VCE Economics Units 1&2 Complete Study Guide

Complete study guide · Units 1&2 · AceGuides

This guide follows the VCAA VCE Economics Study Design (version 1.1), accredited from 2023 and in force for Units 1 and 2 in 2026. It covers every key knowledge dot point for Unit 1 (Economic decision-making) and Unit 2 (Economic issues and living standards), including all four Unit 2 economic issues, so you can study whichever two your school chooses.

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About this guide

How to use it

Each section matches one Area of Study in the study design. Work through a section in this order:

1. Read the explanation and learn the **bold** definitions word for word. Economics marks are often lost on loose definitions.
2. Work through the worked examples yourself before reading the answer. Every number in this guide has been checked.
3. Read the Exam tip and Common mistake boxes. They target the errors that cost the most marks.
4. Answer the Check your understanding questions in full sentences, then mark yourself using the Worked solutions section.
5. In the final fortnight, use the One-page summary and the Practice exam.

Statistics in this guide are given with the year they apply to. Economic data changes every month, so for any SAC check the latest figures from the ABS (abs.gov.au), the RBA (rba.gov.au) and Treasury. A good habit is to keep a one-page "data sheet" that you update each term.

How Units 1 and 2 are assessed

Units 1 and 2 are assessed entirely by your school. VCAA does not set an exam for these units

and the results are not reported to VCAA or used directly in your ATAR. You receive an S (satisfactory) or N (not satisfactory) for each unit, and your school decides how to grade you. Even so, Units 1 and 2 build the skills and models (demand and supply, the circular flow, aggregate demand and supply, living standards) that Units 3 and 4 assume you already know. Unit 3 and 4 Economics is assessed by SACs (25 per cent each unit) and a two-hour end-of-year exam (50 per cent).

Unit	Area of Study	Outcome (summary)	Typical task types
Unit 1	AoS 1 Thinking like an economist	Describe the economic problem, roles of economic agents, factors affecting decisions	Structured questions, folio of exercises
Unit 1	AoS 2 Decision-making in markets	Explain relative prices and non-price factors; analyse competition	Case study of a market, data analysis
Unit 1	AoS 3 Behavioural economics	Explain how behavioural economics complements traditional views	Report on an experiment, media analysis
Unit 2	AoS 1 Economic activity	Purpose of activity, living standards, growth, costs and benefits	Data analysis, extended response
Unit 2	AoS 2 Economic issues	Explain factors affecting two issues and evaluate responses	Report, essay, case study, debate

Schools choose from a long list of task types, including an analysis of statistical evidence, a folio of applied exercises, an essay, a structured report, structured questions, a presentation, a media analysis, a case study and, in Unit 1, reporting on a behavioural economics experiment. Ask your teacher early which tasks you will sit and when.

Ten-week revision plan

Week	Focus	Tasks
1	The economic problem, PPF, opportunity cost	Learn definitions; draw three PPFs from memory
2	Economic systems, circular flow, economic agents	Draw the three-sector model; incentives table
3	Demand and supply, shifts and movements	Ten shift diagrams; Worked example 2.1
4	Equilibrium, market power, Competition and Consumer Act	Market structure table; your contemporary market
5	Behavioural economics	Learn the three "boundeds"; one experiment write-up
6	Economic activity, five-sector flow, business cycle	Draw both models; indicator table
7	AD, AS, measuring growth	GDP calculations; costs and benefits of growth
8	Living standards measures	Compare GDP per capita, HDI, Measuring What Matters
9	Your two economic issues	A–E plan for each issue with current data
10	Practice exam and review	Timed exam; mark with solutions; redo weak sections

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10. One-page summary

1. Unit 1 AoS 1: Thinking like an economist

This Area of Study gives you the language and tools of economics. Almost every later topic uses these ideas, so learn the definitions carefully.

Microeconomics and macroeconomics

Microeconomics is the study of the decisions of individual economic agents (consumers, workers and businesses) and how individual markets work. Examples: why the price of avocados falls in summer; how a café decides what to charge for coffee.

Macroeconomics is the study of the economy as a whole, using aggregates such as total output (GDP), the unemployment rate and the inflation rate. Examples: why Australia's unemployment rate rose in 2020; how a change in the cash rate affects total spending.

A simple test: if the question is about one market or one decision-maker, it is micro; if it is about national totals or averages, it is macro.

Positive and normative economics

Positive economics consists of statements about what is, was or will be. They can be tested against evidence, even if they turn out to be wrong. Example: "An increase in the minimum wage will raise the incomes of low-paid workers who keep their jobs."

Normative economics consists of value judgements about what ought to be. They cannot be proved true or false by data. Example: "The minimum wage should be raised because inequality is unfair."

> **Exam tip:** Signal words for normative statements include "should", "ought", "fair", "too high" and "better". A positive statement can be false and still be positive, because it can be tested.

Resources and the factors of production

Resources (factors of production) are the inputs used to produce goods and services that satisfy needs and wants.

Factor	Meaning	Example	Reward (income)
Land (natural	Gifts of nature	Iron ore, farmland,	Rent

resources)		water, sunlight	
Labour	Human physical and mental effort	Nurses, electricians, teachers	Wages
Capital	Man-made goods used to produce other goods	Machinery, computers, trucks, buildings	Interest
Enterprise (often added)	Organising the other factors and taking risk	A person starting a business	Profit

Needs are things required for survival, such as food, shelter and clothing. **Wants** are things that improve our quality of life but are not essential, such as a new phone or a holiday.

The basic economic problem: relative scarcity

Relative scarcity means that resources are limited relative to the unlimited needs and wants of society. Because we cannot have everything, every individual, business and government must make choices. This is why economic decision-making is needed.

Scarcity is "relative" because even a rich society cannot satisfy all wants. Australia is wealthy, yet hospitals, housing and teachers are still limited compared with what people want.

> **Common mistake:** Scarcity is not the same as a shortage. A shortage is a temporary market situation where quantity demanded exceeds quantity supplied at a given price. Scarcity is permanent and applies to all resources.

Opportunity cost

Opportunity cost is the value of the next best alternative forgone when a choice is made. It is only the single next best alternative, not every alternative.

Applications:

- A student who works a Saturday shift earning $160 instead of studying has an opportunity cost of the study time (and possibly better marks).
- When the government spends $5 billion on a new freeway, the opportunity cost might be the hospitals it could otherwise have built.
- A business that uses its own building has an opportunity cost equal to the rent it could have earned by leasing it out.

The production possibility model

A **production possibility frontier (PPF)** shows the maximum combinations of two goods an economy can produce when all its resources are fully and efficiently used, with a given level of technology.

How to describe the diagram in words: draw "Good B (e.g. cars)" on the horizontal axis and "Good A (e.g. wheat)" on the vertical axis. The PPF is a line, usually bowed outward (concave to the origin), from the maximum of wheat on the vertical axis to the maximum of cars on the horizontal axis.

The model illustrates five ideas:

- **Scarcity:** points outside the curve cannot be reached with current resources.
- **Choice:** the economy must choose one point on or inside the curve.
- **Opportunity cost:** moving along the curve to produce more of one good means producing less of the other.
- **Efficiency:** any point on the curve uses all resources fully and efficiently.
- **Under-utilisation of resources:** a point inside the curve means some resources are unemployed or used inefficiently (for example during a recession).

The PPF shifts outward (economic growth) when the quantity or quality of resources rises, for example through population growth, more capital, better education or new technology. It shifts inward after events that destroy resources, such as a major natural disaster.

Worked example 1.1: increasing opportunity cost

The table gives the production possibilities of an economy that produces cars and wheat.

Point	Cars (thousands)	Wheat (thousand tonnes)	Wheat given up per extra 1000 cars
A	0	100	—
B	10	95	0.5
C	20	85	1.0
D	30	70	1.5
E	40	45	2.5
F	50	0	4.5

Moving from B to C: wheat falls from 95 to 85, so 10 thousand tonnes are given up for 10 thousand more cars. Opportunity cost = 10 ÷ 10 = 1 thousand tonnes of wheat per thousand cars.

Moving from E to F: wheat falls by 45 for 10 more cars, so the opportunity cost is 4.5 per

thousand cars.

The opportunity cost of cars rises as more cars are produced. This is why the PPF is bowed outward: resources are not equally suited to both goods. The first workers and land moved into car production are those least useful for farming, but eventually the best farmland and farmers must be moved too.

If instead the economy could make either 100 wheat or 50 cars and the PPF was a straight line, the opportunity cost would be constant at 100 ÷ 50 = 2 wheat per car.

> **Exam tip:** A point such as (20 cars, 60 wheat) lies inside the PPF in Worked example 1.1 because at 20 cars the economy could make 85 wheat. Say it shows under-utilised resources, and give a real cause such as unemployment.

Trade-offs and cost-benefit analysis

A **trade-off** is giving up some of one thing to get more of another. Every trade-off has an opportunity cost.

Cost-benefit analysis is a decision-making method that compares the total expected costs of an option with its total expected benefits, including the opportunity cost. A rational decision-maker chooses the option where benefits exceed costs by the largest amount.

Worked example 1.2: a household cost-benefit analysis

A household is considering a $6000 rooftop solar system expected to save $1100 a year on electricity bills for at least 10 years.

1. Payback period = 6000 ÷ 1100 ≈ 5.5 years.
2. Savings over 10 years = 1100 × 10 = $11 000.
3. Net benefit over 10 years = 11 000 − 6000 = $5000 (ignoring interest).
4. Opportunity cost: the $6000 could instead have paid down a mortgage or been saved in a bank account earning interest. A full analysis would compare the $5000 net benefit with this forgone interest and include non-financial benefits such as lower emissions.

The three basic economic questions

Because of scarcity, every society must answer:

1. **What and how much to produce?** Which goods and services, and in what quantities (e.g. more housing or more aged care).
2. **How to produce?** Which combination of resources and technology (e.g. labour-intensive or capital-intensive, renewable or coal-fired energy).
3. **For whom to produce?** How output is distributed among people (e.g. by income, by need, or equally).

Economic systems

System	Who answers the questions	Strengths	Weaknesses	Example
Market economy	Consumers and businesses through prices	Efficient, responsive, innovative	Inequality, under-provision of public goods	Closest examples: Hong Kong, Singapore
Planned (command) economy	Government planners	Can direct resources to priorities, reduces inequality	Inefficient, shortages, weak incentives	North Korea, former USSR
Mixed economy	Markets mostly, with government intervention	Balances efficiency and equity	Debate about the right size of government	Australia, UK, Canada
Traditional economy	Custom, tradition and family roles	Stable, sustainable, community-focused	Slow change, low material living standards	Some subsistence farming communities

Australia is a **mixed economy**: most resources are allocated by markets, but governments provide health, education, infrastructure and welfare, regulate businesses and collect taxes.

The three-sector circular flow model

The **circular flow model** shows how income and spending flow between sectors of the economy. The three-sector version includes households, businesses and government.

Describe the diagram in words:

- Households sell their resources (land, labour, capital, enterprise) to businesses and receive income (rent, wages, interest, profit).
- Households spend their income on goods and services, which flows back to businesses as revenue (consumption spending).
- The government collects taxes from households (e.g. income tax) and businesses (e.g. company tax). These are **leakages** (withdrawals) from the flow.
- The government spends on goods, services and welfare payments (e.g. paying public servants, building roads, paying the age pension). These are **injections** into the flow.

Flow	From	To

Factors of production	Households	Businesses
Factor incomes	Businesses	Households
Consumption spending	Households	Businesses
Taxes	Households and businesses	Government
Government spending and transfer payments	Government	Households and businesses

If injections exceed leakages, the level of economic activity rises; if leakages exceed injections, it falls.

The purpose of economic activity and living standards

Economic activity is the production, distribution and consumption of goods and services. Its purpose is to satisfy needs and wants and so raise living standards.

Living standards are the overall wellbeing of individuals and society.

- **Material living standards** are the tangible goods and services people can buy and the income they have to buy them (e.g. housing, food, cars, access to paid services). They are usually measured by real GDP per capita or real household disposable income.
- **Non-material living standards** are the intangible aspects of wellbeing that cannot easily be bought, such as health, life expectancy, leisure time, safety, political freedom, environmental quality and social connection.

The economic agents and the public and private sectors

Economic agents are the decision-makers in the economy: consumers (households), businesses (producers) and the government. Workers are households selling their labour.

The **private sector** is the part of the economy owned and run by individuals and businesses for profit or personal benefit. The **public sector** is the part owned and run by government (federal, state and local), such as public hospitals, government schools and Australia Post.

Consumers: the traditional economic viewpoint

Traditional (neoclassical) economics assumes consumers:

- act in their own **self-interest**;
- aim to **maximise utility** (the satisfaction gained from consumption);
- are **rational**, meaning they weigh costs and benefits consistently;
- make **informed decisions**, having enough information about prices and quality;
- consider **marginal benefit**: they buy one more unit only if the extra satisfaction from it is at least worth its price.

Diminishing marginal utility explains why consumers buy more at lower prices: the third slice of pizza gives less extra satisfaction than the first, so you would only pay less for it.

How consumers and workers respond to incentives

An **incentive** is a reward or benefit that encourages a behaviour; a **disincentive** discourages it.

Tool	Example (Australia)	Likely response
Tax	Tobacco excise, increased repeatedly since 2010	Some smokers quit or smoke less
Tax rebate / offset	Low-income tax offset	Encourages low-income earners to work more hours
Subsidy	Child Care Subsidy (expanded July 2023)	Parents, often mothers, increase paid work
Subsidy	Home battery rebate (Cheaper Home Batteries Program, from July 2025)	Households install batteries sooner
Regulation	National minimum wage set	Raises pay for low-paid

End of free sample

This is 10 of 61 pages.

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