

Axe 02: The Basic Economic Problem

The economic problem, sometimes called the fundamental economic problem, is one of the fundamental economic theories in the operation of any economy. It asserts that there is scarcity, that the finite resources available are insufficient to satisfy all human wants. The problem then becomes how to determine what is to be produced and how the factors of production (such as capital and labour) are to be allocated.

Economics revolves around methods and possibilities of solving the economic problem. The economic problem is most simply explained by the question:

"How do we satisfy unlimited wants with limited resources?"

1) WHY DO ECONOMIC PROBLEMS ARISE?

The economic problem arises in every economy due to.

- (a) Unlimited wants;
- (b) Limited resources;
- (c) Alternative uses of resources.

a) **Unlimited Wants:** Human beings are required to satisfy their basic needs for their survival. For example, a person needs food, water, clothing and shelter in order to survive. These are the basic needs of a person.

However, no person would like to satisfy only his/her basic needs if he/she could improve his/her life. People, by nature, want more than what they just need for survival. If one want is satisfied, many others crop up and this goes on endlessly. Let us understand this through an example.

b) **Limited Resources:** People may have high or low income but not unlimited income. Hence, resources (or income) available to consumers are scarce or limited. Resources also include factors of production: land, labour, capital and entrepreneurship. These resources are not available in abundance in this world. They are scarce or limited. Scarcity means that the demand for the resources is greater than their availability.

c) **Alternative Uses of Resources:** Similarly, all factors of production can be put to alternative uses. For example, a piece of land can be used to do farming, build a factory, develop a school or build a hospital. A labour can be used to plough a field, to make baskets or to sell vegetables. Hence, we see that resources have alternative uses.

From the above discussion we can see that wants are unlimited but resources (to satisfy the wants) are limited which happens to be the basic economic problem faced by all economies. We have also discussed that resources have alternative uses. This basic problem exists in every economy – whether rich or poor; developed or developing. Scarcity of resources also leads to choice.

2) CENTRAL PROBLEMS OF ECONOMY. As we have discussed above, every economy in the world faces the economic problem of unlimited wants and limited resources. This economic problem gives rise to people making choices about how they would like to use scarce resources. This economic problem gives rise to the central problems of an economy which are as following:

- What to produce and in what quantities?
- How to produce?
- For whom to produce?

These are called central problems because every economy has to face them and seek solutions to them.

Collectively, these central problems are called the Problem of Allocation of Resources. Let us discuss each of these central problems in detail

a) What to produce and in what quantities?

The fact that resources are scarce leads to the problem of ‘what to produce’ and in what quantities to produce. An individual producer needs to decide on how to employ the sources that are available to him for production.

For example, if Mohamed, a farmer has a piece of land, he needs to think about what crop she would like to produce on his land. Let us assume that he can grow either sugarcane or wheat. Given that his land is limited, he needs to choose whether he wants to use the land to produce sugarcane or wheat or both. Once Mohamed has taken this decision he needs to think about the quantity of the crop that he would like to produce. For example, 10 quintals, 20 quintals or 50 quintals. This problem of ‘what to produce’ and in what quantities to produce is faced by all economies.

An economy needs to choose whether it wants to use its resources to produce consumer goods or producer goods. Alternatively, to what extent should luxury goods be produced in comparison to necessities or goods of mass consumption?

An economy may also be faced with the question of how much of civilian goods to be produced and how much of defence goods to be produced. In other words, scarce resources require economies to decide the combination of goods and services they should produce. The problem of what to produce and in what quantities to be produced can be solved by a government that decides the allocation of resources in different areas of production. Alternatively, it can be solved based on the preferences of people in an economy and on the price of goods and services in market.

b) How to produce?

Choosing the technique of production relates to the problem of 'how to produce'. By technique of production we mean the different combination of factors of production that can be used to produce a good. Generally all goods can be produced through different methods of production. Various methods of production require different combinations of factors of production. A technique of production could be either labour intensive or capital intensive. In a production process when more units of labour are used in proportion to capital, it is termed as a labour intensive technique. Alternatively, when the proportion of capital used is more than labour, the production process is called a capital intensive technique. Let us understand this with the help of some examples. On Mohamed's farm, he has the choice of using different combinations of labour and capital to produce his crop. If he chooses to do the ploughing, sowing, harvesting and threshing with her bullocks and employing people, then he is using a **labour intensive technique**. On the other hand, if he uses machines such as tractor, harvester and thresher to do the same work, then he is using a **capital intensive technique** of production. Similarly, in cloth production the use of handlooms is a labour intensive technique to produce cloth whereas the use of power looms is a capital intensive technique of production of cloth. The solution of the problem of how to produce is based on the extent of output that is produced for a given level of resources. Any producer would like to maximize the level of output from the available resources. At the same time cost of using a technique is equally very important. A producer will use that particular technology which is available at least cost.

c) For whom to produce?

The problem of 'for whom to produce' relates to how the value of the produced output of an economy gets distributed amongst different people. People do not receive the output they produce as their compensation. The output is sold and the money is earned in the production process. This money is paid as income to people for the work they have done in the production process. This income, in turn, is used by people to satisfy their wants.

Hence, the problem of for whom to produce tells us how the different factors of production are compensated for their work. In our example, once Mohamed's crop is harvested and sold, he needs to pay the various factors of production for their services. The labour will be paid wages, land will be paid rent, and capital (in the form of machinery) will be paid interest. Lastly, Mohamed will earn profit as an entrepreneur for organising the factors of production and undertaking some risk of running the production activity.

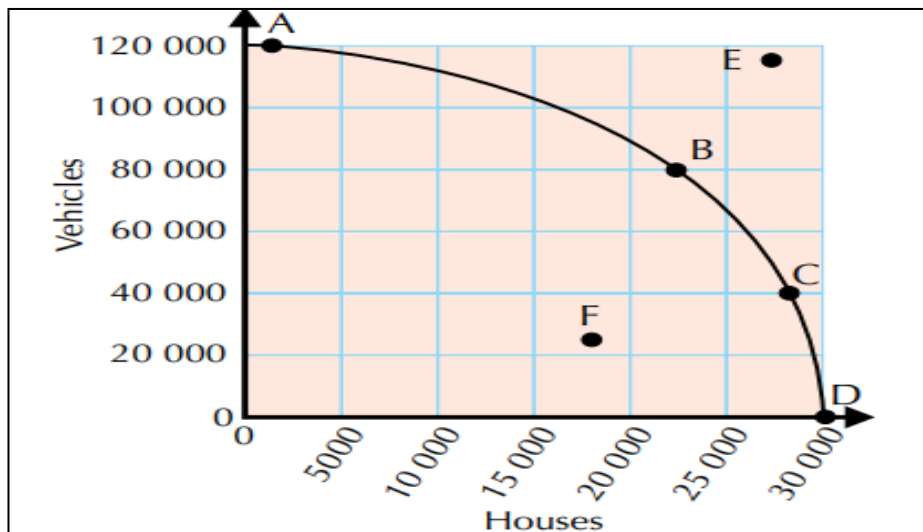
d) Production Possibility Frontier (PPF): Just as individuals face scarcity of resources, the resources of an economy as a whole are always limited in comparison to what the people in the

economy collectively want to have. The scarce resources have alternative usages and every society has to decide on how much of each of the resources to use in the production of different goods and services. In other words, every society has to determine how to allocate its scarce resources to different goods and services. An allocation of the scarce resource of the economy gives rise to a particular combination of different goods and services. Given the total amount of resources, it is possible to allocate the resources in many different ways and, thereby achieving different mixes of all possible goods and services. The collection of all possible combinations of the goods and services that can be produced from a given amount of resources and a given stock of technological knowledge is called the production possibility set of the economy.

e) Production Possibility Frontiers show the Maximum possible output: The basic problem in Economics is how best to allocate scarce resources. A production possibility frontier (PPF) shows the options that are available when you consider the production of just two types of goods or services. Production Possibility Frontiers show the Maximum possible output.

- The PPF below shows the maximum number of houses (on the horizontal axis) and vehicles (on the vertical axis) that can be made, using the existing level of resources in an economy. ** You can draw a PPF for any two products, or any two categories of products — e.g. capital and consumer goods. Capital goods are used in the production of other goods, whereas consumer goods are bought directly by consumer.

- Points A, B, C and D (and every other point on the PPF) are all achievable without using any extra resources. However, they are only achievable when all the available resources are used as efficiently as is actually possible. • Notice how, as you move along the curve from A to B, you're building more houses (about 22 500 instead of 1000) but fewer vehicles (80 000 instead of 120 000). • Moving along the curve from A to B like this corresponds to allocating more resources to the production of houses, and fewer resources to the production of vehicles. • In other words, there's a trade-off between 'building more houses' and 'making more vehicles' — to do more of one, you have to do less of the other.



3) OTHER CENTRAL PROBLEMS OF THE ECONOMY.

In addition to the central problems discussed in the previous section, every economy faces two other problems. These are:

- (a) The problem of optimum utilization of resources
- (b) The problem of growth of resources.

Let us discuss each of these problems in detail.

a) Optimum Utilization of Resources:

Resources are scarce they must not be wasted. They must also be used judiciously to give the maximum output. Thus, optimum utilization of resources has the following implications:

- All resources must be utilized and
- Resources must be used efficiently These two issues are discussed below.
- **All resources must be utilized:** If resources are not utilized/employed or are lying idle, it means that they are being wasted. Wastage of resources results in low output. For example, people may be unemployed. This means that human resources are being wasted. Similarly, when workers in a factory go on strike, capital resources lie idle and are wasted. If these resources are utilized, the output that can be produced in the economy shall rise. Thus, every economy must ensure that scarce resources are utilized and not left idle or unemployed.
- **Efficient Utilization of resources:** Since resources are scarce, they should not be underutilized. Under utilization of resources means that resources are not being used to their fullest capacity. For example, if a person finds a job in which he works only for 4 hours a day, but his capacity to work is 8 hours a day, then his labour is underutilized. In other words, the person is not being employed efficiently. If he had a job for 8 hours a day, the output would increase. Under utilization of resources also results in wastage of resources. Hence, every economy must try and adopt techniques of production that ensure efficient utilization of resources.

b) Growth of resources. We have studied earlier in the chapter that wants are unlimited. This means that people continuously want more and more goods. However, these ever increasing wants can not be satisfied unless the resources that produce goods and services are increased. Thus, resources must grow to satisfy the constantly increasing wants in an economy. So, how can resources grow in an economy? Resources can increase if:

- There are quantitative changes in the resources Quantitative increase in resources occurs when the actual quantity of resources that is available in the economy increases. For example, when the population increases, then the quantity of human resource increases. Similarly, when more natural resources are found, it increases the availability of resources in an economy.
- There are qualitative changes in resources Qualitative changes in human capital occur due to better training and skill development. Qualitative changes in man made capital occur when there is an improvement in technology. Under qualitative changes, the amount of resources available does not change but their productivity increases. Productivity is defined as the output per unit of input. For example, if labour gets trained, then the output from the same person can increase. Productivity improves due to better skill and training. To conclude our discussion, growth of resources occurs when the physical availability of resources increases and/or there is technological up gradation or an improvement in the quality of resources.