OCR – A Level Economics

Component 1 – Microeconomics

1 Introduction of microeconomics

Revision Notes

Contents

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1.1 The economic problem

What is economics?

Economics exists because of a very simple (but BIG) problem:
We humans have **unlimited wants and needs**, but the world only has **limited resources**.

Since we can't have everything, economics is all about figuring out the **best way to use scarce resources**.

Economic Goods vs Free Goods

- **Economic goods**: These are things that are **scarce** (limited in supply). Because we can't have unlimited amounts, they have an **opportunity cost** (choosing one thing means giving up another).
    - Example: A new iPhone, petrol, or even water in some countries.
- **Free goods**: These are things that are **not scarce** and have no opportunity cost because there's enough for everyone.
    - Example: Air (at least in most places), sunlight, or seawater.
- Economists mainly focus on **economic goods** because those are the tricky ones to allocate fairly.

1.1 The economic problem

What is economics?

Microeconomics vs Macroeconomics

Economics can be studied at two levels:

- **Microeconomics** (small scale):
  Focuses on individuals, households, and businesses. It's like zooming in on the economy.
    - Example: Why does Starbucks charge £3.50 for a latte?
- **Macroeconomics** (big picture):
  Looks at the economy as a whole; things like unemployment, inflation, and economic growth.
    - Example: Why did the UK economy shrink during COVID-19?

Think of it this way: **Economics = life's ultimate budgeting game.**
You want everything… but you can't afford it all.

Developing Models

- **What is Economics?**

Economics is a social science that studies how societies operate and how individuals and groups make decisions.

- **Purpose of Economic Models**

Economic models simplify complex real-world economic activities to improve understanding and make predictions.

- **Examples of Economic Models**

The Circular Flow of Income model illustrates the movement of money between different groups in the economy, such as households, businesses, and the government.

- **Importance of Assumptions**

All models rely on assumptions that simplify behaviour, choices, and outcomes to address complex human behaviours and ever-changing conditions. It's important to always consider these underlying assumptions when evaluating different models.

- **Evaluating Economic Models**

Evaluating a model involves scrutinizing the assumptions made and their impact on the model's accuracy. It's essential to consider how closely a model's predictions match real-world data.

1.1 The economic problem

- **Selecting Variables**

Economists choose variables based on the study's objective, the theory being tested, and data availability. Deciding which variables to include or exclude can significantly affect a model's outcomes.

Ceteris Paribus

- **Using Ceteris Paribus:** Economists use the principle of ceteris paribus, which is Latin for "all other variables remain constant." This helps them focus on specific economic interactions without getting overwhelmed by too many variables.
- **Purpose of the Principle:** By applying ceteris paribus, economists can simplify complex scenarios to better understand cause and effect, even though this method simplifies real-world dynamics based on certain assumptions.
- **Practical Example:** When studying the effect of tax reductions on consumer spending, economists might use the ceteris paribus assumption to ignore changes in employment rates or inflation during their analysis.
- This allows them to specifically analyse how tax cuts alone influence spending behaviours, assuming all other economic factors remain constant.

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The Scientific Method

Scientific Method in Natural Sciences vs. Social Sciences

In **natural sciences,** the scientific method is clear and repeatable:

1. Pose a question.
2. Predict an outcome (hypothesis).
3. Test it through experiments.
4. Analyse and report the results.

When these steps are repeated under the same conditions anywhere in the world, the results should ideally be the same.

In **social sciences** like economics, achieving consistent results is challenging because of the complex nature of human behaviour. Social scientists adapt the scientific method as follows:

- Define ~~specific~~ economic research questions.
- Form hypotheses, often using the "ceteris paribus" (all else equal) assumption to focus on one variable.
- Use empirical methods (i.e. surveys, observations, opinion polls) to gather data.
- Analyse the data and report conclusions.

This **social scientific method** accepts that results may vary due to differences in researchers, timing, locations, and cultures. Thus, economic models are regularly updated and validated rather than being considered universally proven, as in the natural sciences.

1.1 The economic problem

Positive statements

- **Positive economics deals with facts and avoids personal opinions. It explains what happens in the economy and can be tested to see if it's true or false.**

Example: "Raising taxes on cigarettes reduces smoking." This is testable with data.

Normative statements

- **Normative economics is based on value judgement and opinions, focusing on what should happen rather than what does. It cannot be tested as true or false and is a non-scientific approach to economics.**

It often includes words like "should", "ought", "better", "worse", "unfair" or "fair."

Example: "The government should raise the minimum wage to help people live better." This reflects a **value judgment**, not something you can test directly.

The role of value judgement

Economists often use facts (positive statements) to support opinions or recommendations (normative statements). For example, the normative statement "Taxes should be lowered to boost spending" could be supported by the positive statement "Consumer spending has decreased over the past year."

Value judgments can influence economic decisions and policies. For instance, one economist might see decreased spending as a sign to lower taxes, while another might prioritize other solutions.

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1.1 The economic problem

Central purpose of economic activity

The main reason we have economic activity is simple:
To take limited resources and turn them into goods and services that people need or want.

- **Needs** are things we must have to survive – like food, water, and shelter.
- **Wants** are things we'd *like* to have – like phones, fancy clothes, or chocolate milkshakes.

The tricky bit?
People's needs and wants are **infinite,** we always want more!
But the resources (like time, money, land, and labour) to make these things are **limited** (finite).

🛠 What Happens During Economic Activity?

It's all about answering three key questions:

- **What should we make?**
- **How should we make it?**
- **Who gets to have it?**

This helps decide how to use resources wisely and fairly.

📦 To Produce Goods or Services

Businesses exist to **make goods or provide services**:

- **Goods** = physical stuff (like trainers, laptops, or furniture)
- **Services** = things people do for you (like getting a haircut or ordering food delivery)

1.1 The economic problem

Central purpose of economic activity

🎯 Meeting Customer Needs

The goal is to **make people happy** by giving them what they need or want.

- When businesses meet people's needs, customers keep coming back.
- This builds **loyalty**, improves the brand's reputation, and helps the business grow.

Example: A bakery that always has fresh, tasty bread will get loyal regulars.

💎 To Add Value

Adding value means improving a product or service to make it more attractive.

This could be by:

- Making something better quality
- Designing it to look cooler
- Making it easier to use

All of this helps the business **stand out** (this is called a **unique selling point** or USP).

Example: A water bottle that keeps drinks cold for 24 hours is adding value over a basic one.

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1.1 The economic problem

The role of economic agents

Economic agents are the key groups that make decisions in the economy. These include **households, firms, and governments**. Each plays a unique role in how resources are used and distributed.

🏠 Households

Households have **two main roles** in the economy:

- **Consumers of goods and services** – Households buy things like cars, groceries, clothes, or Netflix subscriptions. This process is called **consumption**.
- **Providers of labour** – Households also provide the workforce. Example: A nurse works in the NHS, a builder constructs new houses, or a student takes a part-time job at Starbucks. This is called **labour supply**.

So, households are both spenders and workers in the economy.

🏭 Firms

Firms also have **two main roles**:

- **Producers of goods and services** – Firms like Apple, Tesco, or a local bakery produce the goods and services we use every day.
- **Buyers of inputs** – To produce, firms must purchase things like land, machines, and workers. For example, a gaming company buys computers and hires programmers to create new games.

So, firms are both **creators** and **shoppers** in the economy.

1.1 The economic problem

The role of economic agents

🏛 Government

The government has **many roles**, such as:

- Using **taxation** (taking money from households/firms) and **spending** (on schools, hospitals, roads) to influence both the **microeconomy** (specific markets) and the **macroeconomy** (the whole economy).
  - Example: The UK government places high taxes on cigarettes to reduce smoking (micro).
  - Example: It provides unemployment benefits to support people during job loss (macro).
- Passing **laws and regulations** to improve society.
  - Example: Minimum wage laws or banning harmful substances.

Not everyone agrees with how governments act, but that's where **politics and economics overlap**.

🧠 Rationality

In economics, we often assume that **economic agents act rationally,** meaning they make choices in their **best interest**.

- **Households** want to maximise **satisfaction (utility)**.
  - Example: You buy a cinema ticket 🎬 if you think the fun is worth £10; if not, you keep your money.
- **Firms** want to maximise **profit**.
  - Example: A bakery only hires an extra baker if selling more croissants 🥐 will earn more money than the baker's wages.
- **Workers**: They try to balance job satisfaction, pay, and benefits.
- **Governments** want to maximise **welfare** (the well-being of society).
  - Example: They ban smoking indoors 🚭 because it harms public health, even if tobacco companies lose profit.

Of course, in real life people don't always act rationally, sometimes we buy stuff we don't need (impulse shopping 🙃), or governments make political choices instead of purely rational economic ones.

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1.1 The economic problem

Factors of production

Every product or service you use, whether it's a burger, a bike, or a haircut, is made using **four key ingredients** called the **factors of production**:

Land 🌍	Labour 👷	Capital 🏭	Enterprise 💼
This means all **natural resources** we get from the Earth. It's not just soil, think oil, forests, rivers, and even cows. Some countries are lucky to have lots of one resource and can specialise in it. *E.g. Saudi Arabia has a lot of oil, so it exports tons of it.*	This is the **human effort** used to make goods or deliver services. Can be physical (like a builder) or mental (like a software developer). Workers can be **skilled** (e.g. a brain surgeon) or **unskilled** (e.g. a delivery driver). *E.g. Chefs, factory workers, teachers, all count as labour.*	These are **man-made tools and machines** that help make things. It's not money. Think of anything that helps production. *E.g. Computers in an office, machines on a factory floor, or even a pizza oven.*	This is the brain and risk-taker behind the business: the **entrepreneur**. They combine land, labour and capital to make goods or services. They take risks, make decisions, and (hopefully) make a **profit**. *E.g. A tech start-up founder or the person who opens a new bakery.*

1.1 The economic problem

Factors of production

Who Owns These Resources?

In a **free market economy** (like the UK or USA), these resources are owned by **households or private firms**, not the government.

- Households supply these resources to businesses
- Businesses pay for them in the **factor markets**

What Do Households Get in Return? 💰

When households offer their resources, they earn **factor income**:

- **Land** → earns **rent**
- **Labour** → earns **wages and salaries**
- **Capital** → earns **interest**
- **Enterprise** → earns **profit**

1.1 The economic problem

The environment is a scarce resource

Environmental resources are **natural materials** we get from the Earth, like water, trees, oil, and air. These resources are part of **land**, one of the four **factors of production** (land, labour, capital, enterprise) used to make goods and services.

🔄 **The Problem: We Use Too Much**

As we produce more stuff, we often take too much from nature. This is called **overconsumption**, and it damages or **degrades** the environment. That means we're using up resources faster than they can be replaced.

- **Non-renewable resources** (like coal and oil) can't be replaced once they're gone and they're running out fast.
- **Renewable resources** (like water and air) should last forever...
  But if we pollute or waste them, they can also become **scarce** (in short supply).

🌱 **Why It Matters: Sustainability**

This leads us to **sustainability:** making sure we use resources in a way that doesn't stop future generations from enjoying them too.

🧃 **Example:** If we keep polluting rivers, there may not be enough clean water for our kids and grandkids.

1.1 The economic problem

The environment is a scarce resource

Continue to the next page...

1.2 The allocation of resources

Incentives

An **incentive** is basically something that **motivates people to act**. In economics, incentives usually link to:

- **Profit** (firms want to make money 💰)
- **Prices** (consumers love a bargain 🛒)
- **Social welfare** (governments want people to be safe, healthy, and happy 🏥🌳)

Example:

- If **train tickets get cheaper**, more people might take the train instead of driving 🚆.
- If **coffee shops can earn higher profits**, they'll open more branches ☕.

⚡ The Effectiveness of Incentives

Economists often assume that people and businesses respond logically (or "rationally") to incentives. But in real life, it's not always that simple.

- 👖 Example: If jeans go on sale, you *might* buy them… but only if you actually like them and have enough cash.
- 🏭 Firms may not always use the cheapest production method if it means risking quality or reputation.
- 🏛️ Governments may not always ban harmful things (like fast food 🍔) if the policy is unpopular.

So, while incentives are powerful, they don't always guarantee a response.

1.2 The allocation of resources

Incentives

🔑 What Makes Incentives Work (or Fail)?

The success of an incentive depends on:

- 💸 **Size of the incentive** – A 1p price rise won't change behaviour much, but a big tax might.
- 📦 **Type of good/service** – Essentials like bread or medicine are harder to give up, even if prices rise.
- ⏳ **Timescale** – Some changes take years (e.g., switching to renewable energy).
- 🎯 **Objectives of the agent** – Consumers want satisfaction, firms want profit, governments want welfare.
- 🌍 **Other market changes** – A new technology or global crisis may affect how people respond.

1.2 The allocation of resources

Economies can be set up in different ways to produce goods and services. Think of it as a scale, with a **Market economy** on one end, a **mixed economy** in the middle, and a **Planned economy** on the other.

Market Economy (or market economy)

- **A Market economy refers to an economic system where the prices of goods and services are set freely by the forces of supply and demand and without intervention by the government.**

In a free market economy, people have the freedom to make their own choices and own resources (like land and businesses) without government interference. Resources are allocated through **supply and demand** (the price mechanism).

- **Consumers Rule**: What gets produced depends on what consumers are willing to buy. If people want it and are ready to pay, producers make it.
- **Decision-Making**: Consumers make choices based on what makes them happy, while producers focus on making a profit.

There aren't any *completely* free markets in the world today. Governments still play a small role, like setting minimum wage, health and safety standards, and subsidies. Without these basics, even a free market couldn't function properly.

Adam Smith, a famous economist, was a big fan of free markets with limited government. He argued that economies work best when individuals act in their **own self-interest,** but he did think the government should step in a bit to ensure things like public goods (such as roads) and merit goods (like education) are available.

1.2 The allocation of resources

Advantages of a Market economy

- **Profit Incentive**: The chance to earn profits motivates people to work hard and come up with new business ideas.
- **Variety of Goods & Services**: Since businesses are competing, there's usually a wide range of products and services to choose from.
- **Better Quality**: Competition pushes companies to improve quality to win over customers.
- **Lower Prices**: More competition often leads to lower prices, as companies try to attract more buyers.
- **Encourages Innovation**: Businesses constantly try to invent or improve products to stay ahead.
- **Unlimited Earnings Potential**: People can earn as much as they're able to, which can lead to higher living standards.
- **Efficient Resource Use**: Resources are used more wisely since companies aim to be as efficient as possible.

Disadvantages of a Market economy

- **Wealth Inequality:** Wealth tends to concentrate among the few who own most of the resources, widening the gap between rich and poor.
- **Lower Quality to Save Costs:** Sometimes, companies cut corners on quality to boost profits.
- **Worker Exploitation**: In the drive for profits, workers may end up underpaid or overworked.
- **Environmental Damage:** Companies might ignore environmental impacts, leading to resource depletion and pollution.
- **Monopolies:** Big companies can buy out competitors, reducing competition and creating monopolies.
- **Consumer and Supplier Exploitation:** Monopolies can lead to higher prices for consumers and pressure on suppliers to cut costs.

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1.2 The allocation of resources

Planned Economy

- **A Planned economy is one where the government owns all resources and decides how goods and services are produced and distributed.**

Karl Marx thought free markets naturally lead to **capitalism**, where the people who own resources (the capitalists) take advantage of the workers. According to him, this creates huge inequality and eventually leads to conflict between the rich and the poor.

His solution? The **State** should take control and make sure resources are shared fairly among all workers. This meant:

- **No private property**: Everything should be owned collectively, not by individuals.
- **Central planning**: The government should step in and decide what to produce, how to produce it, and who gets it.

In short, Marx believed sharing and planning were the keys to a fairer society, instead of leaving things to the free market.

An example of a Planned economy is North Korea. In North Korea, the government owns all the resources and controls what gets produced, how it's made, and who receives it. For instance, the state decides the production of goods like food, clothing, and housing and allocates them to the population based on its policies and priorities, rather than market demand or individual choice.

1.2 The allocation of resources

Advantages of a Planned Economy:

- **Focus on Equality**: The system aims to reduce inequality by prioritising social equality over profits.
- **Equal Wages for All**: Everyone gets paid the same, no matter their job or role, promoting fairness.
- **Lower Unemployment**: The government ensures jobs for everyone, so unemployment is minimal.
- **Quick Action on Priorities**: Resources can be quickly directed to urgent needs, like disaster relief or major infrastructure projects.
- **Consumer Protection**: Since the government controls big industries, it prevents exploitation, like unfairly high prices.

Disadvantages of a Planned Economy:

- **No Incentive for Hard Work**: Why spend years studying to be a doctor if you'll earn the same as someone with no training?
- **Less Innovation**: Without competition, there's little push to create better products or develop new ideas.
- **Inefficiency**: It's unrealistic for the state to make all decisions correctly, which can result in overproduction or shortages, leading to wasted resources.
- **Limited Living Standards**: Most people have restricted access to luxury goods or higher standards of living.
- **Less Freedom**: The government controls many aspects of life, limiting personal choices.

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Mixed Economy

- **Mixed economy is where resources are partly allocated by the price mechanism/market and partly by the government/state.**

Both free markets and Planned economies have their pros and cons, so most countries aim for a middle ground, a **mixed economy**. In a mixed economy, resources are allocated partly by the free market (supply and demand) and partly by government planning. It's a compromise that tries to balance the best of both worlds.

Friedrich Hayek thought Planned economies had some big flaws. He pointed out that central planners often didn't know what the economy needed. This mismatch led to either **shortages** (not enough goods) or **surpluses** (too much stuff no one wanted).

Hayek believed too much government control messed with efficiency and slowed down economic growth. In his view, economies work better when markets are left to figure things out naturally.

Most developed countries are mixed economies for example UK, France, Germany, Canada, Australia and Sweden.

1.2 The allocation of resources

The role of the state in a mixed economy

1. Improving the Market:

- Governments provide public and essential services like healthcare, transport, and emergency services.
- They also reduce harmful goods (like drugs) and address the environmental impact of production.

2. Setting Rules and Protections:

- They stop monopolies (companies with over 25% market share) from overcharging or offering poor services by enforcing competition.
- Protect consumers with laws against poor-quality products or services.
- Ensure workplaces follow safety standards for both employees and employers.

3. Redistributing Income:

- They use taxes (like income tax) to move money from the wealthy to support the less fortunate.
- This helps fund benefits for those in need and provides essential services like education and healthcare that everyone can access.

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1.3 Opportunity cost

The problem of scarcity – where there are unlimited wants and finite resources

- **Scarcity arises because resources are limited or finite in supply and so cannot meet all human wants.**

Here's the big issue: there just aren't enough resources to satisfy everyone's endless wants and needs. In economics, we call these limited resources the *factors of production* (land, labour, capital and enterprise). Because of scarcity, everyone (whether it's producers, consumers, or governments) has to make tough choices about how to use resources most efficiently.

Economics is the study of how we tackle scarcity by deciding what to produce, how to produce it, and who gets it.

In a nutshell, scarcity makes us think carefully about how we use what we have, since we can't have it all.

1.3 Opportunity cost

The importance of Opportunity Costs

- **Opportunity cost refers to the value of the next best alternative foregone.**

In other words, opportunity cost is all about what you give up when you make a choice. Since resources are limited, every decision comes with a trade-off, the thing you didn't choose is your opportunity cost.

Some examples include:

- **For Consumers**: If you decide to spend money on a vacation, you might not have enough left to buy a new laptop. Here, the laptop is the opportunity cost of choosing the vacation.
- **For Businesses**: If a bakery uses all its flour to make bread, it might not have enough flour left to make pastries. In this case, pastries are the opportunity cost of focusing on bread.
- **For Governments**: If a government chooses to invest in building more roads, it might not have the funds to improve healthcare facilities. The healthcare improvements become the opportunity cost of building roads.

In short, every choice means giving something up. Opportunity cost is simply the name for what you give up to get something else.

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1.3 Opportunity cost

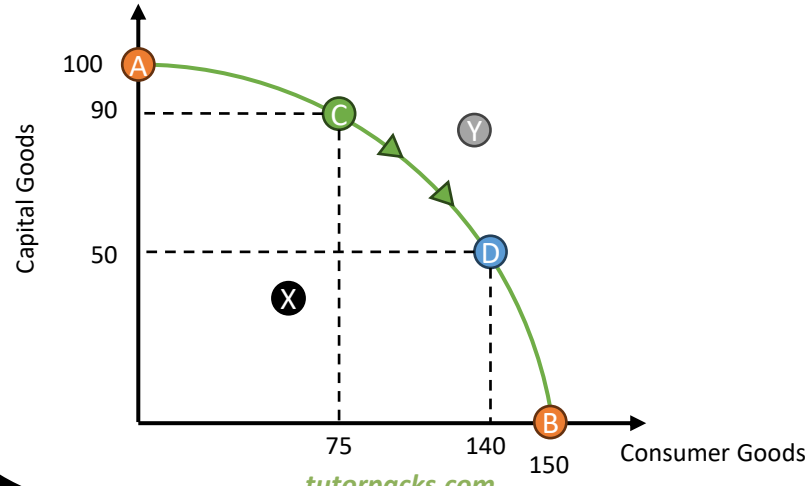
- **PPF is the maximum output combinations an economy can achieve when all resources are fully/efficiently employed.**

The PPF model is a simple way to show the most a country can produce if it uses all its resources (land, labour, capital and entrepreneurship) efficiently to make just two products. Think of it as the "max production line" for two goods or services.

You can use any two products to explain this model, but a common combo is **capital goods** and **consumer goods**:

- **Capital Goods:** These are tools or machines that help make other products. For instance, a commercial over in a bakery is a capital good because it's used to bake food.
- **Consumer Goods:** These are finished products for people to use, like a pair of headphones. They're the end of the line, no future production use here.

In short, the PPF shows us opportunity cost and scarcity.



1.3 Opportunity cost

Understanding the PPF Diagram:

The curve itself represents all possible combinations of two goods this economy can make by fully utilising its resources.

- **On the Curve (Points A, B, C, D):**
  - At **Point A,** all resources go into making **only capital goods** (100 units).
  - At **Point B,** all resources go into making **only consumer goods** (150 units).
  - **Points C and D** show combinations where resources are split efficiently between both goods. For example, at **Point C,** the economy makes **90 capital goods and 75 consumer goods.**

Opportunity Cost on the PPF

- Moving along the curve shows opportunity cost; what you give up to produce more of something else.
- For instance, shifting from **Point C (90 capital goods, 75 consumer goods)** to **Point D (50 capital goods, 140 consumer goods)** means producing **65 more consumer goods** but sacrificing **40 capital goods**.

Efficiency and Attainability

- Any point **on the curve** shows **productive efficiency;** all resources are fully used.
- Points **inside the curve** (like Point X) show **inefficiency,** where resources are underused.
- Points **outside the curve** (like Point Y) are **unattainable** with current resources.

1.3 Opportunity cost

Efficiency means getting the most out of your resources, like time, money, or materials, without waste.

Economists focus on **two main types** of efficiency:
🔵 **Productive Efficiency**
🔵 **Allocative Efficiency**

🏭 **Productive Efficiency – "No Wasted Effort!"**

Definition:
Productive efficiency happens when an economy (or business) produces as much as it can with the resources it has; nothing goes to waste.

On a PPF:
Any point **on** the curve shows productive efficiency. It means the economy is using **all** its land, labour, capital, and enterprise in the best way possible.

Example:
Imagine a bakery using every oven, worker, and bag of flour to bake as many loaves and cakes as possible. That's productive efficiency.

✅ No resources are sitting idle
❌ Producing inside the curve (like in the middle of the graph) = underused resources (maybe some ovens are off or workers are waiting around!)

1.3 Opportunity cost

⚖️ **Allocative Efficiency – "What People Actually Want!"**

Definition:
Allocative efficiency means using resources to make the **right mix of goods and services;** the ones people want and need most.

On a PPF:
Not every point on the curve is allocatively efficient. Just because you're producing a lot doesn't mean it's the right stuff.

Example:
Back to our bakery:
If they only bake 100 loaves of bread but people also really want muffins, that's not allocative efficiency.
But if they bake 60 loaves and 40 muffins — and that's what customers want, bingo. That's the best use of resources.

🔄 It's all about matching production with **consumer preferences**.

🔑 **In a Nutshell:**

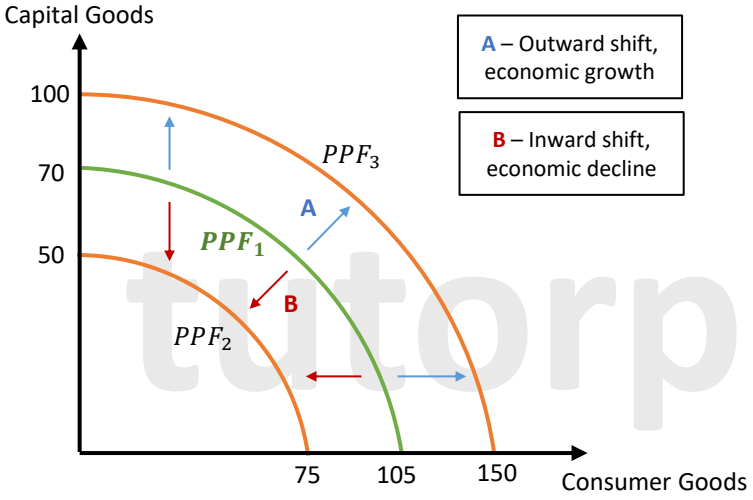
- **Productive Efficiency** = no waste, full use of resources (e.g. all ovens and staff working)
- **Allocative Efficiency** = making the right things people want (e.g. the perfect mix of bread and muffins).

💡 Bonus Tip: Changing how you use your resources might increase one type of efficiency but reduce the other, it's all about finding the right balance.

1.3 Opportunity cost

Shifts in the PPF

Unlike a movement along the PPF (where production choices shift within the current curve), the entire PPF can shift inwards or outwards.



1.3 Opportunity cost

Economic Growth: Outward Shift

- **Economic growth is an increase in real output or an increase in the productive capacity of an economy.**

When an economy grows, it can produce more of everything; both consumer and capital goods. This growth shows up as an outward shift of the PPF.

What causes this growth? An increase in the quality or quantity of resources.

- Improving Quality: If new technology makes factories more efficient, production goes up, and so does the economy's capacity.
- Increasing Quantity: If a new natural resource (like a large oil reserve) are discovered, the economy can produce more goods.

Economic Decline: Inward Shift

On the other hand, if the economy loses resources or their quality decreases, the PPF shifts inwards, meaning less can be produced overall.

What causes decline? Events that reduce resources or their quality.

- Example: A prolonged drought reduces the availability of water, affecting agriculture and shrinking the economy's production capacity.
- Example: If a skilled portion of the workforce retires without enough replacements, the economy loses productivity, resulting in an inward shift.

In short, when resources improve, the PPF shifts outward, showing growth. When resources are lost or damaged, the PPF shifts inward, showing a decline in the economy's potential.

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