It can help to increase government tax revenue [1] if tariffs are imposed as a form of trade protection [1].

7 Possible reasons include:
- The lack of scarce resources in the domestic country [1], e.g. Bangladesh does not have sufficient supplies of crude oil and natural gas [1], whereas Brunei Darussalam does not have the arable land needed to grow rice and tropical fruits [1], so they need to trade with other countries.
- It is often cheaper to import products than to produce them domestically [1], e.g. Sweden could, in theory, grow its own pineapples and bananas but it would be more economical to purchase these from overseas countries such as Thailand, the Philippines and India [1].
- International specialisation and trade can benefit consumers as there is more competition [1], leading to more choice and improved quality of products [1].
- Employment opportunities [1] can also arise from international trade and greater volumes of output [1].

Chapter 38

Test yourself

1 market, supply

2 There is an appreciation in the exchange rate if the exchange rate is rising against other currencies. By contrast, there is a depreciation of the exchange rate if its value falls against other currencies.

3 Fixed exchange rate system exists when the central bank (or monetary authority) buys and sells foreign currencies to ensure the value of its currency stays at the pegged value.

4 Cheaper export prices (due to the lower value of the currency) leading to rising export sales and a larger trade surplus for the country; exporters gain from a price advantage over their foreign rivals, which helps to create income and wealth in the domestic economy.

5 Reduce export prices to maintain their price competitiveness, seek alternative suppliers of cheaper raw materials, focus on supplying more price inelastic and income inelastic products, focus on non-price factors such as quality, or relocate production processes overseas where costs of production are lower.

Exam-style questions

1 The price (value) of one currency in terms of another currency [1] or a weighted basket of other currencies [1], e.g. £1 = $1.25 [1].

2 If the country sells products with price inelastic demand [1], this would mean demand falls by less than the rise in price [1], so the economy would earn more export revenues [1].

3 1 : 6.5 = 65 : 422.5 [1], so the price of the wine = CNY422.5 [1]

4 0.65 : 0.75 = 1 : 1.15 [1], so the exchange rate is GBP1 = EUR1.15 [1]

5 Possible benefits include:
- Market forces of demand and supply determine the exchange rate [1], establishing an equilibrium price (exchange rate) that is efficient [1].
- There is no need to keep foreign currency reserves [1] as with a fixed exchange rate system, so the central bank does not need to actively buy or sell the currency to support its value [1].
- This allows the government to concentrate on its other aims [1], such as economic growth or reducing unemployment [1], as the government does not need to get involved in changing interest rates to manipulate the exchange rate [1].
- The exchange rate should change automatically based on market forces [1] in order to correct a current account disequilibrium [1], i.e. a fall in the exchange rate should boost export sales while a higher exchange rate will improve the sale of imports [1].

6 Possible ways include:
- It can buy the currency [1] using its foreign currency reserves and/or gold reserves [1], thereby pushing up the exchange rate [1].
- It can raise the rate of interest [1] in order to increase the demand for the currency [1] or to reduce the supply of the currency [1].
- It can impose or raise foreign exchange controls [1] in order to limit the availability of foreign currencies needed to purchase imports [1].

7 Discussion points could include:
- An exchange rate determined by market forces of demand and supply [1] should automatically adjust the current account to a balanced position [1], e.g. the exchange rate will fall, thus lowering export prices, to rectify a deficit [1].

- A floating exchange rate system avoids the need for foreign reserves to influence the exchange rate [1], freeing up finances for other purposes [1].
- Operating the exchange rate through market forces means the exchange rate is not a policy objective [1], so the government can focus on pursuing other policy objectives such as employment or price stability [1].
- A fixed exchange rate system is maintained by the government or central bank [1] by buying and selling the currency [1] in order to create exchange rate certainty [1].
- Stability and certainty enable firms to plan ahead [1] and encourage investment by domestic and foreign firms [1].
- The exchange rate may be set deliberately at a low rate [1] in order to stimulate economic growth and to create employment opportunities [1].
- Alternatively, the exchange rate may be set deliberately high [1] in order to reduce the rate of inflation [1].

Award up to 5 marks for an unbalanced, one-sided answer.

Chapter 39

Test yourself

1. financial, current
2. The sum of the trade in goods plus the trade in services, i.e. the visible balance + invisible balance.
3. Primary income (investment income) is a record of a country's net income earned from investments abroad, whereas secondary income records net income transfers, per time period (i.e. income transfers between residents and non-residents).
4. A current account deficit occurs when a country spends more money than it earns (i.e. imports exceed exports), whereas a current account surplus exists if a country exports more than it imports.
5. Reduced overall demand in the economy, unemployment, lower living standards, increased borrowing (to pay for the over-spend), and a lower exchange rate.
6. Fiscal policy, monetary policy, supply-side policies and trade protectionist measures.

Exam-style questions

1. Another component(s) of the current account must have a surplus [1]. Hence, the surplus on the invisible balance (trade in services) could be in surplus [1]. Alternatively, the balance of income and current transfers could be in surplus [1].
2. A current account deficit occurs when the value of a country's imports is greater than its exports [1]. The current account is comprised of the trade in goods (visibles), trade in services (invisibles) [1], investment incomes [1] and net transfers [1] – the overall balance of these components would have to be negative for the current account to be in deficit [1].
3. Possible causes include:
   - A depreciation or devaluation of the exchange rate, thereby making exports cheaper and imports more expensive [1].
   - The country has a good reputation for its exports, based on their quality, reliability and/or price [1].
   - Higher productivity levels which reduce prices and/or raise the quality of exports [1].
   - A significant rise in foreign tourist expenditure in the country [1].
   - Net positive investment income such as dividends from shares held in foreign companies [1].
   - Other countries experience economic growth, so purchase more imports with their higher incomes [1].
   - Prices are lower as the inflation rate in overseas countries is higher, thus making the home country's goods and services relatively cheaper [1].
4. Possible consequences include:
   - A current account deficit that is not controlled will make the country less wealthy [1] as there is a net outflow of money from the country to pay for imports [1].
   - Consequently, GDP will fall [1] and unemployment will rise [1].
   - If a country has a current account deficit, it means that another country will have a surplus on its current account [1].
5. Possible reasons include:
   - A fall in the exchange rate reduces export prices [1].
   - Lower export prices may increase export earnings [1].
   - The fall in the exchange rate raises the price of imports, thus reducing the demand for imports [1].
   - The combination of higher export revenues and lower import expenditure should improve the country's current account deficit [1].
6. Possible reasons include:
   - The surplus could lead to a higher exchange rate [1] with detrimental effects on the country's economic growth and employment in the future.
   - One country's surplus is another country's deficit [1], which can therefore lead to protectionist measures being imposed to correct this deficit [1]; trade protection can harm international relations [1].
   - A sustained surplus could damage the country's competitiveness [1] as exports become more expensive in the long run [1].
   - It can lead to fewer goods being available in the domestic market [1], as these are exported, leaving consumers with less choice [1].
   - High volumes of exports may deplete the country's scarce resources [1] with negative impacts on the economy in the long run [1].

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