



Higher Economics

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Unit 1 Topic 1

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Topic 1 – The Basic Economic Problem

Scarcity, Choice and Opportunity Cost

The basic economic problem is that of scarcity. In economics this means that the resources required to produce all the commodities people want are limited, however our wants as consumers are unlimited. We therefore have to make decisions about how to allocate resources i.e. a choice has to be made. By allocating resources in one way we are sacrificing their use in another way. This is known as opportunity cost i.e. the sacrifice of the next best alternative.

Opportunity cost can refer to three groups of people:

- individuals e.g. you could buy either a shirt or a pair of jeans, if you buy the shirt then the pair of jeans is the opportunity cost
- firms e.g. by hiring new staff the firm may go without new machinery, the new machinery is therefore the opportunity cost
- government e.g. the government could build a new school or a new hospital, by building the new school they forego production of the new hospital, therefore the hospital is the opportunity cost

Goods which have an opportunity cost are known as *scarce* goods or *economic* goods. Most goods that we think of are examples of scarce goods, however some goods are plentiful in supply and there is enough to satisfy the wants of everyone. These are known as *free* goods e.g. air, sea water.

Scarcity is said to be relative as there will never be enough goods and services produced to satisfy all the wants for certain commodities. No country in the world has enough resources to produce enough goods and services to satisfy all the wants of its people; scarcity is therefore universal.

Unlimited Wants

The basic economic problem states that “*our wants as consumers are unlimited*”. There are several reasons for this:

- our wants are constantly changing; once we get one thing we will immediately want another – this is human nature
- effective advertising campaigns create increased demand for commodities
- people want what others have so they don’t feel left out
- goods eventually wear out and need replaced
- continuous development of new products means new wants are always being created

Scarcity and Shortages

It is easy to confuse a scarcity with a shortage. In economic terms scarcity and a shortage are very different:

- scarcity is when there are insufficient resources to supply consumers with what they want
- a shortage arises when the demand for a product outstrips the supply for it

Resources

The problem of scarcity is partly based around the fact that “*the resources required to produce all the commodities people want are limited*”. This is a very broad statement and can be broken down into the three ‘factors of production’ known as land, labour and capital:

- land is all the gifts of nature that are useful to people e.g. minerals, water, forests
- labour is any human effort used in the production of goods and services e.g. teachers, hairdressers, doctors
- capital is any man-made aid to production e.g. computers, factories, machinery

Resources take a long time to create and they have alternative uses, this is why resources are said to be limited.

There is a fourth factor of production known as *enterprise*. This involves a person known as an entrepreneur who brings together the other three factors of production and takes the risks and uncertainty associated with using these resources within a business.

Mobility of Resources

The mobility of resources is the ease with which resources can move from one place to another (i.e. geographical mobility) and the ease with which resources can be put to different uses (i.e. occupational mobility).

- land cannot be moved from one place to another and is therefore geographically immobile; it can be put to several different uses so is occupationally mobile
- labour may be geographically immobile depending on factors such as family ties, cost of living in different areas; the degree of occupational mobility varies depending on how easily it is for a worker to train to do different jobs
- capital is likely to be geographically immobile as it is often heavy and large in size; it is likely to be highly specialised for a particular purpose and not able to be adapted into other uses and is therefore occupationally immobile

Mobility of resources is normally concerned with labour and methods used to increase their mobility. Measures to increase the geographical mobility of labour include the payment of relocation expenses, national advertising of vacancies, paying people subsidies to move into and work in certain areas and improving transport infrastructure. Occupational mobility of labour can be improved by increasing education and training meaning workers can gain the necessary skills for different jobs.

More on Choices

Since all economies experience problems of economic scarcity there need to be methods of addressing the three basic economic problems of:

- what to produce;
- how to produce;
- for whom to produce?

The method used to address these problems is an *economic system*. The three economic systems are; the planned economy, the market economy and the mixed economy.

The Planned (or Command) Economy

All resources are allocated by the government. Planners are employed to decide exactly how the economy will use their scarce resources. This type of economy answers the three basic economic problems as follows:

- what to produce? – the government decide what the people of their country need and produce a fixed amount of each of the good or service they decide on
- how to produce? – the government decides on the amount of resources used and methods used to produce a good or service
- for whom to produce? – the government produces an equal amount of goods and services for everyone in the economy

This type of economic system has several advantages:

- everyone has the same basic standard of living as goods and services are priced so that everyone can afford them
- non profitable goods can be provided by the government that will benefit everyone e.g. street lighting, pavements
- government can take control of production to prevent pollution, although fulfilling production plans tends to take priority

There are also several drawbacks of this type of economic system:

- what the government decided to produce is not necessarily what the people of the economy want
- governments can easily price goods wrongly leading to shortages and surpluses of products
- producing goods and services when profits go to the government means there is little incentive to produce high quality products and there is often inefficiency in producing goods and services
- it is extremely bureaucratic, forms must be filled in about production now and in the future, this can lead to poor organisation and wasted labour – these people could be employed to produce goods and services that people actually want
- working to a target level of production leads to rushed production and poor quality

The Market Economy

In a market economy resources are owned by private individuals and producers can produce whatever they like. This type of economy answers the three basic economic problems as follows:

- what to produce? – decided by consumers as they are willing to pay for them
- how to produce? – decided by producers to keep down costs and make the greatest profit
- for whom to produce? – decided by the level of income of consumers and their ability to pay for goods and services

More often, the allocation of resources in this type of economy is done by using the *price mechanism*. The price mechanism works as follows:

- producers are motivated by profit maximisation and will therefore supply more at a higher price
- consumers aim to maximise their satisfaction so they buy the goods that give them the greatest value for money
- consumer sovereignty exists which means the freedom of the consumer to choose what to buy dictates how resources are allocated
- when consumers demand more of a product demand increases and prices rise
- quantity supplied rises as it is now more profitable for the producer
- increased output leads to greater profits; new firms may enter the industry to move resources into production of more popular, and therefore more profitable, goods
- conversely, when demand falls prices fall and producers supply less as less profit will be made
- resources are moved out of production of that product and are used to produce more profitable goods

This type of economic system has several advantages:

- resources are used to produce those goods and services consumers want
- the price mechanism ensures production is set to ensure there are no shortages or surpluses
- there is a financial incentive to be productive and efficient, goods are therefore of greater quality
- there is no need for government planners and officials

There are also several drawbacks of this type of economic system:

- producers will not produce products that are not profitable to do so, therefore basic facilities such as street lighting may not be provided
- poor people are likely to lose out as goods and services will be given to the rich who will be willing to pay more for them
- social effects such as pollution may be ignored in the interest of profit
- dangerous goods such as drugs may be supplied in the interest of profit

The Mixed Economy

In this type of economic system there are elements of both the planned and market economic systems. Government planning is combined with the use of the free market to try and solve the basic economic problems. There is both a public and a private sector in this economic system:

- the public sector involves industries owned and controlled by the government
- the private sector involves private individuals who own scarce resources with the aim of making as high a profit as possible

The reasons for having a mixed economy are:

- to reduce unemployment as the government can provide schemes to create jobs for people
- to provide public goods which are financed through taxation e.g. street lighting, pavements, defence; these are goods no private firm would be willing to pay for as they are unprofitable
- to provide merit goods which everyone needs but could not possibly be adequately provided by a private firm e.g. education, health care
- to prevent dangerous goods being supplied
- to prevent pollution
- to provide a fair standard of living for all whilst still allowing the rich the opportunity to buy luxuries

This economic system attempts to use the advantages of the planned and the market economic systems together.

Economic Efficiency

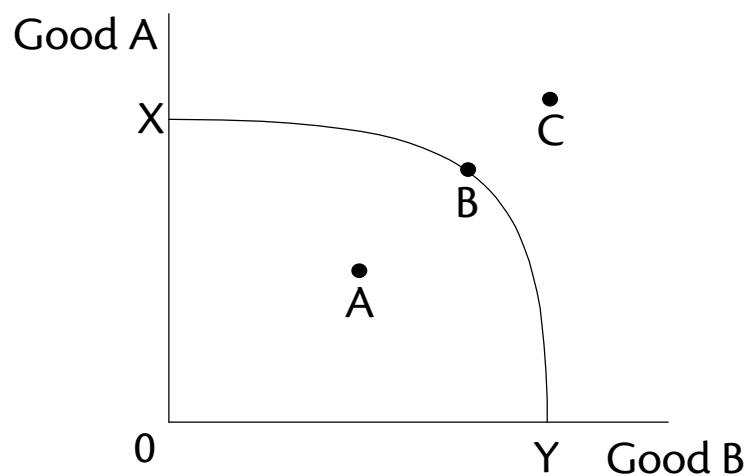
By making the best use of the resources that are available, there is said to be economic efficiency. Resources will be used to produce those commodities consumers want to buy to satisfy as many wants as possible. To be economically efficient, technical efficiency must also be achieved. This is when a given quantity of output is produced using the least number of inputs possible i.e. at lowest costs.

Equity

This is concerned with the fairness of the allocation of resources within an economy. Most economies have a very unfair allocation of resources where there are a handful of extremely rich people, whilst the majority are relatively poor.

Production Possibility Curves (PPCs)

A production possibility curve shows the maximum possible combination of two commodities that can be produced given existing levels of resources.



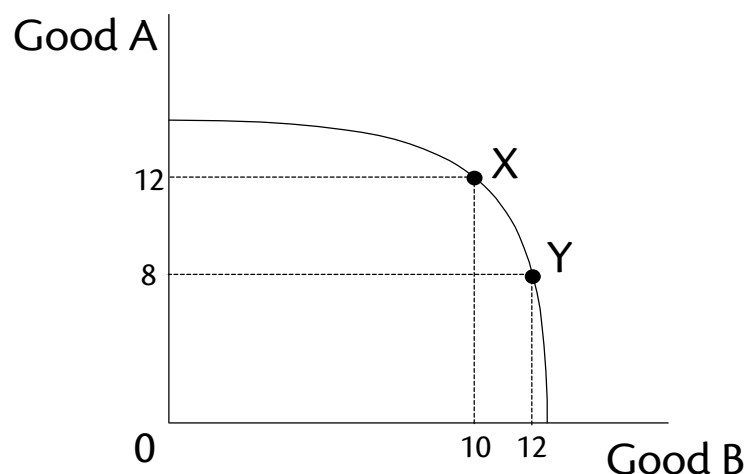
If an economy is producing at a point inside the curve (point A) then resources are not being used efficiently; more of one good could be produced without foregoing production in another.

If an economy is producing at a point on the curve (point B) then all resources are being used efficiently; no more of one good could be produced without foregoing production in another.

It would not be possible for an economy to produce on a point beyond the curve (point C) as there are not enough resources available. Only through economic growth (an increase in a country's productive capacity) can point C be reached. See section on economic growth later.

Production Possibility Curves and Opportunity Cost

Production possibility curves can be used to diagrammatically show opportunity cost. Since we only have limited resources, if we operate at capacity, we cannot increase production in one good without foregoing production in another.

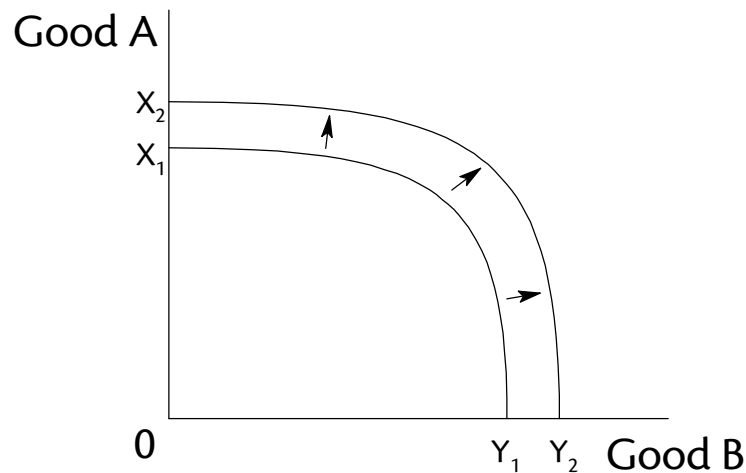


In the above production possibility curve, if an economy re-allocates resources from X to Y, it will gain 2 units of good B but sacrifice 4 units of good A. The opportunity cost of 2 units of good B is 4 units of good A.

The production possibility curve normally curves outwards from the origin because as more of a good is produced, the greater the opportunity cost will be of producing one other. This is because resources are not perfectly mobile between uses.

Production Possibility Curves and Economic Growth

When a country experiences economic growth the production possibility curve will shift outwards.



The production possibility curve shifts outwards like this when a country has increased its ability to produce goods and services. This could be because of:

- discovery of new raw materials e.g. oil
- advancements in technology meaning increased productivity
- increased training meaning increased efficiency and productivity
- research and development to stimulate technical progress

Economic growth is caused by improvements in the quantity and quality of a country's resources. This is discussed in more depth in *The Economy* unit.