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CENTRAL PROBLEMS OF AN ECONOMY

As you are aware, we have multiple wants but only limited resources to fulfill them. We need different goods and services to satisfy different wants. But due to scarcity of resources, we cannot produce all the different types of goods and services for everybody in the economy at the same time. Also due to scarcity, we cannot afford to waste the resources. So every economy must find solutions to these problems.



OBJECTIVES

After completing this lesson, you will be able to:

- *understand about the need to make a choice;*
- *know that scarce resources have alternative uses;*
- *be familiar with central problems of an economy;*
- *understand resource allocation in different types of economies;*
- *explain relationship between growth of economy and growth of resources.*

5.1 SCARCITY AND CHOICE

Suppose you want to buy a shirt, a book and a gift for your friend. You also want to watch a movie in a cinema hall. These are a number of wants which are to be satisfied. But you have only Rs.110 with you. Supposing a shirt is available at Rs.150, a book is worth Rs.95, a gift costs Rs. 90 and a movie ticket can be purchased at Rs.100. So together all of them will cost you Rs.435 which you do not have. Obviously, you cannot purchase all the things since you have limited money or resource with you. What will you do? With Rs.110, you cannot buy a shirt as its price is more than the money you have. But you can think of buying either a book

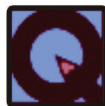


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or a gift or a movie ticket. Here you have to make a choice about which one of these things you want to buy.

Why does the problem of choice arise? If you had a magic wand or a magic lamp, you could have had everything to satisfy your wants and the problem of making a choice would not arise. This is an ideal situation, which can never happen. You have only Rs.110 and not Rs.435 which implies that the resources (money in this case) with you are limited or scarce. Since you can buy only one item with your scarce resource, you face the problem of deciding exactly what good is to be bought to satisfy your want. While making a choice as to which one to buy, notice another important thing. That is, resources can be put into alternative uses. How? Even if you cannot buy all of them, you can buy a book or a gift or a movie ticket. So resources can be put to alternative uses.

Similarly, the economy also has to decide what goods and services are to be produced and how resources are to be used. **Thus the issue of 'choice' arises because a) the resources are scarce and b) the resources can be put to many alternative uses.**



INTEXT QUESTIONS 5.1

1. What can be the alternative uses of the following items?
 - (a) A bus
 - (b) A room
 - (c) A building
 - (d) A computer

5.2 CENTRAL PROBLEMS OF AN ECONOMY

We may enlist three major problems facing any economy. These are

1. Problem of Allocation of Resources
2. Problem of Utilization of Resources
3. Problem of Growth of Resources

Let us discuss these issues one by one.

5.2.1 Allocation of Resources

An economy also confronts three fundamental economic problems:

1. What goods and services shall be produced and in what quantities?



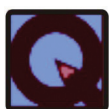
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2. *How* shall goods and services be produced?
3. *For Whom* goods and services are to be produced?

What goods and services shall be produced and in what quantities? Every society may face similar problem of choice; however the priorities may be different. In less developed economies the choice may be between production of food crops and manufacture of bicycles. In advanced economies the choice may be between building more shopping malls or producing more cars.

How shall goods and services be produced? It is related to the method by which these are to be produced? Once the goods to be produced are decided, there is a problem of how to produce them. What tools are needed, how much land and how many workers are needed. There are many different ways of making things. For example, clothes can be produced by employing more labour and less machines or more machines and less labour. If goods and services are produced by employing more of labour and less of capital, it is known as labour intensive method of production. If goods and services are produced by employing more of capital (machinery etc.), it is called capital intensive method of production.

For Whom goods and services are to be produced? Who is to enjoy and get the benefit of the goods and services produced? It is not possible to satisfy everyone's want due to scarcity, so it must be decided to whose wants are to be satisfied. Should the economy produce more of food crops or more of computers? Whose needs are to be addressed, the poorer people or the richer people? Should everybody get equal share of the total goods and services produced, even if some people may need more than others? All these decisions refer to the distribution of income and wealth in the society.



INTEXT QUESTIONS 5.2

1. Give one reason which gives rise to economic problems?
2. Name the three central problems of an economy.

5.2.1.1 Resource Allocation in a Capitalist Economy

Capitalist economy is an economic system in which factors of production are privately owned and goods and services are produced with the objective of earning maximum profit. In a capitalist (market-oriented) economy, there is no central authority to guide the choice of goods and services. The production is in the hands of individuals - farmers, manufacturers, producers, service providers and others. The resources like land, labour, capital etc. are owned privately by people. All these individuals produce for the market and are guided by profit motive. They produce only those goods which

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are demanded by the consumers. They try to produce the goods in the cheapest possible way so that they can earn maximum profits. These individual producers will try to move their resources away from producing things which people do not buy, towards the production of goods which people like to buy. The products are meant for the people who demand such products and can afford to buy these.

Rajan is a businessman who produces shirts. He realized that a lot of his shirts remain unsold. He also observed that young boys and girls are wearing t-shirts these days. These young people are willing to spend money now-a-days on t-shirts rather than shirts. As Rajan's profit has started falling, he decides to produce t-shirts, instead of shirts. As his resources are limited, he diverts his resources to the production of t-shirts to satisfy the demands of the young people. Rajan now can produce the t-shirts by employing 2 sewing machines and all his 10 workers. By this process, each t-shirt will cost him Rs. 100/. Another option for Rajan is to produce t-shirts by using 5 machines and only 8 workers, in which case the t-shirt will cost Rs.125/. Rajan will choose the first and cheapest method because he wants to make as much profit as he can by selling his t-shirts. Now Rajan's t-shirts are very popular among the youngsters. He earns higher profits now than what he was earning when he produced shirts. The young people who can afford to pay Rs.100/ are all wearing the t-shirts produced by Rajan.

Thus, the important characteristics of a capitalist economic system are given below:

- Only those goods and services are produced which the consumers want.
- Maximum quantity of goods are produced at the minimum cost per unit.
- Goods and services are produced for everyone who can pay for them.

5.2.1.2 Resource Allocation in a Planned Economic System

In a planned economic system, there is a central planning authority of the government which decides what to produce, how to produce and for whom to produce. The planning authority sets the production targets. The government sets the goals and the firms try to meet the goals. When there is an agreement on the targets, the firms start the production. It is unlike the market economies, where people who have money can satisfy their wants and people who do not have money cannot afford to buy things to satisfy their wants. In a planned system, the government wants everybody to be equal. They produce the goods which everybody needs and can be shared equally by everyone. It is not that people who can afford can have more. At least in case of services like health and education, roads and housing, everyone should get equal opportunity, irrespective of their affordability. Thus in case of planned economies, the government decides to produce the goods and services which it thinks people should have and not what people think they should have. Thus, the government produces goods and services to satisfy the wants of masses.

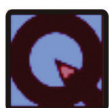


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As the government determines the production of various goods and their quantities, it is possible that the government produces more scooters and tractors whereas the consumers demand car. Regarding how to produce, the central planning authority may not be able to calculate the cost of so many things and there is a danger that resources are not allocated in an ideal manner. A socialist economy solves the problem of whom to produce on the basis of basic needs of people like food, clothing and shelter are sought to be satisfied. Everyone is treated alike and no one gets precedence over the other. It is however said that planned economic system does not allocate the resources in the most ideal manner as it is not based on the choice and preference of people. It is based on the decision of government. However, the system is based on the principle of social welfare.

5.2.1.3 Resource Allocation in a mixed economy

A mixed economic system combines government planning with the free market economy. No economy in the world is totally centrally planned or totally market-oriented. Most of the economies today are mixed economies. In the mixed economic system the choice of goods and services to be produced by the private sector depends on the basis of profit motive. The choice of goods and services to be produced by the government depends on the basis of needs and requirements of the people. It combines the efficiency of production with the justice of distribution; the government owns scarce resources to produce goods and services that they think their country and people need. People and firms in the private sector also own some scarce resources with the aim of making as much money as possible. Thus, mixed economic system attempts to combine the advantages of the market economic system with the advantages of the planned economic system.



INTEXT QUESTIONS 5.3

1. What is the main aim of producing goods and services:
 - (a) In a market economy
 - (b) In a planned economy
2. For whom are the goods are produced in a market economy?

We have discussed that total resources are limited and the resources are capable of producing different commodities. In deciding what to produce and how much, the economy has to take decisions regarding allocation of resources among thousands of different possible commodities. Let us assume that the economy is producing only two commodities, wheat and bicycles. With the limitation of the total resources, if all the resources are utilized in the production of wheat, 20 quintals of wheat can be produced and no production of bicycle will take place. If more and more resources



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are being diverted towards the production of bicycles, little amount will be left for the production of wheat. Similarly if all the resources are being used in the production of bicycles, 100 bicycles can be produced and no resources will be left for the production of wheat.

Table1: Production Possibilities

Production Possibilities	Wheat (quintals)	Bicycles
A	20	0
B	8	30
C	5	60
D	2	75
E	0	100

The above table shows an example of some of the production possibilities of different combinations of two goods, wheat and bicycles. There are only five possibilities. There can be many more possibilities. If some amount of wheat is given up, we can have more of the bicycles; if some bicycles are given up, more of wheat can be produced. Therefore the scarce resources are employed in various combinations to get alternative production possibilities.

5.2.2 Full Utilisation of Resources

The other central problem of an economy relates to full utilisation of resources- land, labour, capital. You have seen that you can have more of bicycles by sacrificing some amount of wheat. If all the resources in the economy are fully employed, then the quantity of one commodity can be increased only by forgoing some quantity of the other. This happens when production takes place efficiently. But in reality, most of the time production does not take place efficiently. The factors are not fully employed and the production is below the optimum capacity of economy. You must have seen some of your family members or friends who are unemployed despite being educated. Similarly in our agricultural land we still grow only one crop in a year. This is not a good sign, as the resources are already scarce. If these scarce resources are also not utilized fully, it is wastage of resources. Thus it is the duty of an economy to ensure that the scarce resources do not remain unutilized or under-utilized.

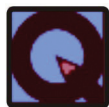
5.2.3 Growth of Resources

If resources like labour, capital and technology grow over a period of time, the problem of scarcity can be addressed. Thus, for the growth of any economy, the

resources available to the economy should grow. It is only through the effective growth of resources that a society can enjoy a higher standard of living. This is how the countries have developed. If the resources have failed to grow, the countries continue to be underdeveloped. Thus, the economies should make efforts so that their resources grow gradually to meet the growing needs.



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INTEXT QUESTIONS 5.4

1. Give one example of under utilization of resources.
2. Give two examples of growth of resources.



WHAT HAVE YOU LEARNT

- The issue of ‘choice’ arises, because a) the resources are scarce and b) the resources can be put to many alternative uses.
- An economy confronts three fundamental economic problems, **what** goods and services to produce, **how** to produce and **for whom** to produce.
- Capitalist economy is an economic system in which factors of production are privately owned and goods and services are produced with the objective of earning maximum profit.
- In a planned economic system, there is a central planning authority of the government which decides what to produce, how to produce and for whom to produce.
- A mixed economic system combines government planning with the free market economy.
- For the growth of any economy, the resources available to the economy like labour, capital and technology should grow.
- If all the resources in the economy are fully employed, then the quantity of one commodity can be increased only by forgoing the quantity of other. This happens when production takes places efficiently.
- If the scarce resources are also not utilized fully, it is wastage of resources. Thus it is the duty of an economy to ensure that the scarce resources do not remain unutilized or under-utilised.

**Notes****TERMINAL EXERCISE**

Choose the write answers in Q1 and Q2

1. Central problem of an economy arise, because:
 - I. Many goods are sold in market
 - II. Government makes decisions
 - III. Shortage of labour
 - IV. Multiplicity of wants and scarcity of resources
2. Choice is fundamental to economic behavior, because:
 - I. People find it difficult to choose what they want
 - II. Resources are scarce in relation to people's wants
 - III. People behave rationally
 - IV. Price of a commodity depends on choice
3. Explain how scarcity and choice go together?
4. Why it is said that free market economy ensures most efficient allocation of resources?
5. Explain the three central problems with one suitable example of each.

**ANSWERS TO INTEXT QUESTIONS****Intext Question 5.2**

1. Scarcity of resources.
2. (i) what to produce, (ii) how to produce, (iii) for whom to produce.

Intext Questions 5.3

1. (i) Profit motive.
(ii) To satisfy the wants of masses.
2. Who can pay for it?

Intext Questions 5.4

1. Unemployment of labour.
2. Increase in the number of skilled and unskilled workers through population growth.