

Basic Economic Problems

What is meant by the term economics?

Different economists define economics in their own way. According to Adam Smith economics is a science of wealth. Economics is essentially a study of the ways in which humankind provides for its material wellbeing. According to Robins, “it is a study of human behaviour as a relationship between ends and scarce resources which have alternative uses”. So we can define economics is a science which deals with limited resources which have alternative uses and unlimited wants which might have different preferences for the betterment of mankind.

Micro and macro economics

Micro economics is the study of individual market. It deals with the problems of a consumer, firm, industry and a region.

Macro economics is the study of the whole economy. It deals with the problems of unemployment inflation, economic growth, balance of payment and exchange rate.

Needs and wants.

Needs are necessities of life without which one cannot survive. These are food, clothing, shelter, medical care and education. Wants are above than the necessities which include all comforts and luxuries of life. For instance basic food is a necessity where as eating at a five star restaurant might be comfort or luxury.

When does economic problem arise?

Economic problem arises at that point where economic resources are less than the wants. We call it **scarcity**, if there is no scarcity there is no economic problem. For instance if a person has \$10 and can meet all of his wants within \$9, there is no scarcity, but on the other hand a consumer has \$100 and he needs \$102 to meet all of his wants, there is scarcity. Hence scarcity is a relative concept, which does vary with the situation.

Economic problems can be sorted out by making a right **choice**. First of all wants are arrayed and then fulfill them according to preferences. Therefore choice is inevitable in case of scarcity.

Opportunity Cost

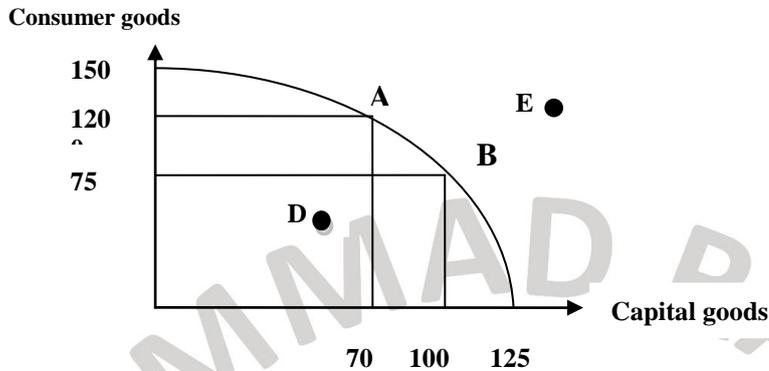
It is the true cost which is paid in an economic activity. It is the cost in terms of best alternative forgone. This cost is paid by all economic agents e.g. a consumer, firm or even state. For instance, a consumer has \$20 and he can buy a shirt or a book. If he buys the book shirt will be the opportunity cost. Similarly a firm has resources to produce good A or good B, if it produces good A good B will be the opportunity cost. Even state has limited resources therefore, government has to forgo some projects if it starts some.

Production possibility curve (PPC/PPF).

PPC shows different combinations of two different goods which can be produced by an economy by using all of its resources in the best possible ways under the given circumstances.

PPC is drawn under the following assumptions

- a) Economy produces just two goods
- b) Resources are given, that is , no change in economic resources
- c) There are no technological changes
- d) Resources are fully employed
- e) Average cost of production is minimum in all over the economy



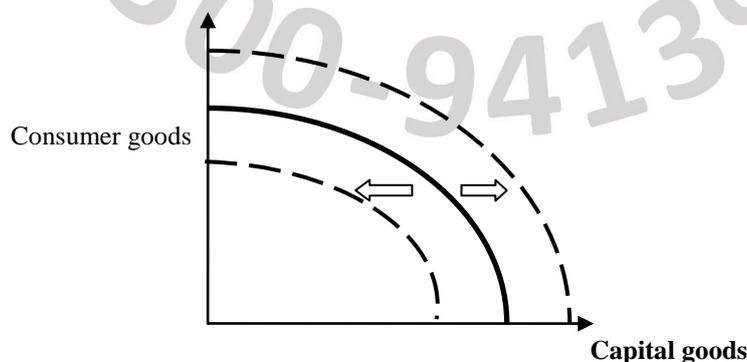
In the above diagram, at point A economy is producing 120 units of consumer goods and 70 units of capital goods. If it opts to produce at point B, it can produce 75 units of consumer goods and 100 units of capital goods. It could be seen that opportunity cost of producing 30 additional units of capital goods is 45 units of consumer goods.

Performance of an economy can also be explained with PPC. For example in the above diagram if economy produces either at point 'A' or 'B', there is an efficient use of resources i.e. economy is producing at its potential. However, point 'D' determines inefficient or underemployment of resources i.e. economy is not producing at its potential. Whereas, in the fig. point 'E' is unattainable under given conditions.

Another important concept which can be driven, if economy is producing at 'A', it produces more of consumer goods and less of capital goods, therefore, there is a possibility of inward shift in the PPC because of depletion of resources. However, at point 'B' more capital goods are produced, which are produced for the sake of further production, so, there is a possibility of outwards shift in PPC.

Shifts in PPC

There is a complete rightwards shift in PPC if there is an increase in the quantity and quality of natural resources or increase in the quality and quantity of capital or improvement in health, education, motivation and skill of the labour force or due to research and development and even international specialization or trade shift PPC outward. In the above diagram point 'E' is attainable if PPC shifts outwards.



PPC may shift inwards if there is depletion in resources or the economy faces some natural calamities, wars and even civil war etc.

PPC may have pivotal shift like the following, if economy finds out better techniques of production to produce capital goods only, it will have an outwards pivotal shift, similarly, if there is a depletion of resources or due to any other negative reason(s) for the product, leftwards pivotal shift in PPC.

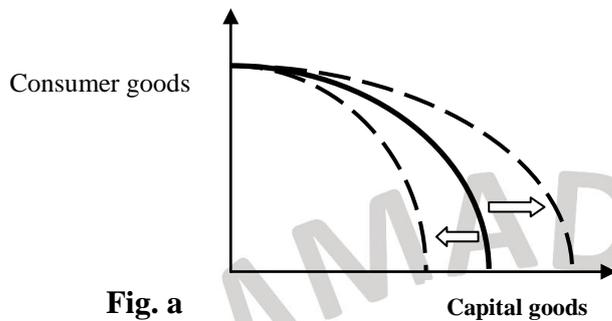
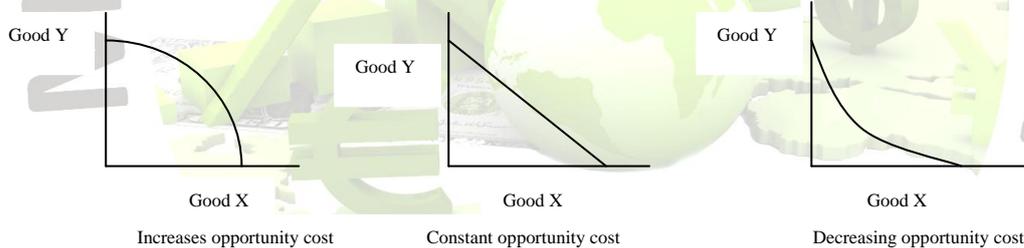


Fig. a

Shapes of Production possibility Curve

PPC shapes depend upon the opportunity cost (rate of transformation) and opportunity cost depends upon the gradient of the curve. If gradient increases opportunity cost increases and the shape of the PPC will be concave i.e. outwards bending. If gradient is constant, PPC will have a linear curve which means opportunity cost is constant and if the gradient decreases, opportunity cost will be decreased and the shape of the curve will be convexes that is bending toward origin.



Positive economics

It is the study of economic propositions which can be verified, at least in principle, by the observation of real world events, and without using normative propositions or value judgments. For example Pakistan is an over populated country or UK is a developing economy. Above mentioned statements can be proved false or true by the observation of real world events. For instance, first statement is true whereas second statement is wrong, which can be proved easily.

Normative economics

It deals with subjective opinions. It tells us something about peoples' view about the world, rather than the world itself; they are about values, attitudes and tastes. These statements are usually debatable, hence cannot be proven true or false. It involves value judgment. Usually, such statements have words like 'ought' or 'should be'. For example, inflation is more harmful than unemployment or government should concentrate more on the control of inflation than the unemployment.

Factors of production

Land

It includes all natural resources which are the part of a production process. Sea, forests, mines, rain, sunlight are examples of land. Land is also considered as natural resources. Some of these resources are renewable, which means can be re produced. Some of the natural resources are non renewable for example oil, natural gas. According to economists supply of land is strictly limited; however, it applies to the total supply of land in the world, although reclamation and other techniques can be used to increase surface area of land. Reward for land is rent

Labour

It is an important part of human resources. It includes all human mental and physical efforts which involve in a production process. Labour earns wages which are paid according to the productivity of labourers. It must be borne in mind that only services of labour are bought not the labourer itself.

Capital

Capital is manmade resources. It does not mean money but all those goods and services which produce by humans and involved in a production process. Machinery, raw material, technology, road canal are examples of capital. Interest is the reward for capital. Capital is usually divided into two broad categories. Fixed capital, which is not used up in a production process like machinery, and, working capital, which is used up in a production process, for example, raw material.

The entrepreneur

This factor of production is involved in decision making and risk bearing. It decides what to produce , how to produce and how to distribute. Entrepreneur arranges other input factors to produce goods. It produces goods and services by undertaking an anticipation of demand to make profit. He is the main risk bearer. It is another important function of the entrepreneur.

Stages of Production

Primary production:

It is also called as an extractive industry. At this stage natural resources are extracted from land. Mining, fishing, farming and production of raw material are included in this sector. Developing economies mostly rely on primary stage of production.

Secondary production:

It is also called manufacturing industry. At this stage raw material is converted into finished and semi finished goods. For example, extracted crude oil is converted in to petrol, diesel and in kerosene at this stage.

Tertiary production:

It is also called service industry. At this stage produced goods and services are distributed. It includes commercial services; which involve distribution of goods, like retailing, transportation, banking, insurance etc. in personal services, services of teachers, doctors, engineers, musicians etc. are involved.

Division of labour

It is a process where a work is split in to large number of small production processes where each production process is performed by a specialize worker. Hence specialization is inevitable in the process of division of labour. Specialization means where an economic agent prefers to perform that task at which it considers itself the best.

Advantages of division of labour

1. When there is a repetition of a specific task, it increases proficiency at that particular operation. It makes the work simple as a result output increases.
2. Division of labour saves time due to no movement from one job to another or by putting down one set of tool and picking up another set of tools.
3. Division of labour creates occupations. When a work split into many operation, for each operation a specialized worker is required who suits to that job, as a result employment will rise.
4. Division of labour encourages mechanization. When a complex process has been broken down into a series of separate, simple processes, it is possible to device machinery to carry out each operation. Due to use of machinery, once again productivity increases, waste decreases as a result output increases and average cost falls.
5. It encourages inventions and innovations in the production process. When a worker perform a task again and again he may find out better techniques and methods to produce goods efficiently and economically.
6. In division of labour, there is best use of one's ability, because one prefer to perform that task at which it is the best. It raises the productivity and the output.

Due to above mentioned reasons, not only there is an increase in number of goods and services which leads to increase in the wealth of the nation i.e. the GDP, but also increases income of workers who are able to spend more to buy more goods and services to improve their living standards.

Disadvantages of division of labour

1. Repetition of a task creates monotony and boredom among workers. There is no opportunity for the workers to exercise initiative, judgment, manual skills and responsibilities. Sometimes workers commit some careless mistakes due to which average cost of production increases.
2. Specialization leads to increase in the use of machinery, due to which most of the work become automatic. Hence, basic skills are transferred from the hands of workers to machines. Now machines control the designs, the quality and the quantity of the product, and not the person.
3. It also increases risk of unemployment. Firstly, workers specialize in certain field. If there is no vacancy is vacant of that particular skill, they remain unemployed. Secondly, in division of labour a business becomes more capital intensive; hence, lesser workers are required, which create unemployment.
4. Interdependency increases due to division of labour. As if there is a break down at one stage whole of the working process will be halted, as a result there is no production. Similarly, specialization leads to increase interdependency in an economy. It is not simply the question of workers specializing, factories, firms and even whole industry specializes. Therefore, if a unit suffers, whole of the economy suffers.

5. Another disadvantage is the lack of variety. In division of labour, there is a large scale production, hence, it is not possible to produce goods in different design and most importantly in different sizes.

From the above mentioned reasons, it can be assessed that increase in division of labour may not be good all the time, it may cause reduction in productivity and production and choice of consumers, but also deters living standard due to lack of job satisfaction and variety.

However, history tells us that mostly all inventions and developments are more and less based upon specialization and division of labour. So if its limitations are rectified or reduced still it is very much beneficial for the economy.

Functions of Money

In the absence of money, exchange must take form of barter where there is a direct exchange of goods and services. However, there are many flaws in this system like lack of double coincidence, difficult to measure the value of anything, difficult to hold goods over a longer period of time and similarly, buying or selling on credit.

Money makes it convenient, and removes many of the problems of barter system.

Medium of exchange is the primary function of money. It makes possible in the great extension of the principle of specialization. Use of money allows us to exchange hours of labour for an amazing variety of goods and services. Here, no double coincidence is required. If one's has money, can buy any good or service at any time.

Another important function of money is a **unit of account or a measure of value**. The direct exchange of goods and services would raise all sorts of problems regarding valuation. Money overcomes this problem by measuring value in standardized units. Now, one can conclude that what is cheaper and what is dearer.

Money also performs function of **store of value**. Once a commodity becomes acceptable in exchange for goods and services, it is possible to store that good as a wealth. However it is convenient to hold wealth in form of money because commodities may deteriorate during storage or may lose its value.

Money may also act as a **transfer of value**. For instance, if a person wants to shift from one place to another, it is quite in convenient for him to transfer all of his stuff. Money makes it very convenient. Now that person can transfer his wealth by selling his stuff at one place and buy again at another place.

An important function of money in the modern world, where so much business is conducted on the basis of credit, is to serve as a **mean of deferred payments**. When goods are supplied on credit, buyers can use them immediately and payments are made in installments over a longer period of time. The whole of the banking system is also based on money. If there is no money, there is no borrowing or lending, hence no banking system.

Money can perform its functions effectively if it possesses all of the, or some of the following characteristics.

Good money should possess the feature of **general acceptability** to perform its primary function of medium of exchange. If money is not acceptable, transactions can not be held and it is useless to hold money.

Portability is another essential characteristic of money. An efficient medium of exchange must have a high ratio of value to bulk and weight. It is inconvenient to use large heavy or bulky object as money.

Good money should be **divisible** in to small units without losing its value. For instance \$ is a good money which can be divisible into 5p, 10p, 20p and 50p. Whereas certain commodities may lose their value if are divided in smaller units like a sheep.

Good money should be **durable**. People will not accept anything which subject to rapid deterioration and hence loses value under possession.

Money should be in *limited supply* i.e., it should be in scarce form. If there is an abundant supply of money it loses its confidence and people reluctant to accept that money. For example in the past sea shells or pebbles were used as money which did not have limited supply hence lost their confidence.

Homogeneity is another important quality of good money. If money is not homogeneous, it cannot be recognized hence there is no general acceptability and as a result unable to perform its primary function of medium of exchange.

Legal tender: It is actually any form of money that must by law be accepted in settlement of debt.

Near money: Near money items fulfill some but not all the function of money and usually have to be converted into true money before they can be spent.

Economic questions

All societies face three fundamental questions and how these are answered depend on the type of economic system being operated.

The first question is what to produce. The community wants to produce all kinds of varieties of goods and services but due to limited resources it has to decide, which goods should be produced and in what quantities. If they require more of consumer goods, then consumer goods should be produced in larger quantity. But if they desire for more of the capital goods, society will have to act upon accordingly.

The second question is how to produce. Due to scarcity, resources should be used efficiently. Economists use the term labour intensive and capital intensive to describe alternative methods. In labour intensive method more of the labour is used and less of the capital. Such methods are used in those economies where labour is in abundant form and capital is in scarce form or relatively expensive. This method is usually applied in developing economies which mostly rely on primary production. In capital intensive methods a vast amount of capital and little labour is used. These methods are used in developed economies which produce goods like machinery, electrical appliances etc. The total output of the community depends not only on the availability of resources but how to use those resources too.

The third question is how to distribute goods and services. It is once again the economic system which has to determine the relative sizes of the shares going to each household. For example in primitive societies goods were distributed among those who produced. In planned economies goods are distributed among all, whereas in market economies usually goods are given to them who have ability to pay for them.

Planned Economic System

In such systems all resources are owned and controlled by the state. There is no concept of private ownership. All land, housing, factories, power stations, transport systems etc are owned by the government.

The logic of public ownership in these societies is based upon the desire for a more equitable distribution of income and wealth.

In these societies all of the decisions, what to produce, how to produce and how to distribute are taken by the state. Production decisions are very complex in planned economies. At the first stage a survey is carried out which looks at the resources of labourers, machines, factories etc., to produce goods and services and then find out which quantities of

goods and services should be produced. Usually planned economies opt those methods of production which employ more workers to maintain certain level of employment.

Ideally, the complete planning of production is accompanied by the complete planning of distribution. What have been produced could then be allocated to consumers by some kind of physical rationing scheme.

In planned economies only those goods are produced which require to mass but not according to the buying power of some of the consumers. Therefore, mostly necessities of life are produced.

This system is bureaucratic by nature, hence, changing decisions are very complex and time consuming. Usually workers are paid equally without considering their ability and productivity; therefore, there is low incentive to work hard. Another drawback of this system is lack of profit motive; hence, there is no incentive to innovate. As a result firms operate inefficiently. In such economies usually goods are of poor quality as well as no variety is available to consumer, as a result they do not enjoy better living standard.

Market Economic System

This system is based on laissez-faire, which means let the people do. Like pure planned economies this system in pure form does not exist. In this system resources are allocated on the basis of price mechanism. Market forces, that is, demand and supply are allowed to move freely in allocation of resources. This is why; decisions are made easily and quickly by seeing the changes in demand and supply forces. Government plays very limited role in this system. Private ownership of resources is an important feature of this system. Private property not only confers the right to own and dispose of real assets but it also provides the right to generate income form assets.

In this system there is a freedom of choice and enterprise. Consumers are freed to spend their income anyway they wish. On the other hand entrepreneurs may use their resources as they see fit. Consumers are considered sovereign in this system because goods and services are produced according to their desires. Profit is the main motive in this system, this is why there is an incentive to innovate. Another important feature is competition. Competition leads to increase efficiency in businesses.

On the other hand there are many flaws in this system. In this system only those good and services are produced which bring profit for the business. There is no concept of the production of public goods like parks, roads etc. similarly merit goods like education and health are under produced. On the other hand, demerit goods like weapon, drugs, cigarettes are produced more to generate healthy profit.

In market economies, to gain higher profit, firms reduce their cost of production by neglecting negative externalities. It is the cost which incur by the whole society due to a production process. Firms only employ those factors of production which bring profit for the firm; as a result many of the factors of production remain unemployed.

It is said that consumers are sovereign in market economy but actually there is a producer sovereignty, which produce goods and force consumer to buy them. In market economies monopolies are established, and due to weak control of the state exploit consumers.

Another big drawback of this system is inequalities in the distribution of income and wealth. This system creates a wide gulf between rich and poor.

Mixed Economies

Actually, there is no existence of pure planned economies as well as pure market economies. Usually we have mixed economies. However, in some of the mixed economies government plays major role and in some of the economies individuals are stronger.

In mixed economies, there are usually two sectors; private sector, which is controlled by individuals. It possesses most of the features of market economies like private ownership, economic freedom for producers and consumers, profit is the main motive, competition etc. this sector also possesses some of the evils of market economies like under provision of merit goods or no provision of public goods, similarly, self interest as the dominating motive which may exploit interest of the society.

Another sector is the public sector, which is controlled by the state. In many of the developed and emerging economies this sector has very limited role to play. However, this sector not only produces those goods and services which are not producing or under produce by the private sector but also control activities of private sector. It makes laws which protect consumers and society from the evils of market economy. It forms competition policies which control monopolies but also control quality, quantity and to the certain extent prices of products. It makes laws against pollution, redundancies and unfair trade practices.

Problems faced by economies during their transition period from planned economies to market economies.

The first problem which was faced by these economies was **inflation**. Command economies usually keep prices below than that charge by non government produces. When private sector replaced public sector, general price level was shoot up. In 1994 rate of inflation in Russia was above than 400%.

Second biggest problem was **industrial unrest**. Workers pressed firms to raise their wages which enabled them to meet high prices. They were also likely to try to maintain their job securities. In the early 90's a number of strikes occurred in Russia and other countries of the communist bloc.

Thirdly, there was a change in the **pattern of employment**. There was likely to be large scale structural change, with some industries expended, some of them were contracted and some went out of business. This required workers and machines to move from one job to another. However, many of the machines and workers were not able to do so due to geographical and occupational immobility. Therefore, they became redundant and unemployed.

Fourthly, there was a fall in over all **living standards** in those economies. Many of machines were out dated or out of order. To replace them considerable resources were required. Due to lack of resource many of the consumer goods were forgone. Similarly during transition period real GDP also fell which further deteriorate the living standards.

Another problem was faced by those economies was huge deficit in their **balance of payments**. Not only countries spent large resources to import modern machinery to replace out dated machinery but also had to import common consumer goods.

Other concepts and terminologies

Ceteris paribus; it means other things being unchanged. Usually in a theory, a certain relationship is created between the given variable. But at the same time there are some simultaneous changes in other related variable and as a result, theory cannot be proved. Therefore, to prove that theory we keep all other factors constant.

The margin; the margin is important in economics as it is the impact of small changes in variables rather than their level per se that determines whether rational economic agents change them. It is the average level of utility, cost or revenue that tend to determine whether things are produced and consumed at all, but the marginal utility, cost or revenue that determine how much is consumed or produced once a decision to do so at all has been taken.

Economic goods; these goods are in scarce form. Such goods incur opportunity cost. People will have to price for such goods. For example, cars, food, clothe etc.

Free goods; these goods are abundantly available in the world. People usually do not have to pay any price of them. Such goods have no opportunity cost. For example, air, rain, sunshine etc.

Consumer goods; an economic good purchased by a household for final consumption. It is the use to which it is put determines whether a good is consumer good, not the characteristic of the good itself.

Capital goods; these goods are produced for the sake of further production. Such goods generate income and wealth. Machinery, raw materials are common example, but once again it is the use to which it is put determines whether a good is capital good, not the characteristic of the good itself.

Durable goods; these goods yield services or utility over time rather than being completely used up at the moment of consumption, for example washing machine and machinery.

Non-durable goods; such goods are used up completely at the moment of consumption; raw material and food stuff are common examples.

Liquidity; the degree to which an asset can be quickly and cheaply turned into money, which by definition, is completely liquid.

Market; an abstract concept concerning all the arrangements that individuals have for exchanging with one another like, labour market, commodity market, finance market etc.

Investment; it is an addition to the capital stock of a firm or economy. It is the part of the total income which will be used to produce goods in future or to generate future income.

Value judgment;

