

Basic Problems and Solutions to Basic Problems

Elementary Economy

Main function or the Central task of an Economy?

Scarcity of economic resources

Three main economic problems are in the three questions of What? How? Whom? : (1) What to produce? (2) How to produce? (3) For whom to produce? -

Manner of allocation of these limited resources

Basic Problem is that Resources are limited and wants are unlimited . How to satisfy unlimited wants with limited resources ?

Maximising the satisfaction of unlimited human wants

Production and distribution , as main economic activities , for maximizing satisfaction of wants of conflicting interest groups. Generally, economy caters to interest of its controlling class.

Problem (1) What to Produce?

Satisfaction of human wants needs consumption of commodities. in the form of goods and services . These have to be produced before they can be consumed

What commodities are to be produced?
In how much quantity?

What technology is to be used ?

Resources for Production, are limited. The quantity of each goods needs to be decided first. Therefore, 'How much to produce of what goods and services?' Next, How to produce these? Which technology or technique is to be used to reduce costs of production?

Goods and Services ?

Production and distribution costs?

Different countries have different resources and can produce certain goods at lower costs of production? Solutions can be found with :

Resources available?
Raw material for Input , skilled labour and other costs?

Level of skill available.
Technology to be used for the quantity determined?

Problem (2) For whom to produce?

Target consumers

- Deciding the manner in which the produced commodities are to be used.
- How are they to be distributed as the problem of 'For whom' is linked to distribution

Solution through market mechanism

- Price mechanism determined through supply and demand balance This can determine not only kind of commodities produced, but also the prices of all factors of production
- Social customary needs also determine the goods and their prices

Equity

- Equity means equal opportunity to consumption of the minimum necessities of life, by all strata of society for leading a healthy and socially acceptable life. Example : Food and drinking water, health and sanitation, facilities for education.
- It does not mean equal consumption.

Production Possibility Curve (PPC) as a solution to the three economic problems

Can also be used to estimate the future trends of input and output ratio of production

The curve indicates the goods and resources on 'x' axis and technology available on the 'Y' axis

Improvement in quality and quantity through increase of higher resources is also found through the PPC

The different combinations possible lie in the positive quadrant

The curve can be used for finding the efficient use of available resources

Two additional problems of (d) efficient use of resources and (e) rate of economic growth

Efficient use of resources mean

Avoiding wastage of resources in production

Avoiding wastage of consumption

Efficiency in production

At any given amount of resource input, the output must be optimal or maximum

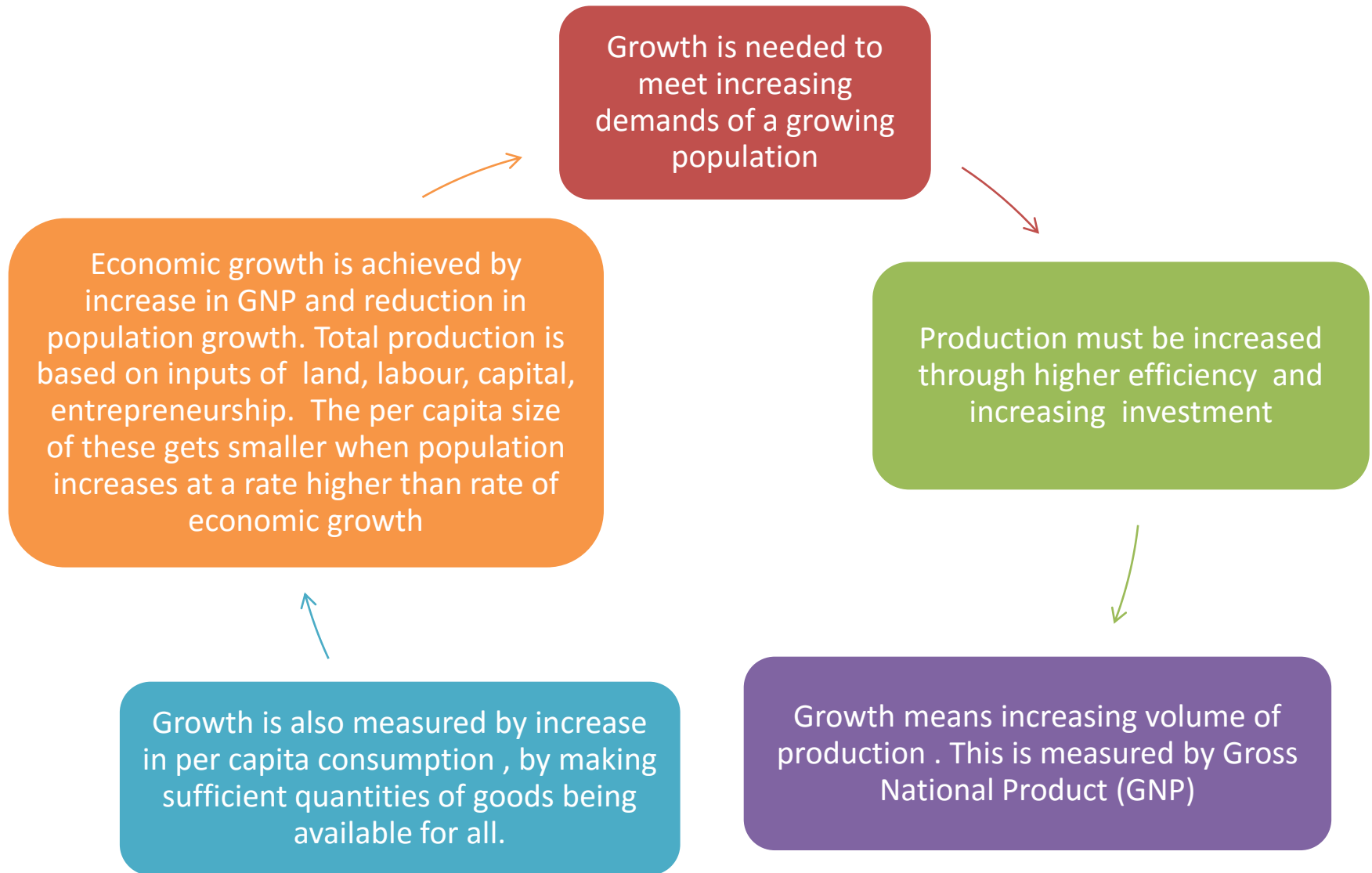
Avoiding high wastage in production, gives minimum costs and maximum production

Efficiency of consumption

Efficiency of consumption through equity and fair distribution

Pattern of individual consumption must maximize satisfaction

Problem of determining (e) rate of economic growth



Stages of Economic Growth

(1) Traditional society and (2) Pre-take off stage

- Production based on traditional methods is barely sufficient for consumption
- There is no surplus for marketing to others

(3) Self sustaining growth and (4) drive to maturity stage

- Social and Economic Infrastructure is built by government, and surplus accumulated in the form of saving by individuals
- Modern technology is adopted for production

(5) High mass consumption stage

- Per capital consumption of commodities is very high and it sustains high demand in the market for all goods and services
- USA, Japan, Norway, Sweden , Denmark (+50)

Difference between Economic Growth and Economic Development

Economic growth indicates increase in GNP and quantitative increase in consumption

- A country may be growing but it may not be developed

Economic Development indicates qualitative improvement in the standard of living of all sections of society, and includes economic growth

- Please refer to comparative chart on page 48 of your book

Ch 5. Solutions to Basic Problems

Price mechanism is the system in which market prices act as signals of coordinated action of all decision making units in the economy. It synchronises the economic behaviour of consumers and producers .

Price Mechanism in markets

Free market economy exists where there is no interference in the market by the Government.

Others have controlled market prices.

Prices are determined as per 'equilibrium prices'. Its functions include (a) determine the factor prices for capital, labour and land (b) they determine the aggregate production. (c) Production quantity determines sales revenue

(d) Commodity market prices determine the quantity of each good being produced. (e) Helps in efficient allocation of resources across the economy

Price Mechanism in a free market

(a) Price and income determine consumption.

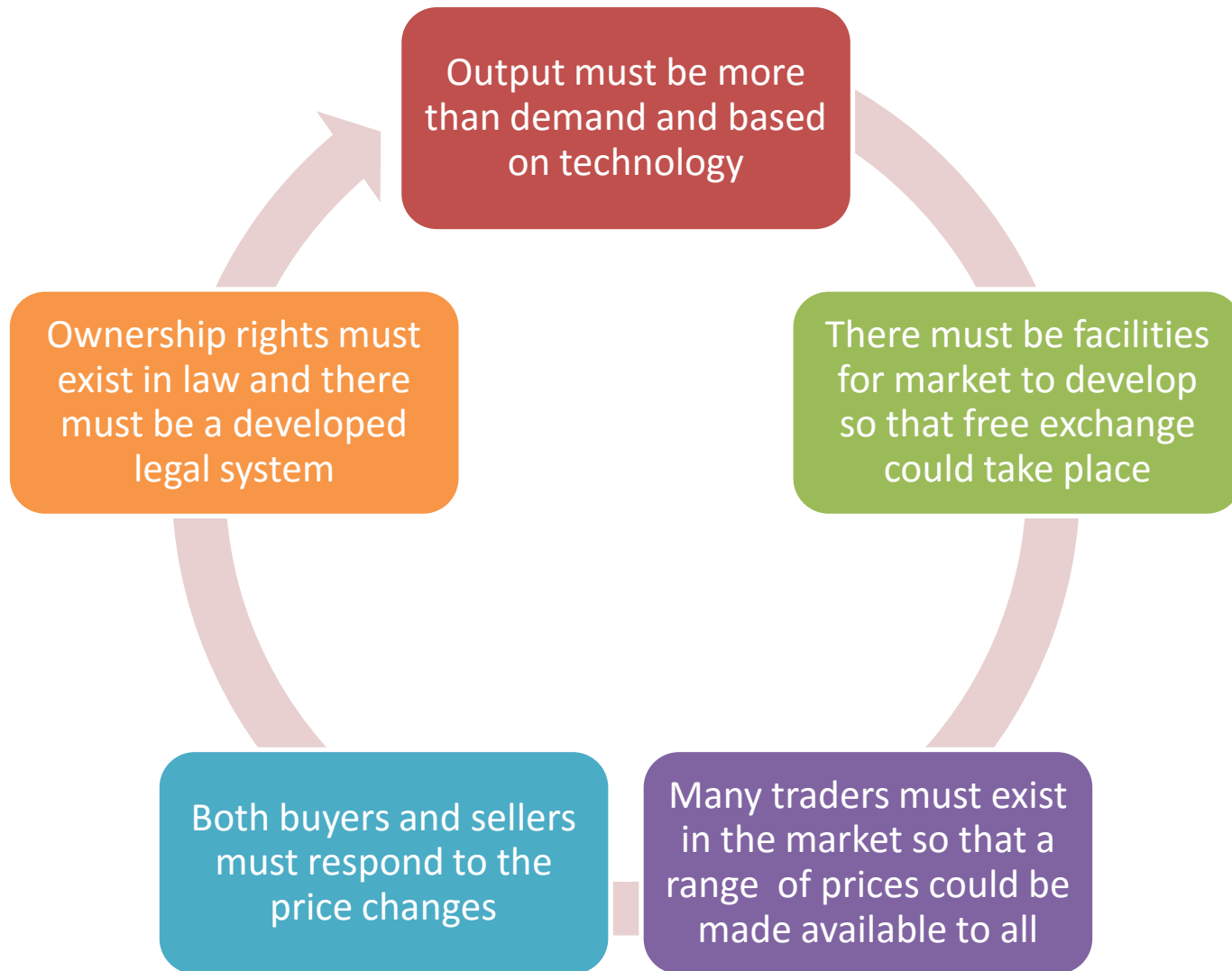
(b) Market prices and optimal profits determine production as a bundle of commodities

(c) Resource allocation is part of the price mechanism. Prices are revised to establish a balance between demand and supply. It also determines resources for different goods

Price mechanism in a controlled economy

Government fixes the minimum price of a few essential commodities.

Conditions for free price mechanism



Advantages of Price Mechanism as a system of resource allocation

Is self enforcing

- When demand exceeds supply prices rise, and when supply is in excess, prices fall
- Government does not need to intervene

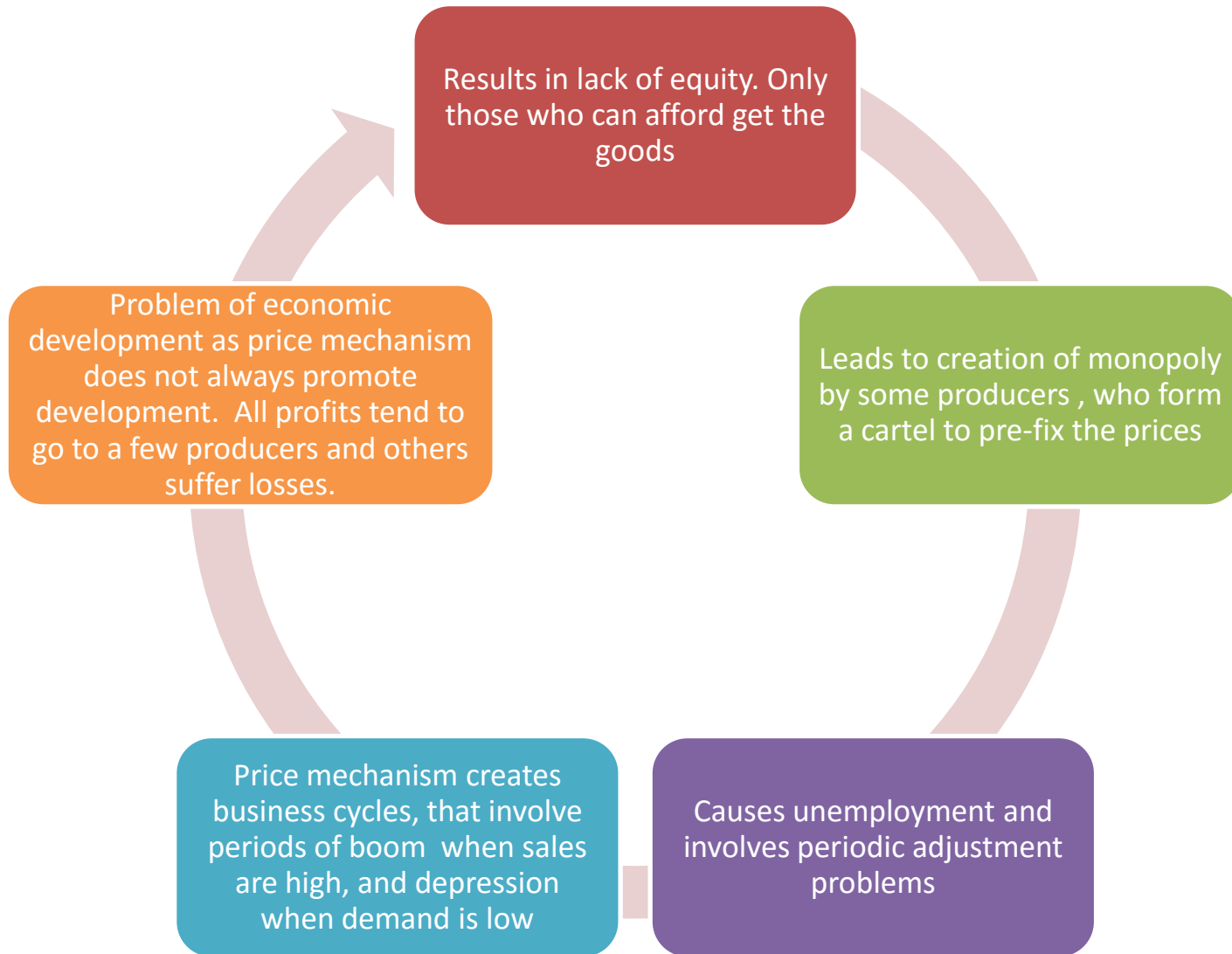
Is inexpensive

- The Government does not incur any expenditure on determining or enforcing the price mechanism
- In Government determined price system Government has to monitor to ensure that its policy is implemented.

It preserves individual freedom to decide to produce and consume

- Citizens' freedom to take economic decisions is ensured
- In other systems , this freedom is often controlled by government decisions on prices.

Limitations of Price Mechanism



Thank You

