

# IB Economics SL

YOUR NOTES



## 1. Introduction To Economics

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## 1.1 What Is Economics?

### 1.1.1 Economics as a Social Science

#### The Social Nature of Economics

- Economics is a **social science**
  - Social sciences study societies and the **human interactions** within those societies
  - Human interactions are complex and are influenced by **many variables**
  - Social sciences also include subjects such as Psychology, Politics, Geography and Business Studies
- Due to the complexities within societies, economists **build models** so as to better understand certain interactions
  - A model is a **simplified version** of reality
  - Some models are **more complex** than others. Examples of models include, the circular flow of income, production possibility curves, demand and supply
  - All models make a **range of assumptions**. These are often generalizations about behaviour, choices and likely outcomes
  - These assumptions are necessary so as to account for complex human behaviour and **constantly changing variables**
  - When evaluating different models, the **underlying assumptions** should always be considered
- To **think like an economist** involves identifying which variables will be studied and which ones will be excluded
  - This way of thinking considers the type of relationship between variables (**causal or correlation**). E.g. Data shows that when ice cream sales increase, so do car thefts. Correlation, yes. Causation, no
  - Some economists will **build an argument** to include certain variables in a study and others will argue to exclude them. They will each provide a **justification** for their decision
  - Two economists analysing the same data may end up with **vastly different interpretations**. This is often due to the different variables that each economist chooses to focus on
  - This is the complexity found within **social sciences**

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## Microeconomics & Macroeconomics

- **Microeconomics** is the study of **individual markets** and sections of the economy, rather than the economy as a whole. Microeconomics examines:
  - The different **choices** individuals, households and firms make
  - What factors influence their **choices**
  - How their decisions affect the price, **demand and supply** of goods/services in a market
  - How Governments influence **consumption and production**
- **Macroeconomics** is the study of economic behaviour and decision making in the **entire economy**, rather than just an individual market. Macroeconomics examines:
  - The role of the government in achieving **economic growth** and human development through the implementation of specific government policies (fiscal, monetary and supply-side)
  - The role of the government in achieving **price stability**, low unemployment and a stable Current Account balance on the Balance of Payments account
  - The interaction of the economy with the rest of the world through **international trade**

### Some of the Differences Between Micro and Macroeconomics

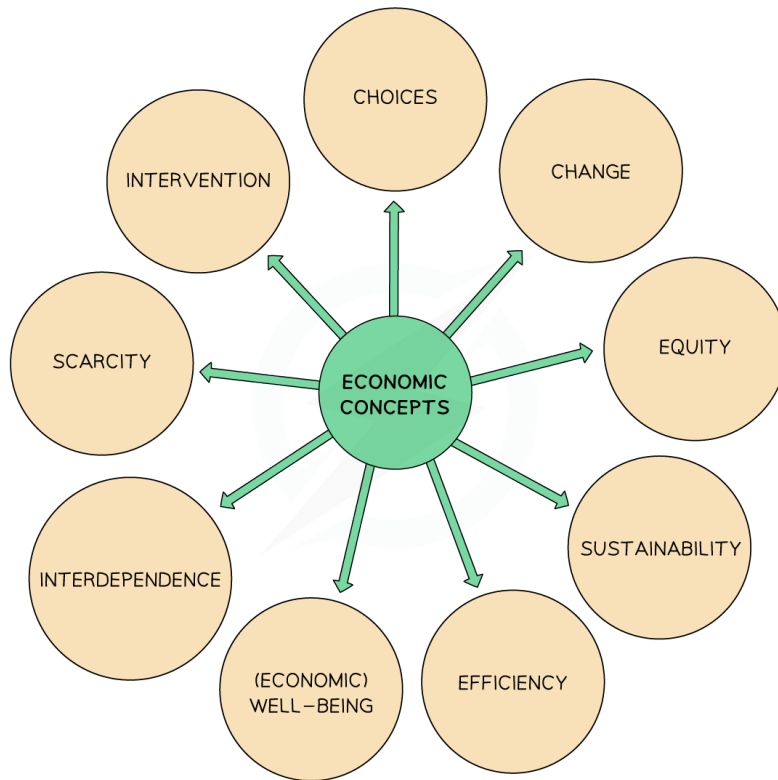
Microeconomics	Macroeconomics
Single market e.g. milk	Entire economy e.g. Singapore
Price of a good/service	Average price levels in an economy (inflation/deflation)
Individual/market demand	Total demand in an economy
Individual firm/market supply	Total supply in an economy
Government intervention in a market e.g. cigarettes	Government intervention in the economy e.g. income tax
Reasons for differences in workers wages	Unemployment and minimum wages

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## The Nine Central Concepts

- Most student learning focusses on **topics** and within each topic is the **acquisition of facts**
- Each topic is better understood within broader **concepts**
  - E.g. globalisation as a topic is interesting, but it makes much more sense when studied within the concept of **interdependence** that exist between nations
- Understanding the concepts and using them helps to deepen your critical thinking skills
  - E.g. Thinking about how a particular tax policy relates to the concepts of equity, efficiency or government intervention requires critical thinking



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*The nine concepts which all of your learning in economics connects to*

Explanations of each Concept as Defined by the International Baccalaureate (IBO)

Scarcity	Efficiency	Intervention
Change	Choices	Sustainability
Equity	Interdependence	Economic well-being

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1. **Scarcity:** since **resources are scarce**, economics is a study of choices. It is clear that not all needs and wants can be satisfied; this necessitates choice and gives rise to the idea of opportunity cost. Economic decision-makers continually make choices between competing alternatives, and economics studies the consequences of these choices, both present and future
2. **Efficiency:** is a quantifiable concept, determined by the **ratio of useful output to total input**. Allocative efficiency refers to making the best possible use of scarce resources to produce the combinations of goods and services that are optimum for society, thus minimising resource waste
3. **Intervention:** intervention in economics usually refers to **government involvement in the workings of markets**. There is often disagreement among economists and policymakers on the need for, and extent of, government intervention. There is a considerable debate about the merits of intervention versus the free market
4. **Change:** the economic world is continuously changing and economists must adapt their thinking accordingly. Economics focuses not on the level of the variables it investigates, but on their change from one situation to another. There is continuous and profound change at institutional, structural, technological, economic and social levels
5. **Choice:** since resources are scarce, **economics is a study of choices**. It is clear that not all needs and wants can be satisfied; this necessitates choice and gives rise to the idea of opportunity cost. Economic decision-makers continually make choices between competing alternatives, and economics studies the **consequences of these choices**, both present and future
6. **Sustainability:** is the ability of the present generation to meet its needs **without compromising the ability of future generations** to meet their own needs. It refers to limiting the degree to which the current generation's economic activities create harmful environmental outcomes involving resource depletion that will negatively affect future generations
7. **Equity:** in contrast to equality, which describes situations where economic outcomes are similar for different people or different social groups, **equity refers to the idea of fairness**. Fairness is a normative concept, as it means different things to different people. The degree to which markets versus governments should, or are able to, create greater equity or equality in an economy is an area of much debate
8. **Interdependence:** individuals, communities and nations are not self sufficient. Consumers, companies, households, workers, and governments, **all economic actors, interact with each other** within and, increasingly, across nations in order to achieve economic goals. The greater the level of interaction, the greater will be the degree of interdependence
9. **Economic well-being:** is a multidimensional concept relating to the level of prosperity and quality of living standards enjoyed by members of an economy. It includes ♣ present and

future financial security ♣ the ability to meet basic needs ♣ the ability to make economic choices permitting achievement of personal satisfaction ♣ the ability to maintain adequate income levels over the long term

**NOTE**

The definitions for these 9 concepts have been supplied by the International Baccalaureate (IBO). These concepts are widely defined and open to interpretation, hence it is important to use these concepts exactly as the IBO has defined them

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## 1.1.2 The Problem of Choice

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### The Factors of Production

- **Factors of production** are the resources used to produce goods and services
  - Land, labour, capital and enterprise
- The production of any good/service requires the use of a **combination of all four factors of production**
  - Goods are physical objects that can be touched (**tangible**) e.g. mobile phone
  - Services are actions or activities that one person performs for another (**intangible**) e.g. manicure, car wash

### The Four Factors of Production

Land	Labour	Capital	Enterprise
<p><b>Non man-made natural resources</b> available for production. Some countries have a vast amount of a particular natural resource and so are able to specialise in its production e.g. oil</p>	<p>The <b>human input</b> into the production process. Labour involves mental or physical effort. Not all labour is of the same quality. It can be <b>skilled or unskilled</b></p>	<p>Capital is any <b>man-made resource</b> that is used to produce goods/services e.g. tools, buildings, machines and computers</p>	<p>Enterprise involves <b>taking risks</b> in setting up or running a firm. An entrepreneur decides on the combination of the <b>factors of production</b> necessary to produce goods/services with the aim of generating profit</p>

### Some of the Factors of Production Required to Produce a Motor Car

Land	Labour	Capital	Enterprise
<p>iron ore rubber oil sand cows</p>	<p>car designer production director production line staff supply chain staff</p>	<p>robotic arms conveyor belt rolled steel computers seats</p>	<p>CEO</p>

- In a free market economic system, the factors of production are privately owned by households or firms



- Households make these resources available to firms who use them to produce goods/services
- Firms purchase land, labour, and capital from households in factor markets
- **Households** receive the following financial rewards for selling their **factors of production**.  
This reward is called **factor income**
  - The factor income for land → **rent**
  - The factor income for labour → **wages**
  - The factor income for capital → **interest**
  - The factor income for entrepreneurship → **profit**

### The Basic Economic Problem: Scarcity

- The **basic economic problem** is that resources are **scarce**
  - In economics, these resources are called the factors of production
- There are **finite resources** available in relation to the **infinite wants and needs** that humans have
  - Needs are essential to human life e.g. shelter, food, clothing
  - Wants are non-essential desires e.g. better housing, a yacht etc.
- Due to the problem of scarcity, **choices have to be made** by producers, consumers, workers and governments about the best (**most efficient**) use of these resources
- **Economics is the study of scarcity and its implications for resource allocation in society**

#### All Stakeholders in an Economy face the Basic Economic Problem

Consumers	Producers	Workers	Government
<ul style="list-style-type: none"> <li>• In a free market, <b>scarcity</b> has a direct <b>influence on prices</b></li> <li>• The <b>scarcer</b> a resource or product, the <b>higher</b> the price consumers will pay</li> </ul>	<ul style="list-style-type: none"> <li>• Producers selling products made from <b>scarce resources</b> will find their costs of production are higher than if they were selling products made from more abundant resources</li> </ul>	<ul style="list-style-type: none"> <li>• Workers may want a more comfortable and safer working environment but their employers may not have the <b>resources</b> to create it</li> </ul>	<ul style="list-style-type: none"> <li>• Governments have to decide if they will provide certain goods/services or if they will allow private firms to provide them instead</li> <li>• Their decision influences the <b>allocation of resources</b> in society</li> </ul>



## Opportunity Cost Defined

- **Opportunity cost is the loss of the next best alternative when making a decision**
- Due to the **problem of scarcity**, **choices have to be made** about how to best **allocate limited resources** amongst competing wants and needs
- There is an **opportunity cost** in the allocation of resources
  - E.g. When a **consumer** chooses to purchase a **new phone**, they may be **unable to purchase new jeans**. The jeans represent the loss of the next best alternative (**the opportunity cost**)

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## Opportunity Cost in Decision Making

- An understanding of opportunity cost may **change many decisions** made by consumers, workers, firms and governments
- Factoring the opportunity cost into a decision often results in different outcomes and so a different **allocation of resources**

### Examples of how the Consideration of Opportunity Costs can Change Decisions

Stakeholder	Example
Consumer	<ul style="list-style-type: none"> <li>• Ashika is wanting to visit her best friend in Iceland</li> <li>• She looks at flight prices from London to Reykjavik</li> <li>• On Friday night it costs £120 whereas Thursday night is only £50</li> <li>• She is about to book the Thursday flight but then realises that the <b>opportunity cost</b> of saving £60 on a flight is the <b>inability to work on Friday</b> (loss of £130 income)</li> <li>• Ashika books the more expensive flight. If she had booked the cheaper flight, it would have cost her the income from the missed day of work (£130) + £50 for the ticket</li> </ul>
Worker	<ul style="list-style-type: none"> <li>• Ric has been offered two jobs and is deciding which one to accept</li> <li>• Job A offers £400 a month more in <b>salary</b> than Job B, but Job B offers the flexibility of working from home</li> <li>• Most people would only consider the <b>actual cost</b> of commuting before they make a decision, which in Ric's case is £40 a week or £160 a month</li> <li>• Ric values his free time and decides that each hour he can save in commuting is worth £20 to him (£180 a week), he is considering the <b>opportunity cost of commuting</b></li> <li>• Ric decides to take Job B as the <b>cost of monthly travel (4 x £40) and value of the lost hours spent commuting (4 x £180)</b> adds up to £880 a month</li> </ul>



### Exam Tip

Opportunity cost is about the loss of the next best alternative. It is not a monetary amount. Money may well be a factor but opportunity cost is about the loss of the next best choice when making a decision.

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## Economic Goods & Free Goods

- **Economic goods** are **scarce** in relation to the demand for them
  - This makes them valuable
  - Due to their value, producers will attempt to supply them in order to make a profit
  - Anything that has a price tag on it is an economic good e.g. oil, corn, gold, trainers, watches and bicycles
- **Free goods** are abundant in supply
  - Due to this abundance, it is not possible to make a profit from **supplying** free goods
  - Drinking water has been a free good for thousands of years, but as the population increases and water sources become more polluted, it has become an economic good
  - E.g. sunlight, the air we breathe, sea water

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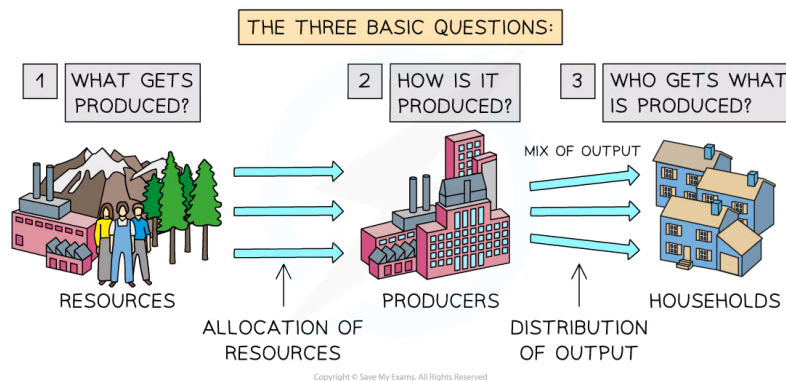
## Economic Systems

- In order to solve the basic economic problem of **scarcity**, economic systems emerge or are created by different economic agents within the economy
  - These agents include **consumers, producers, the government, and special interest groups** (e.g. environmental pressure groups or trade unions)
  - Any economic system aims to allocate the **scarce factors of production**
- The three main economic systems are a **free market system**, mixed economy, and planned economy

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What determines the economic system of a country?



**How the three questions are answered determines the economic system of a country**

- Each economy has to answer **three important economic questions**
- 1. What to produce?** As resources are limited in supply, decisions carry an opportunity cost. Which goods/services should be produced e.g. better rail services or more public hospitals?
  - 2. How to produce it?** Would it be better for the economy to have labour-intensive production so that more people are employed, or should goods/services be produced using machinery?
  - 3. Who to produce it for?** Should goods/services only be made available to those who can afford them, or should they be freely available to all?

**How These Questions are Answered Determines the Economic System**

Type of System	What to Produce?	How to Produce?	For Whom?
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<b>Market System</b>	Demand and supply (the price mechanism)	Most efficient, profitable way possible.	Those who can afford it
<b>Mixed System</b>	Demand, supply and the Government	Some efficiency but also a focus on welfare/well-being	Those who can afford it, plus some provision to those who cannot afford it
<b>Planned System</b>	The Government	Ensure everyone has a job	Everyone

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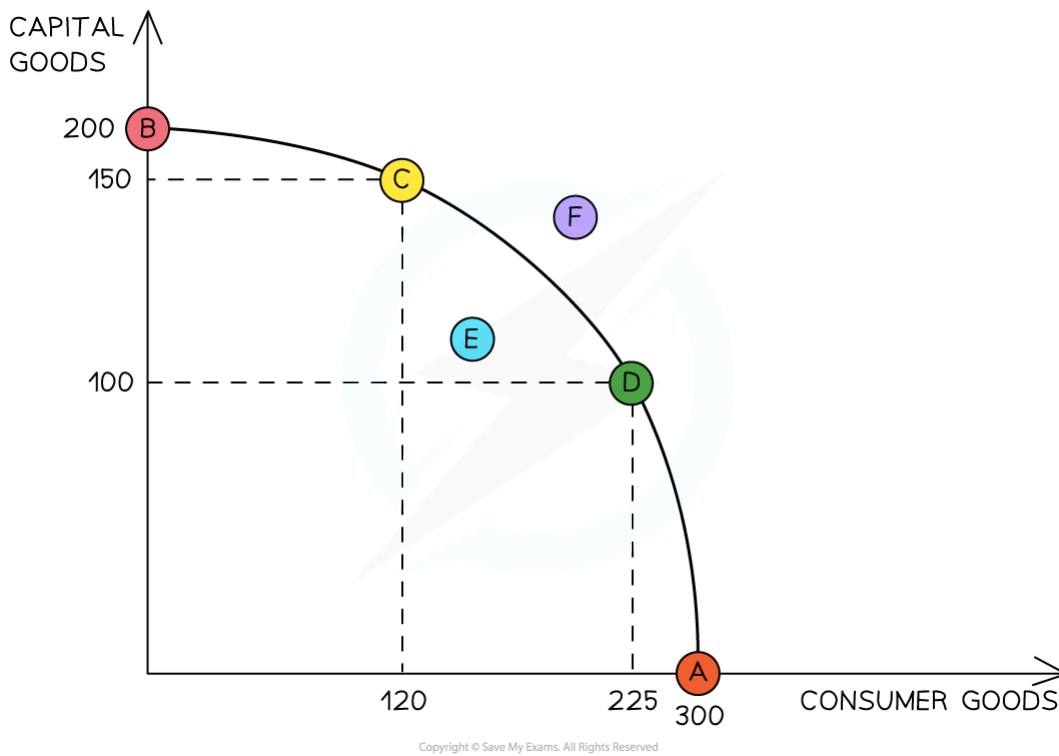
1.1.3 The Production Possibilities Curve Model (PPC)

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**An Introduction to the PPC**

- The **Production Possibility Curve (PPC)** is an economic model that considers the **maximum possible production** (output) that a country can generate if it uses all of its factors of production to produce **only two** goods/services
- **Any two** goods/services can be used to demonstrate this model
- Many PPC diagrams show **capital goods** and **consumer goods** on the axes
  - **Capital goods are assets** that help a firm or nation to **produce output** (manufacturing). For example, a robotic arm in a car manufacturing company is a **capital good**
  - **Consumer goods are end products** and have **no future productive use**. For example, a watch



*A PPC for an economy demonstrating the use of its resources to produce capital or consumer goods*

**Diagram Explanation**

- The use of PPC to depict the maximum productive potential of an economy

- The curve demonstrates the **possible combinations of the maximum output** this economy can produce **using all of its resources** (factors of production)
  - At A, its resources are used to produce **only consumer goods** (300)
  - At B, its resources are used to produce **only capital goods** (200)
  - Points C and D both represent **full** (efficient) use of an economy's resources as these points **fall on the curve**. At C, 150 capital goods and 120 consumer goods are produced
- **The use of PPC to depict opportunity cost**
    - To produce one more unit of capital goods, this economy must give up production of some units of consumer goods (limited resources)
    - If this economy moves from point **C (120, 150)** to **D (225, 100)**, the **opportunity cost** of producing **an additional 105 units of consumer goods** is 50 capital goods
    - A **movement in the PPC** occurs when there is any change in the **allocation of existing resources** within an economy such as the **movement** from point C to D
  - **The use of PPC to depict efficiency, inefficiency, attainable and unattainable production**
    - Producing at any point on the curve represents productive efficiency
    - Any point inside the curve represents **inefficiency** (point E)
    - Using the current level of resources available, **attainable production** is any point on or inside the curve and any point outside the curve is unattainable (point F)

### Assumptions of the Model

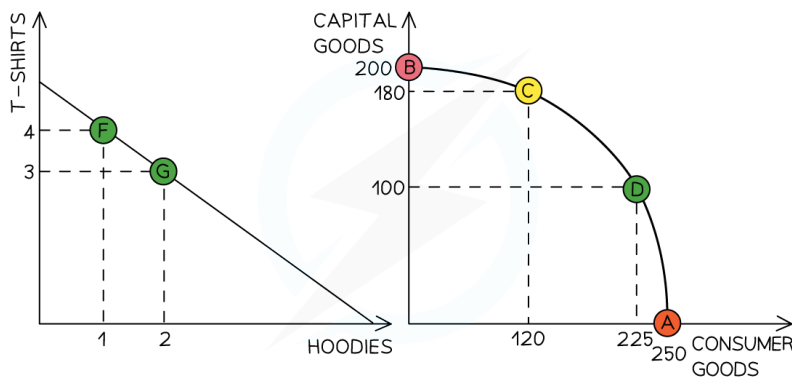
- The PPC Model is a simplified version of reality and so makes the following assumptions about the state of resources in an economy at a particular moment in time
1. **Only two goods are produced:** any two goods can be used to illustrate the underlying principle. In reality, an economy produces many goods/services but focussing on two makes the analysis possible
  2. **Scarcity of resources exists:** the factors of production are limited so choices have to be made about how they are used
  3. **Production is efficient:** it is assumed that there is no wastage and that all resources are used in such a way that the maximum output is attained from the inputs used. In reality, this is often not the case
  4. **The state of technology is fixed:** as the model represents a particular moment in time, it is assumed that the technology is not changing. In reality, improvements in technology are continuously occurring and they create the potential to increase the output using the scarce resources

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## Increasing Versus Constant Opportunity Cost

- Two different types of opportunity cost can be illustrated using PPC curves
- **Constant opportunity cost** occurs when all of the factors of production used to produce one good can be switched to producing the other good without any loss/wastage of resources
  - One unit given up one of good results in one unit gained of the other
- **Increasing opportunity cost** occurs when the factors of production cannot be perfectly switched between the two products
  - One unit given up of one good results in less than one unit gained of the other



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**Constant opportunity cost occurs when switching production from T-shirts to hoodies while there is increasing opportunity cost when switching production from consumer goods to capital goods**

### Diagram Analysis

- For a country producing only **T-shirts and hoodies**, the factors of production can **easily be switched** between the two products e.g. the same labour and land (cotton) can be used to make both products
  - **Changing production** from point F to G decreases the production of T-shirts from 4 to 3 and increases the production of hoodies from 3 to 4
  - There is **constant opportunity cost** when production is switched
- For a country producing **consumer goods and capital goods**, the factors of production **cannot easily be switched** between the two products e.g. the labour required to make a washing machine may not have the skill to produce a robotic arm used in car manufacturing
  - **Changing production** from point A to point C results in a decrease of 130 consumer goods but yields an increase of 180 capital goods
  - Changing production from point C to point B results in a decrease of 120 consumer goods but only yields an increase of 20 capital goods

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- There is an **increasing opportunity cost** as production moves closer and closer to any particular axis

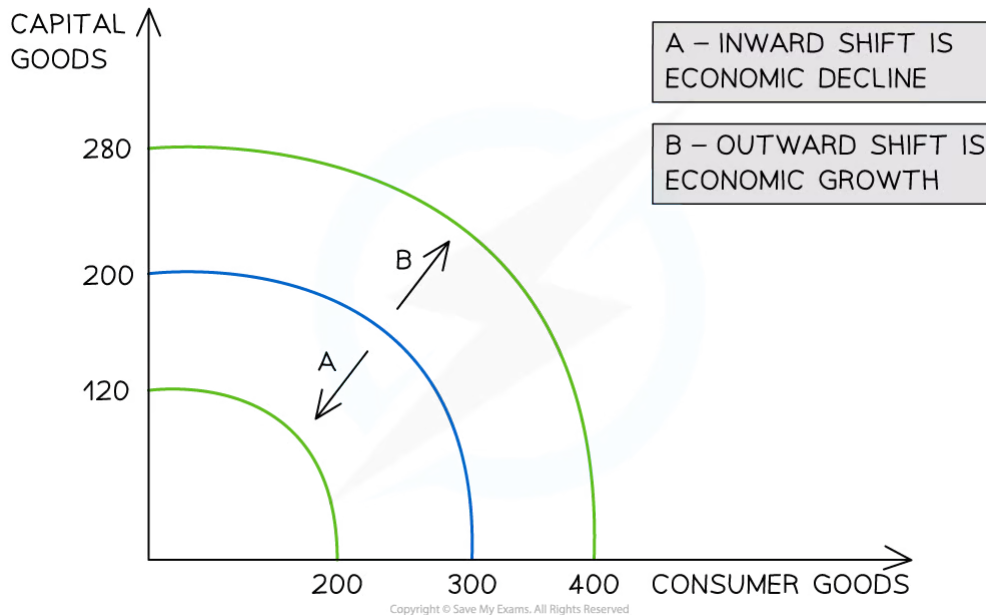
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## Changes in Production Possibilities

- As opposed to a movement along the PPC described above, the **entire PPC of an economy can shift** inwards or outwards thereby changing its production possibilities

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**Outward shifts of a PPC show potential economic growth and inward shifts show economic decline**

### Diagram Explanation

- Economic growth** occurs when there is an increase in the **productive potential of an economy**
  - This is demonstrated by an **outward shift** of the entire curve. **More consumer goods** and **more capital goods** can now be produced using all of the **available resources**
- This shift is caused by an increase in the **quality or quantity of the available factors of production**
  - One example of how the **quality** of a factor of production can be **improved** is through the impact of **training and education on labour**. An educated workforce is a **more productive workforce** and the **production possibilities increase**
  - One example of how the **quantity** of a factor of production can be **increased** is through a change in migration policies. If an economy allows **more foreign workers** to work productively in the economy, then the **production possibilities increase**
- Economic decline** occurs when there is any impact on an economy that **reduces the quantity or quality** of the available factors of production
  - One example of how this may happen is to consider how the Japanese tsunami of 2011 devastated the **production possibilities** of Japan for many years. It **shifted their PPC inwards** resulting in **economic decline**

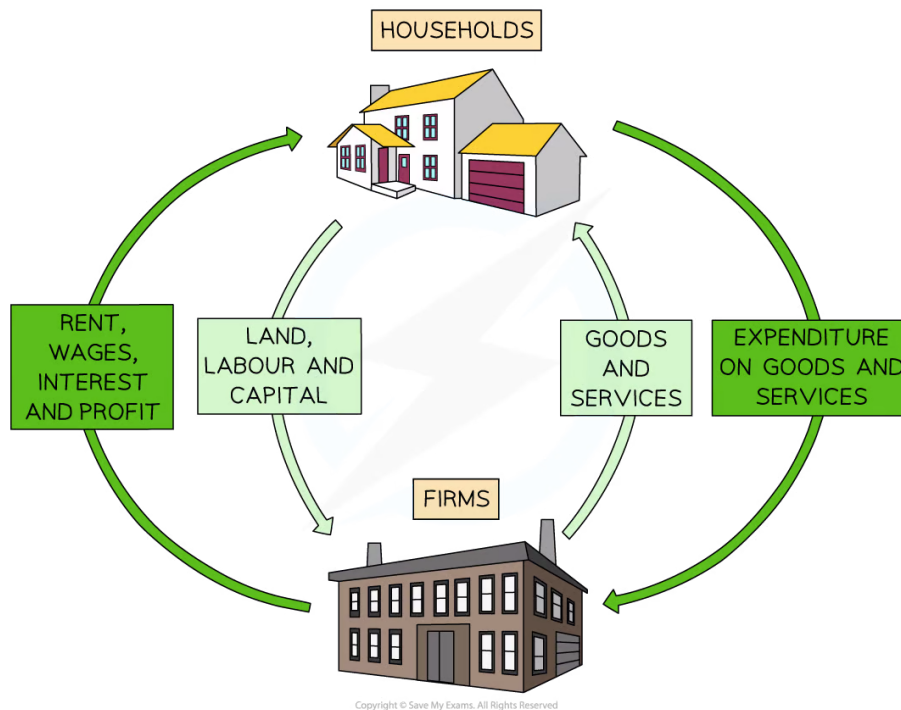
## 1.1.4 Modelling the Economy

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### The Circular Flow of Income

- The **circular flow of income** is an economic model that illustrates the **money flows** in an economy
  - There is a simple model which shows the **money flows** between households and **firms**
  - There is a **more complex model** which adds in other **economic agents** including the **government**, **financial sector** and **foreign trade** (net exports)



*A diagram showing the simplified Circular Flow of Income between households and firms*

#### Diagram Analysis

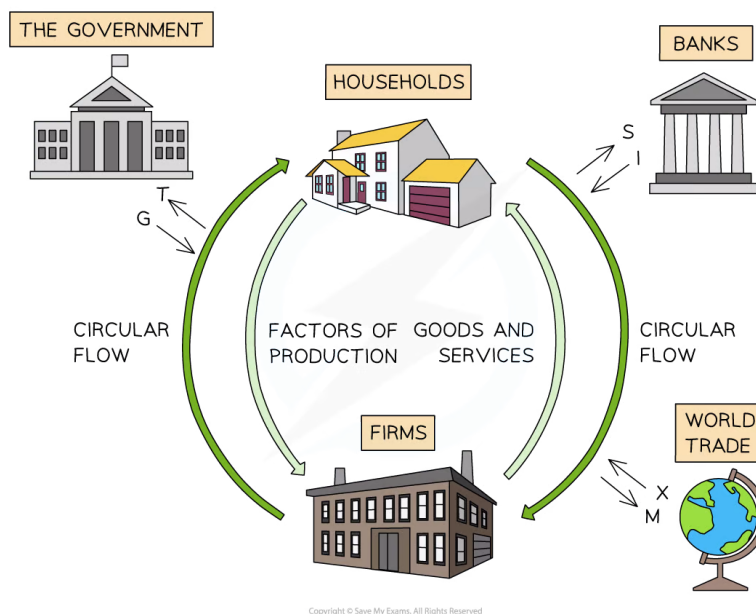
- **Households** own the wealth in the economy
  - These are the factors of production
- **Households supply** their factors of production to firms and **receive income** as a reward
  - They receive **rent** for land, **wages** for labour, **interest** for capital, and **profit** for enterprise
  - With this income, they purchase goods/services from firms
- **Firms** purchase factors of production from households
  - They use these resources to **produce goods/services**
  - They **sell the goods/services** to households and receive sales revenue

## Leakages & Injections

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- **Money can enter or leave** the circular flow of income in an economy
- **Injections** add **money** into the circular flow of income and **increase its size**
  - Increased government spending (**G**)
  - Increased investment (**I**)
  - Increased exports (**X**)
- **Leakages** (withdrawals) remove **money** from the circular flow of income and **reduce its size**
  - Increased savings by households (**S**)
  - Increased taxation by the government (**T**)
  - Increased import purchases (**M**)
- There are high levels of **interdependence** between households, firms, the government, the financial sector, and the foreign sector (foreign firms and households)



*A diagram that shows the injections and leakages that influence the relative size of the circular flow of income*

### Diagram Analysis

- **Government:** Government spending (G) is an injection and taxation (T) is a leakage
- **Financial sector:** Investment (I) is an injection and savings (S) is a leakage
- **Foreign sector:** Exports (X) is an injection and imports (M) is a leakage
- The relative **size of the injections and withdrawals** impacts the size of the economy:
  - Injections > withdrawals = economic growth
  - Withdrawals > injections = fall in real GDP

- Injections represent new income in the economy
- **Changes to any of the factors** that influence government spending, investment, consumption and net exports will **increase/decrease** the relative size of the circular flow of income
  - E.g. An increase in **interest rates** will increase savings (withdrawal), and **reduce consumption** and investment



### Exam Tip

Remember to consider the **net effect and proportionality** of the injections and withdrawals. For example, if the size of the government spending is large, it is likely to completely outweigh the combined withdrawals of savings and imports.

This model connects extremely well to the concept of **interdependence**. There are high levels of interdependence between households, firms, the government, the financial sector, and the foreign sector (foreign firms and households).

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## 1.2 How Do Economists Approach The World?

### 1.2.1 Economic Methodology

#### Positive & Normative Economics

##### What is positive economics?

- **Positive economics** is concerned with **objective statements** of how a market or an economy works
- These **positive economic statements** are based on empirical evidence and tend to be **statements of fact**
- They can be proven to be **true or false**
- Examples of positive economic statements include
  - The unemployment rate in India **has fallen** from 8% to 7.3% in the past twelve months
  - Increasing the minimum wage last year in the UK **resulted in improvements** to wage inequality
  - Prices in the EU **have risen dramatically**, partly due to the 20% **increase in the price of oil**

##### What is normative economics?

- **Normative economics** focuses on **value judgements**
- These judgements are built around **opinions and beliefs** as to what the best economic policies or solutions may be
- These judgements are called **normative economic statements**
- **Normative economic statements** are often the basis for the manifestos of political parties and the different economic agendas they put forward
- Examples of normative economic statements include
  - Every economy **should** aim to provide free healthcare for its citizens
  - Corporation taxes in an economy **should** be higher than personal income taxes
  - **The best way** to deal with a rise in crime is to employ more police



##### Exam Tip

In short answer questions, should you wish to provide an example of a positive or normative statement ensure that normative statements have the word 'should' in them. Positive statements usually include data that is hard to challenge.

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## The Role of Positive Economics

- As a social science, Economics deals with **complex and continuously** changing human interactions
- For this reason it is **harder to examine a relationship** between two variables and always conclude it is exactly the same (as can be done in Science or Maths)
- There are a number of tools which are utilised in **economic analysis** to help ensure that **positive (factual) statements** can be made with a higher degree of reliability

### 1. The use of logic

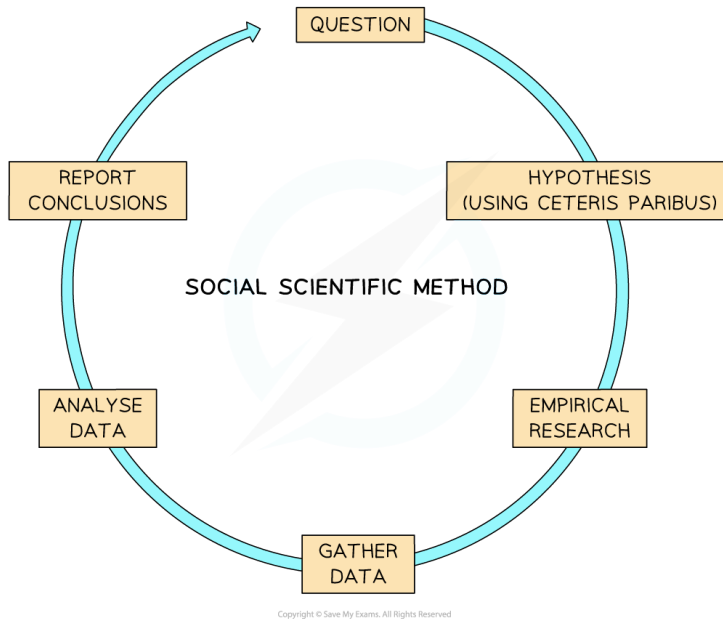
- When analysing markets, a **range of assumptions** are made about the **rationality** of economic agents involved in the transactions
- In classical economic theory, the word '**rational**' means that economic agents are able to consider the outcome of their **choices** and **recognise the net benefits** of each one
- Rational agents will select the choice which presents the **highest benefits**
  - **Consumers** are assumed to act rationally. They do this by **maximising their utility**
  - **Producers** are assumed to act rationally. They do this by **selling goods/services** in a way that **maximises their profits**
  - **Workers** are assumed to act rationally. They do this by **balancing welfare** at work with consideration of both pay and benefits
  - **Governments** are assumed to act rationally. They do this by placing the interests of the people they serve first in order to maximise their welfare

### 2. The use of hypotheses, models and theories

- The **social sciences** use a variation of the **scientific method** of research which is called the **social scientific method**
- There is an **inability to make scientific experiments** the results of which can be proven time and time again
  - This is due to the complexity of human nature and the significant **number of social interactions** that are taking place in any economy **at any given point in time**
- The steps in the **social scientific method** are similar to the scientific method but there is a key difference

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**The social scientific method uses empirical research to gather data**

- Empirical research is collected through **observations, surveys, opinion polls** etc.
  - The results of **the same hypothesis** can vary significantly when conducted by **different researchers** at **different time periods** and **between different places and cultures**
- **Refutation** is the act of a statement or theory being proved to be wrong by the empirical evidence
  - Refutation helps to determine if an **economic statement is positive**
- **Economic models** are developed by economists once a **hypothesis has been repeatedly proven or rejected in different circumstances**
  - A model is a **simplified version** of reality
  - All models make a **range of assumptions**. These are often generalisations about behaviour, choices and likely outcomes
  - These assumptions are necessary so as to account for complex human behaviour and **constantly changing variables**
  - When evaluating different models, the **underlying assumptions** should always be considered

### 3. The ceteris paribus assumption

- Due to the **large number of variables** that can influence any particular economic interaction in society, economists **create models** using the principle of **ceteris paribus**
  - Translated from Latin, ceteris paribus means '**all other variables remain constant**'
  - It allows economists to **simplify and explain** causes and effects, even if the explanation is somewhat limited by the assumptions



- E.g. There are **many factors** that affect the level of unemployment in an economy (interest rates, consumer confidence, firms' investment, government policies etc.). Using **ceteris paribus**, economists can simplify the **economic model** to analyse **just two variables** (e.g. unemployment and interest rates)

## Rational Decision Making

- When analysing markets, a **range of assumptions** are made about the **rationality** of economic agents involved in the transactions
- In classical economic theory, the word '**rational**' means that economic agents are able to consider the outcome of their **choices** and **recognise the net benefits** of each one. Rational agents will select the choice which presents the **highest benefits**
  - **Consumers** are assumed to act rationally. They do this by **maximising their utility**
  - **Producers** are assumed to act rationally. They do this by **selling goods/services** in a way that **maximises their profits**
  - **Workers** are assumed to act rationally. They do this by **balancing welfare** at work with consideration of both pay and benefits
  - **Governments** are assumed to act rationally. They do this by placing the interests of the people they serve first in order to maximise their welfare
- In many ways, the **assumption of rational decision making is flawed**. For example, consumers are often more influenced by **emotional purchasing decisions** than a rational computation of net benefits



### Exam Tip

In your examinations, the essay questions test your ability to **think critically**. The **command words** for these questions are **evaluate, discuss, or examine**.

One way in which you can demonstrate **critical thinking** is to **challenge the underlying assumptions** of economic theory. The idea of **rational decision making** is **one such assumption**. Do consumers act rationally when they make impulse purchases? Do workers act rationally when they accept terrible working conditions for mediocre pay? Do governments actually maximise public welfare or do they implement policies that mainly benefit their core voter base?

**Irrationality** distorts markets and produces fundamentally **different outcomes** than what would be achieved if all economic agents acted rationally.

YOUR NOTES



## The Role of Normative Economics

- [popover id="iHqiDrW5pilekx6-" label="Value judgements"] **influence governments'** choices with regards to the **economic policies** they choose to adopt and spend money on
  - The USA spends more money on imprisoning drug users than rehabilitating them
  - In the UK, the Government has recently increased its spending on **rehabilitation**
  - To say the **UK approach is better** would be a normative statement
  - To say that the UK government spends more per head on rehabilitation would be a **positive statement**
- **Equity** is concerned with economic fairness in the distribution of resources
  - Individuals and societies have different views on **what is fair** and this influences government policy
    - E.g. Some countries believe it is fair for all of their citizens to be able to access healthcare, irrespective of their ability to pay, whereas other countries believe that 'no pay, no access' is fair
- **Equality** is concerned with everyone being equal and having equal recognition
  - Equality is often a normative concept. When are all people equal? When do people all have equal opportunities?
  - **Statistics on inequality** would be considered to be positive economic statements
    - E.g. In 2018, women in the USA were paid 12% less than men in comparable jobs

YOUR NOTES



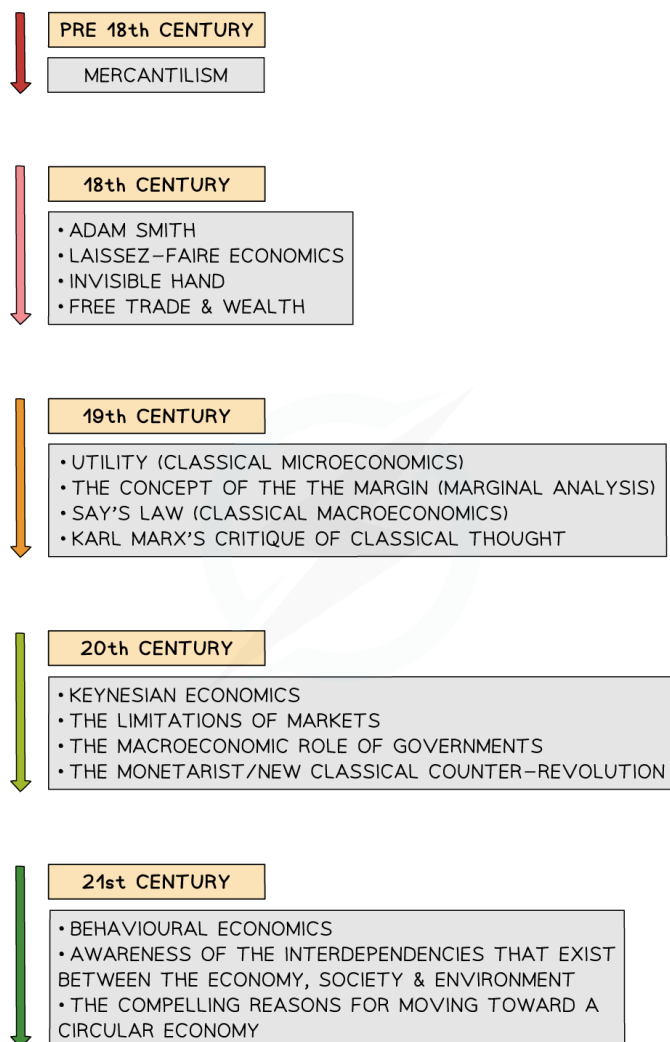
## 1.2.2 Economic Thought

YOUR NOTES



### Introduction to Economic Thought

- Understanding the evolution of **economic thought** over the past 400 years, helps us to understand the strengths and weaknesses of economic policies we use today
- Each period of **economic revolution** was created as a result of challenges societies were facing at the time e.g. classical economics was the solution to centuries of mercantilism while Marxism was the solution to capitalism and worker exploitation
- There is a strong debate around whether societies should create a **new economics** fit for the 21st century challenges



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***A summary of the economic schools of thought from the 18th century***

## Economic Ideas from the 18th Century

- **Adam Smith** published his famous book on Economics in 1776: *The Wealth of Nations*
  - He is widely regarded as the father of Classical Economics
- Written at the start of **The Industrial Revolution**, it captured his thoughts on how markets could be coordinated by demand and supply
  - This book was a natural response to the **previous century of government intervention** in markets in Europe during a period known as mercantilism

### Key ideas from Adam Smith in the 18th Century

Idea	Explanation
Laissez-faire ('to leave alone') economics	<ul style="list-style-type: none"> <li>• A philosophy which believes there should be <b>no (or minimal) government intervention</b> with regard to decisions about resource allocation and production</li> </ul>
Invisible hand	<ul style="list-style-type: none"> <li>• The unseen free market forces of demand and supply that coordinate the <b>best allocation of resources</b> within society</li> <li>• It is driven by consumers and producers seeking to maximise their <b>self-interest</b></li> <li>• <b>Personal incentives</b> and not government decisions determine the allocation of resources</li> </ul>
Free trade	<ul style="list-style-type: none"> <li>• Removing the protectionist measures found in <b>mercantilism</b> would increase production, trade and wealth</li> </ul>
Wealth	<ul style="list-style-type: none"> <li>• <b>Production</b> creates wealth for individuals and when individuals get wealthy, the nation gets wealthy</li> </ul>

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## Economic Ideas from the 19th Century

- During the **19th century**, several key ideas emerged including classical microeconomics (utility); the concept of the margin; classical macroeconomics (Say's law)
- During this period **Karl Marx** also developed his critique of classical economic thought

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### Key ideas from the 19th Century

Idea	Explanation
<b>Classical microeconomics (utility)</b>	<ul style="list-style-type: none"> <li>• The idea of utility as a concept challenged what <b>classical economists</b> believed about how a product should be priced</li> <li>• Previously, prices were a function of the costs of production involved. Now prices were seen as a function of the <b>satisfaction gained in consumption</b></li> <li>• Producers should <b>increase production</b> for goods with high consumer utility</li> <li>• Utility theory assumes that consumers always act rationally (yet many purchasing decisions are based on emotion)</li> </ul>
<b>The concept of the margin</b>	<ul style="list-style-type: none"> <li>• <b>Marginal utility</b> is the additional utility (<b>satisfaction</b>) gained from the consumption of <b>an additional product</b></li> <li>• The utility gained from consuming the first unit is usually <b>higher</b> than the utility gained from <b>consuming the next unit</b> <ul style="list-style-type: none"> <li>◦ E.g. A hungry consumer gains <b>high utility</b> from eating their <b>first hamburger</b>. They are still hungry and purchase a <b>second hamburger</b> but gain <b>less satisfaction</b> from eating it than they did from the first hamburger</li> </ul> </li> <li>• To calculate <b>total utility</b>, the <b>marginal utility of each unit</b> consumed is <b>added together</b> <ul style="list-style-type: none"> <li>◦ This means that total utility <b>keeps increasing</b> even while marginal utility is <b>decreasing</b></li> </ul> </li> </ul>



### Classical macroeconomics (Say's law)

- Say's law of markets was developed in 1802 by the **classical, laissez-faire** economist Jean-Baptise Say
- It can be summed up with the phrase '**supply creates its own demand**'
- By supplying goods to the market a producer generates income from sales which they can then use to purchase (demand) more products
- This law implies that increasing **national output in an economy is vital** to income generation and thus governments should focus on generating production and be less concerned with consumption

## Karl Marx's Critique of Classical Economic Thought

- Free markets **generated incredible wealth** in the Western World
- Karl Marx, a German philosopher, identified that wealth seemed to come **from worker exploitation** (a natural function of profit maximisation) and that inequality was deepening in societies
  - The exploitation was seen in low wages and poor working conditions
  - The **owners of the factors of production (capitalists)** generated the highest income (wages, interest, rent and profit)
  - If all someone had to offer was labour, and wages were suppressed: then inequality was bound to increase
- Marx argued that capitalism would eventually lead **workers to revolt** and that periods of exploitation would be followed by revolutions
  - These revolutions would require **government intervention** to restore stability and equality
  - Governments would need to be involved in the allocation of resources (command economy) to prevent the pattern from repeating
- Marx's ideas were incredibly influential and within a relatively short time frame resulted in more than **a third of the world's population** living in economies influenced by his ideas

## Economic Ideas from the 20th Century

- The first half of the 20th Century was dominated by the **two World Wars** and the **Great Depression**
- The economic ideas of the previous century no longer worked
- In this severe recession, **Say's Law became obsolete** as households were unable to buy goods/services due to a complete lack of income
- **John Maynard Keynes**, a British economist from Cambridge felt new ideas were needed
- His ideas were quickly embraced and the next 50 years saw a widespread **Keynesian revolution** as governments adopted **Keynesian economics**

### Key ideas from Keynes in the 20th Century

Idea	Explanation
The limitations of markets	<ul style="list-style-type: none"> <li>• Contrary to classical theory, Keynes saw that the <b>Great Depression</b> had created a situation where markets did not automatically readjust to a new equilibrium</li> <li>• Some markets remained in a <b>long term period of disequilibrium</b> where supply was greater than demand</li> <li>• Market forces were <b>not resolving the situation</b></li> </ul>
The Macroeconomic role of Governments	<ul style="list-style-type: none"> <li>• Keynes believed that Governments needed to stimulate demand by increasing <b>government spending</b></li> <li>• This would begin to <b>increase the flow of income</b> in the economy which would further stimulate demand which would help markets to function again</li> <li>• He developed the term and field of '<b>Macroeconomics</b>' by explaining how aggregate demand is calculated</li> <li>• He argued that the use of Fiscal Policy was essential to stabilise an economy during periods of recession or depression, much more so than the use of Monetary Policy</li> </ul>

### The Monetarist/New Classical Counter Revolution

- **Monetarism** is an economic school of thought which emphasises the use of **Monetary Policy** to influence an economy
  - Monetarists believe that **poor monetary policy** lead to the Great Depression
  - Monetarists believe that the **use of fiscal policy** leads to inflation as government spending increases aggregate demand
- **Milton Friedman** was one of the leading **Monetarists** of the late 20th Century
  - His ideas influenced Ronald Reagan in the USA and Margaret Thatcher in the United Kingdom
  - Both Governments moved away from **Keynesian economics**

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- From the early 1980s there was a resurgence in the belief in **classical economics and laissez-faire markets**
  - Government spending reduced and the focus shifted to Supply-Side Policies
  - One prominent Supply-Side Policy that the USA and the UK embraced was the use of privatisation

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## Economic Ideas from the 21st Century

- The early part of the 21st Century has seen several **significant global challenges** emerge
  - Climate change
  - On-going wars and displacement of populations
  - An increase of global population in the last 100 years by 7 billion people
  - The **Global Financial Crisis** of 2008
  - The Covid Recession of 2020
  
- **Keynesian economic thought** came to prominence again with the 2008 Financial Crisis as governments chose to spend their way out of trouble
  - Government spending increased to **levels never seen before**, continuing for more than a decade
  - This increased spending was financed by **increased government borrowing**
  - Increased Government borrowing creates **increased tax burdens** for future generations
  
- Even with Government spending extraordinarily high in many economies, expansionary Monetary Policy had to be widely used to bring stability
  
- This pattern of events prompted calls for societies to **rethink Economics**
  - It called for **an economic philosophy** to emerge that is no longer rooted in 'old thinking'
  - It called for ideas fit for a 21st Century world

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### 21st Century Ideas

Idea	Explanation
<p><b>The growing role of behavioural economics</b></p>	<ul style="list-style-type: none"> <li>• A fundamental flaw in economic theory is that <b>individuals behave rationally</b> in markets</li> <li>• Behavioural economics recognises this and combines elements of economics and psychology to understand how and why individuals make the <b>economic decisions</b> they do</li> <li>• Understanding human behaviour creates better opportunities for firms and governments to nudge people towards better choices                             <ul style="list-style-type: none"> <li>◦ E.g. The use of <b>choice architecture</b> for online forms in many countries automatically selects organ donation as a default: individuals have to opt-out as opposed to opting-in</li> <li>◦ Nudge theory is increasingly used by firms and governments across the world</li> </ul> </li> </ul>

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<p><b>Awareness of the interdependencies that exist between the economy, society and environment</b></p>	<ul style="list-style-type: none"><li>• The circular flow of income model has provided a basis for understanding macroeconomies since it was visualised by Frank Knight in 1933</li><li>• The model has been criticised as <b>not fit for the 21st century</b> as it does not take into account the <b>inputs and outputs of societies</b><ul style="list-style-type: none"><li>◦ It focusses on money as opposed to <b>well-being and planetary health</b></li><li>◦ Inputs are the raw materials which are increasingly used in <b>unsustainable</b> ways</li><li>◦ Outputs are the <b>carbon and waste</b> that are generated</li></ul></li></ul>
<p><b>The compelling reasons for moving toward a circular economy</b></p>	<ul style="list-style-type: none"><li>• A circular economy has three main principles<ol style="list-style-type: none"><li>1. Eliminate waste and pollution</li><li>2. Recirculate products</li><li>3. Regenerate nature</li></ol></li><li>• The <b>increasing climate crisis</b> provides a strong reason why economies should rush to move away from the <b>circular flow of income</b> model to the <b>circular economy model</b></li></ul>