

The Basic Economic Problem

Economics

Economics is the social science that describes the factors that determine the production, distribution and consumption of goods and services.

Or

Economics is the study of how we choose to use limited resources to obtain the maximum satisfaction of unlimited human wants

What Is Economics?

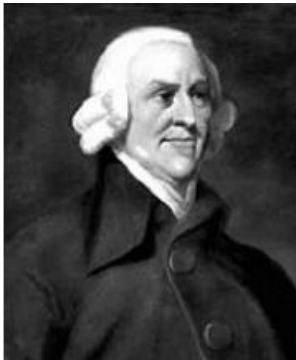
Economics is a social science concerned with the production, distribution, and consumption of goods and services. It studies how individuals, businesses, governments, and nations make choices on allocating resources to satisfy their wants and needs, trying to determine how these groups should organize and coordinate efforts to achieve maximum output.

Economics is a social science devoted to the study of how people and societies get what they need and want. Economics is the study of how societies divide and use their resources to produce goods and services and of how those goods and services are then distributed and consumed.

Resources are the basic ingredients that are needed to produce the goods and services that people buy. These ingredients can be physical things such as land and factory equipment, and they can be intangible things such as the intellectual and emotional capacities of people, whose work is necessary for the production of goods and services. Whether a society is rich or poor, large or small, resources are, from the viewpoint of economics, scarce. This means that almost everyone in every country would like more goods and services than can ever be produced. Given a limited supply of resources and an unlimited desire on the part of individual consumers and nations, choices must be made about what goods and services to produce, how to produce them, and for whom.

Defined of Economics

Definition of Wealth – Adam Smith (1776)



“Economics is the science of wealth”

“An inquiry into the nature and causes of the wealth of nations.”

He is also known as the ‘father of economics.’

According to this definition, economics is a science of the study of wealth only.

It deals with production, distribution, and consumption.

This wealth-centred definition deals with the causes behind the creation of wealth.

Finite Resources

All countries have resources (inputs available for the production of goods and services.) such as water, minerals, soil, plants, animals and people. However, in any country there is a finite quantity of these resources this means that the quantity available is limited. Because there is only a limited quantity, economists say that resources are scarce.

On the other hand, we have limited resources to produce these goods and services we want. Everything on this planet has some limits except for our Wants. When unlimited wants meet limited resources, it is known as Scarcity (a situation in which wants and needs are in excess of the resources available.)

Finite resources and unlimited wants

What stops people enjoying all the products they would like to have is a lack of resources to produce them. Resources, including workers and machinery, are scarce. This means that they are limited in supply. The economic problem of not being able to satisfy everyone's wants arises because of this scarcity.

There is no limit to people's wants they are infinite. For instance, people want more and better clothing, healthcare and improved transport infrastructure. The number of workers, machines, of ices, factories, raw materials and land used to produce these goods and services, however, is finite. At any given time, for example, there are only a limited number of workers and they can produce only a specified amount. This mismatch, between what people want and the maximum that can be produced, gives rise to the economic problem. Choices have to be made about how resources are to be used.

The economic problem in different contexts

The fact that people have to choose which products to buy, which subjects to study, what jobs to do and which products to produce shows that there are insufficient resources.

- As consumers,

We cannot have everything we want. We have limited incomes. Students have to select which courses to study. It is not possible to study economics and chemistry at the same time.

- Workers

Have to make choices about what jobs they do. Some teachers may carry out other work in the evening, but when they are teaching they are not working as writers! Time is in limited supply.

- Producers

Have to decide what to make. Farmers cannot grow rice and wheat on the same land. They have to select one crop as land is scarce.

- The government

Has to decide how to spend tax Revenue. Deciding to build a new hospital may mean that it cannot build a new school.



Definition of Needs

Something essential to survival (Money, Shelter, Foods...)

By the term needs, we mean those requirements which are extremely necessary for a human being to live a healthy life.

Definition of Wants

Something you would like to have, but is not essential to survival

In economics, wants are defined as something that a person would like to possess, either immediately or at a later time. Wants are the desires that cause business activities to produce such products and services that are demanded by the economy.

Definition of Scarcity

Scarcity refers to resources being finite and limited. Scarcity means we have to decide how and what to produce from these limited resources. It means there is a constant opportunity cost involved in making economic decisions. Scarcity is one of the fundamental issues in economics.

Scarcity

A lack of something (in this context, resources). The fundamental economic problem is that there is a scarcity of resources to satisfy all human wants and needs. There are finite resources and unlimited wants. This is applicable to consumers, producers, workers and the government, in how they manage their resources.

Infinite Wants

People have a limited number of needs, which must be satisfied if they are to survive as humans. Some are material needs, such as food, water, heat, shelter and clothing. Others are psychological and emotional needs, such as self-respect and being loved. People's needs are finite. However, no one would choose to live at the level of basic human needs if they could enjoy a higher standard of living.

Alternative Uses

All the resources we have on this planet can be utilized in a number of ways. They have alternative uses. For example, a piece of land can be used for making a factory, or doing farming or constructing a school and so on. Therefore, we have to choose what is best for us. If we talk from an economist point of view it means 'making the optimum use of resource available'.

Opportunity Cost

Though we have alternative uses, we have to select the best way to use these resources. When we choose best alternative, the next best alternative which is left out is known as the Opportunity cost of making a choice. In other words, the benefits we lost and could have achieved from the next best alternative.

Definition

Opportunity cost the cost of any activity measured in terms of the value of the next best alternative forgone (that is not chosen).

Opportunity Cost in Decision Making

Influence of opportunity cost on decision making

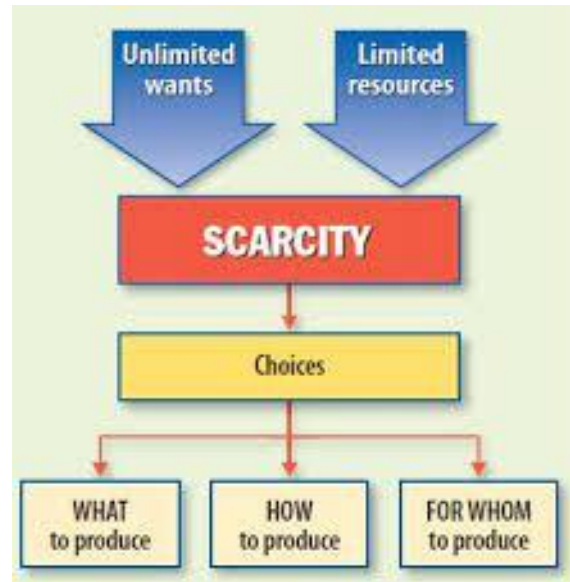
Opportunity cost is the loss of the next best alternative when making a decision. Due to the problem of scarcity, choices have to be made about how to best allocate limited resources amongst competing wants and needs.

There is an opportunity cost in the allocation of resources

- 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)
- When a producer decides to allocate all of their resources to producing electric vehicles, they may be unable to produce petrol vehicles. The petrol vehicles represent the loss of the next best alternative (the opportunity cost)

- When a government decides to provide free school meals to all primary students in the country, they may be unable to fund some rural libraries which may have to close. The libraries represent the loss of the next best alternative (the opportunity cost)

Basic Economic Problem



- The fundamental economic problem is the issue of scarcity and how best to produce and distribute these scarce resources.
- Scarcity means there is a finite supply of goods and raw materials.
- Finite resources mean they are limited and can run out.
- Unlimited wants mean that there is no end to the quantity of goods and services people would like to consume.
- Because of unlimited wants – People would like to consume more than it is possible to produce (scarcity)

Therefore because of scarcity, economics is concerned with:

- What to produce?
Societies have to decide the best combination of goods and services to meet their varied wants and needs. Societies must decide what quantities of different resources should be allocated to these goods and services.
- How to produce?
Societies also have to decide the best combination of factors to create the desired output of goods and services. For example, precisely how much land, labour, and capital should be used to produce consumer goods such as computers and motor cars?
- For whom?
Finally, all societies need to decide who will benefit from the output from its economic activity, and how much they will get. This is often called the problem of distribution. Different societies may develop different ways to answer these questions.

Production Possibility Curve

Production Possibility Boundary/Production Possibility Frontier.

A production possibility frontier (PPF) shows the maximum possible output combinations of two goods or services an economy can achieve when all resources are fully and efficiently employed.

Or

Production Possibility Curve it shows the maximum output of two types of products, and combinations of those products that can be produced with the existing quantity and quality of resources and technology.

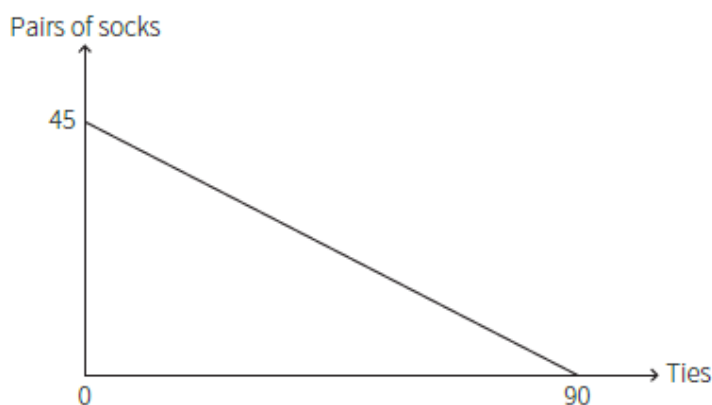
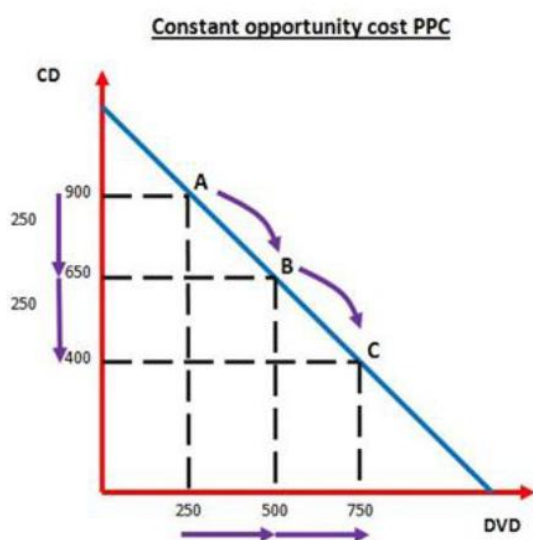
The basic assumptions of production possibility curve are

- According to the production possibility curve, the economy is assumed to have only two goods which represent the entire market.
- The supply of resources to the economy is assumed to be fixed or stay constant.
- The technology or the techniques of production are assumed to be constant.
- The production possibility curve assumes that all the resources are used efficiently and fully. But in reality, these are not used or utilized entirely.

Straight-Line

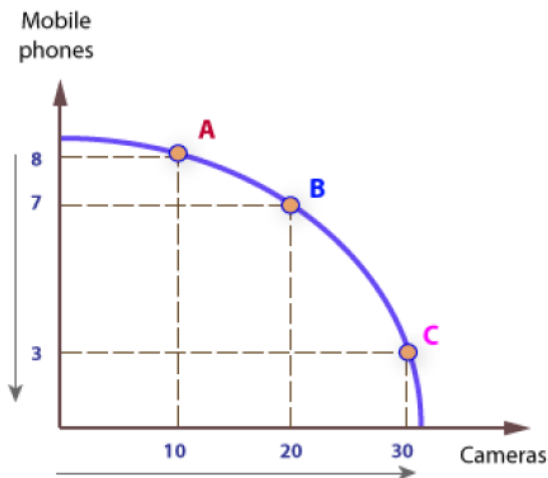
If opportunity costs are constant, a straight-line (linear) PPF is produced. This case reflects a situation where resources are not specialized and can be substituted for each other with no added cost. Products requiring similar resources (bread and pastry, for instance) will have an almost straight PPF, hence almost constant opportunity costs.

In the less common situation where resources are equally suited to producing both types of products, the opportunity cost remains constant. In this case, the PPC is shown as a straight line



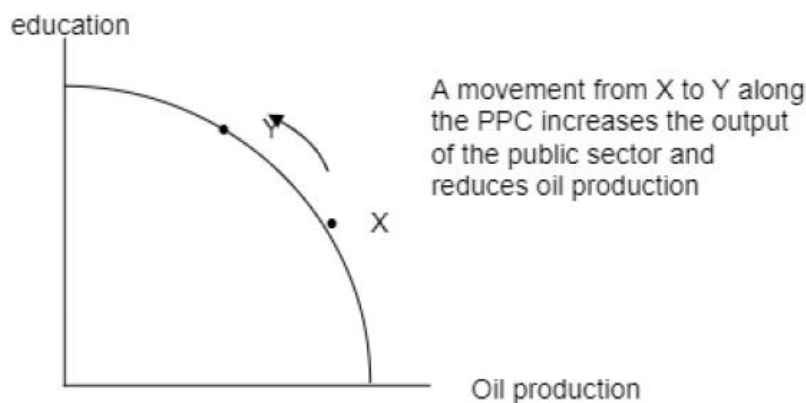
Increasing Opportunity Cost

Opportunity cost can be thought of in terms of how decisions to increase the production of an extra, marginal, unit of one good leads to a decrease in the production of another good. According to economic theory, successive increases in the production of one good will lead to an increasing sacrifice in terms of a reduction in the other good.



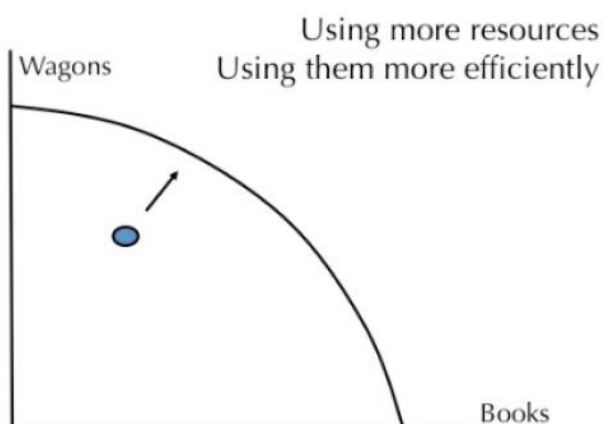
Moving Along the Production Possibilities Curve

Movement along the PPC occurs when there is a change in the combination of goods and services produced. In a market economy, consumers signal to producers the types of goods and services they require, desire and are willing to pay for.



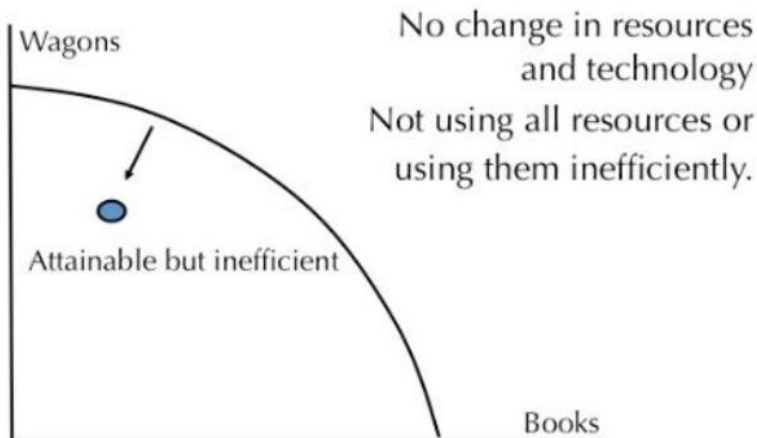
Moving Toward the Production Possibilities Curve

Conversely, if more unused resources are used or the resources are used more efficiently (not due to a change in technology), the society would move toward the PPC.



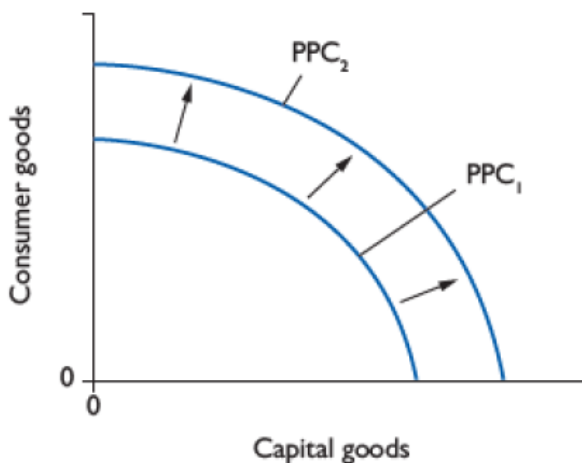
Movements Away from the Production Possibilities Curve

If the resources or technology of a society change, the PPC will shift in or out. However, the PPC does not shift when resources are left unused or when they are not used efficiently. In this latter case, production would simply be illustrated by a point inside the PPC, i.e. society would be moving away from the PPC to an interior point.



Shifts of the Production Possibilities Curve

At a particular point in time, a country cannot produce combinations of goods that lie to the right of the PPC. However, over a long period of time, an economy would expect to raise the production of all goods. This is called economic growth.



There are several reasons for this,

- **New technology**

As time passes, new technology is developed and this benefits businesses.

For example, new machines such as robots, computers, telecommunications and the internet have been used by businesses to help increase productive potential. New technology is usually faster and more reliable in production and therefore more output can be produced.

- **Improved efficiency**

Over time, resources are used more efficiently.

For example, new production methods, such as kaizen and lean production have been developed and adopted. These more efficient methods replace the old ones and more output can be produced with fewer resources.

- **Education and training**

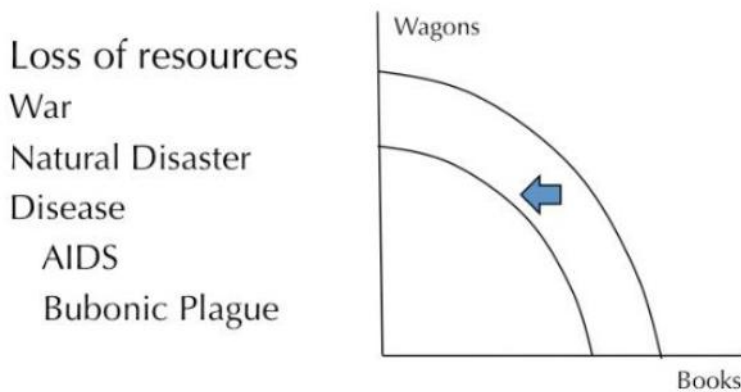
An economy can boost the productive potential of a nation by educating and training the population. A country's economy becomes more productive as the proportion of educated workers increases. This is because educated workers can carry out tasks that require literacy, analysis, evaluation, communication and critical thinking more efficiently.

- **New resources**

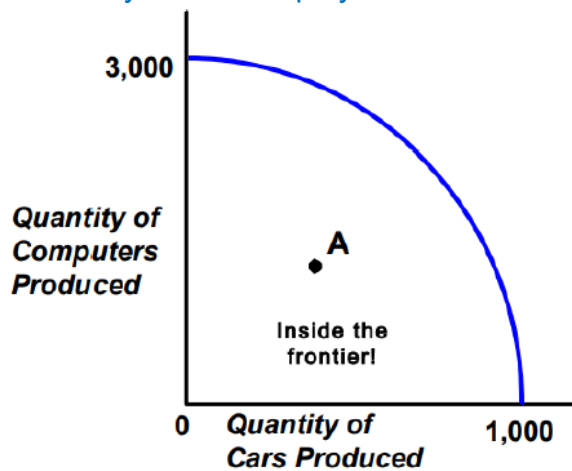
Some countries find new resources which enable them to produce more.

Inward Shift of the Production Possibilities Curve

If a society loses resources, the production possibilities curve would shift in. The loss of resources may come about from war, natural disasters, such as earthquakes or hurricanes, or disease, such as AIDS.



Inefficiency and Unemployment of the Production Possibilities Curve



Biased Technologies of the Production Possibilities Curve

Biased technologies only impact the production of one good. For example, the printing press allowed for more books to be produced, but didn't increase the number of wagons (if all resources were devoted to wagon production). When both goods are being produced, a biased technology reduces the number of resources being required to produce that good, so more of the resources can be devoted to producing the other good.

