

INTRODUCTION TO ECONOMICS
ECONOMIC SYSTEMS & SOLVING
BASIC ECONOMIC PROBLEMS

[UNIT 1.15]

ECON-HUB

THEORY

FUNCTIONS OF AN ECONOMIC SYSTEM

'BASIC ECONOMIC PROBLEMS'

RECAP

Problem(s)

What to produce, in what quantity
[AKA: Allocation Problem]

How to produce
[AKA: Production Problem]

Whom to produce
[AKA: Distribution Problem]

Decision(s)

Production Decision

Choice of Techniques Decision

Distribution decision

WHAT TO PRODUCE & WHAT QUANTITY (ALLOCATION PROBLEM)

The basic problem of what to produce refers to the process of deciding what goods to produce and what are the needs and wants which should be satisfied, by allocating or using limited economic resources with alternative uses.

Due to the scarce nature of economic resources all possible or available alternative goods or services cannot be produced, therefore an economy is forced to make a choice with regards to what goods to produce in what quantities.

In the process of providing a solution to this problem, an economy will also make a decision as to how much resource to be 'allocated' for current consumption and future consumption. This problem emphasizes two main factors.

- What good to produce including the decision of what quantity to produce.
- This becomes a basic economic problem since all societies face a problem of scarcity and choice.

It is also noteworthy, that this problem can be further illustrated effectively, using a production possibilities frontier diagram (which point or product combination to select on the PPF)

HOW TO PRODUCE [PRODUCTION PROBLEM]

The problem of how to produce refers to the process of deciding what alternative production method or resource combination to use in producing goods and services. In simple terms this is a problem relating to the intensity of production factors, i.e. deciding how much each production factor to be used within the production process.

The production method or technique will depend of this intensity or combination of production factors.

The production problem of how to produce is provided with a solution by an economy after considering certain important social, economic, political and cultural factors.

Labour intensive technique

This is where goods and services are produced using more labour resources in comparison with capital resources.

Capital intensive technique

This is where goods and services are produced using more capital resources in comparison with labour resources.

WHOM TO PRODUCE [DISTRIBUTION PROBLEM]

The problem of whom to produce refers to the process of deciding, how the overall output of an economy or national product should be distributed among the households of the economy. This is a problem connected with the distribution of income or wealth.

The distribution of income among households depends on the amount of factor based services owned by the households and prices of such resources etc. Generally factor owners and laborers with high income receive high purchasing power and are able to obtain more goods and services.

SOLVING: WHAT TO PRODUCE

Market Economic System

The problem of what to produce will be solved based on the **price mechanism**, using **price signals mainly issued within product markets**. The **most profitable goods and services** will be produced after considering the relative price of different goods.

The main factor which decides profitability is the price of goods. The price will be decided by the free interactions of consumer demand and producer supply with in the goods market.

The cost of production will also influence profits, therefore the **factor market price** should also be considered in providing solutions to this problem.

SOLVING: WHAT TO PRODUCE

Planned Economic System

The problem of what to produce will be solved based on the specific plans and **commands** of the **central planning authority** of the government.

The central planning committee or government shall prepare a list of priorities based on **social needs of the public**, after conducting a comprehensive '**Input-output Analysis**' in which a decision has to be made with regards to a proportion of resources used for investment (capital formulation) and other consumption activities.

The activities or goods that provide **greatest social welfare** will be given high priority.

SOLVING: WHAT TO PRODUCE

Mixed Economic System

The problem of what to produce will be **mainly** solved **using the price mechanism** with different forms of **government interventions** in order to ensure a certain degree of social welfare.

Government interventions, as deemed appropriate by the government or when requested by the public, will be practices in a directed and indirect manner.

SOLVING: HOW TO PRODUCE

Market Economic System

This problem will be solved based on the **price mechanism**, using **price signals issued in the factor market**. Private enterprises functioning with the objective of profit maximization will select a resource combination or production method which **minimize cost and maximizes profit**.

The decision is mainly with regards to a more capital intensive or labour intensive production method.

In simple terms this production problem is solved by making a choice of techniques (production methods) decision after considering the relative prices of labour and capital (wage-rates and interest rates) within factor markets.

SOLVING: HOW TO PRODUCE

Planned Economic System

This problem will be solved based on the plans and policies prepared by the **central planning committee**. The main focus will be to utilize the resources of the country in order to derive its full benefits to the public.

Therefore the production method will be a one that creates a **balance between inputs and outputs** according to the economic plans while **maximizing the social benefit**.

The production method proposed in the plan will be carried out by government enterprises and private sector enterprises (under the directives of the central planning unit of the government).

SOLVING: HOW TO PRODUCE

Mixed Economic System

This problem will be solved **mainly** based on the **price mechanism** or the market system, but the markets will not function free of **government intervention**.

The government will provide tax benefits to labour intensive industries, implement **minimum wage controls**, introduce and spread new production methods, **provide subsidies**, develop economic **infrastructure** and practice other direct market interventions to **control environmental pollution** etc.

SOLVING: WHOM TO PRODUCE

Market Economic System

The problem of whom to produce will be solved based on the **price mechanism**, using **price signals issued in the goods and factor markets**.

The output will be **distributed** among **parties** with **purchasing power**.

The purchasing power will be decided based on the income distribution among households and the price of goods. Income distribution will depend on the price in the factor markets.

SOLVING: WHOM TO PRODUCE

Planned Economic System

The problem of whom to produce will be solved based on the **wage rates** and **price of goods** specified in the economic **plans prepared** by the **government**.

The main source of income for households will be wages. Such wage rates will be decided by the government based on training, knowledge and skills etc. while **minimizing disparities in income distribution**.

Therefore the output will be distributed among the total population through different **pricing methods** to **ensure greater social equality**.

SOLVING: WHOM TO PRODUCE

Mixed Economic System

This problem will be solved **mainly** based on the **price mechanism** (goods produced to parties with purchasing power). The **government** will practice **market intervention** to **ensure fair distribution of income**. The government will implement some of the following steps in order to minimize income disparities.

- **Progressive taxes** (personal & corporate income taxes)
- **Transfer payments** (pension payments, Samurdhi benefits etc)
- **Merit goods** (health care, education & nutrition programs free of at concessionary prices)
- **Price controls** (price ceilings and floors)
- **Controlling ownership of wealth** and other rules and regulations.

Transition Economies

Transition economies are countries moving (transforming) from one economic system to another. Today this transition mainly takes place from a **socialist planned economic system towards a more capitalist market economic system.**

The main reason for this transformation is the relatively inelastic and inherent limitations of mainly socialist **planned economic systems**. Accordingly transition economies use a variety of market driven economic policies within this transition process.

Examples

- China
 - Vietnam
 - Bulgaria
 - Rumania
- Hungary
Russia
Mongolia

EVALUATING THE PERFORMANCE OF AN ECONOMIC SYSTEM