

# **INTRODUCTION TO ECONOMICS:**

**INTRO TO BASIC ECONOMIC PROBLEMS & HOW  
ALTERNATIVE MECHANISMS SOLVE SUCH PROBLEMS**

**UNIT [1.13]  
RAPID REVISION**

**ECON-HUB**

**THEORY RE-CAP**



Theory Recap Questions [TRQs]  
Practice Questions [PQs]

**Essentials**

# **'LETS MASTER ECONOMIC SYSTEMS**

Economic Systems & Applications Unit 1.13 [REV]  
ECON-HUB

# **ECONOMIC SYSTEMS & SOLVING BASIC ECONOMIC PROBLEMS**



# **FUNCTIONS OF AN ECONOMIC SYSTEM** **'BASIC ECONOMIC PROBLEMS'**

## **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**





RECAP

## [3.3] THE PROBLEM OF CHOICE...

All economic systems in the world are designed to make choices (trade-off-based decisions) and find solutions to three basic problems

- 1) **What** to produce? in what quantity? [Allocation Problem]
- 2) **How** to produce? [Production Problem]
- 3) **Whom** to produce? [Distribution Problem]

**'What'**



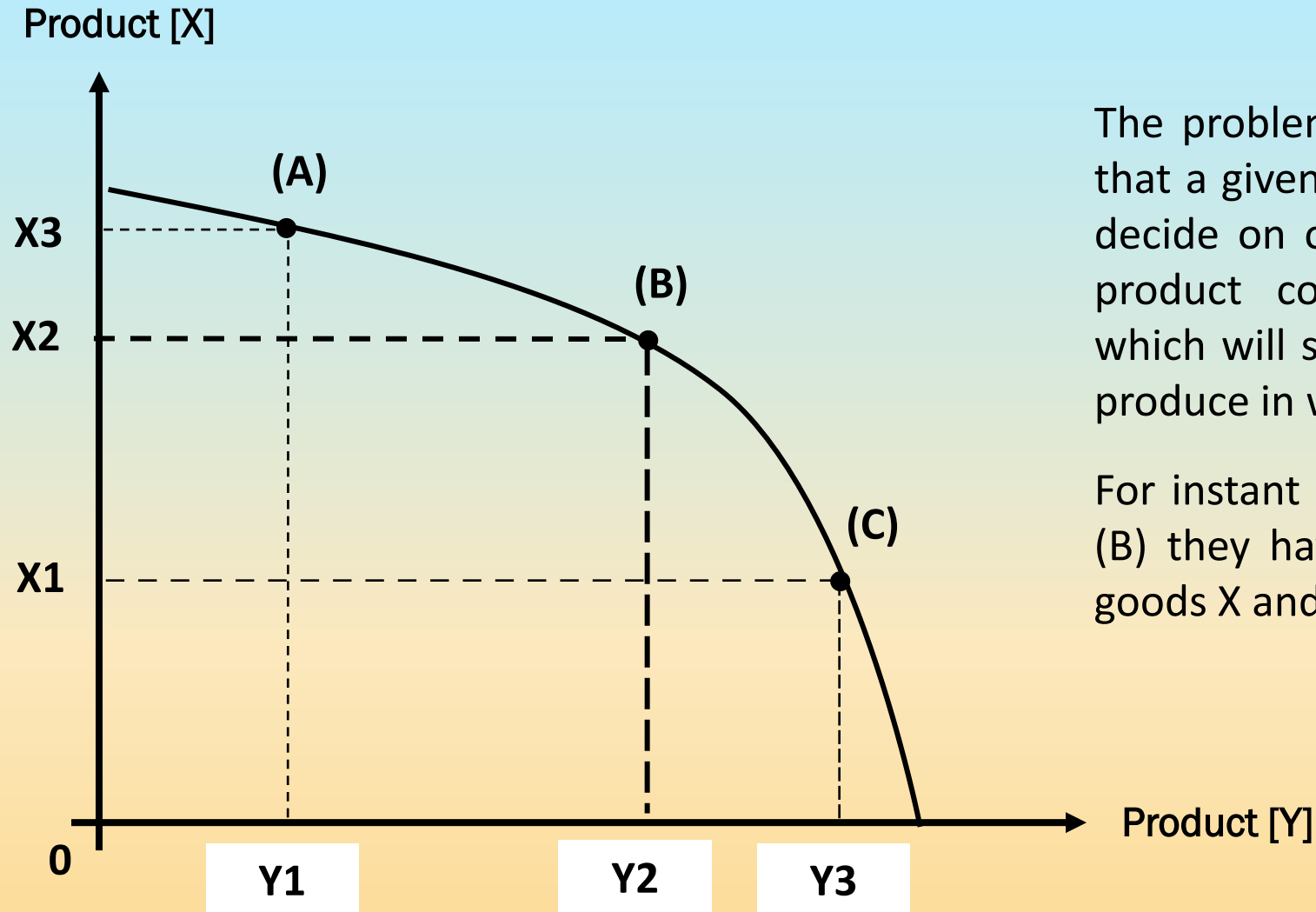
**'How'**



**'Whom'**



## The problem of what to produce and PPF:



The problem of what to produce states that a given economy needs to select or decide on one of the above alternative product combinations (A, B, and C) which will solve the problem of what to produce in what quantity.

For instance if the economy selects point (B) they have decided to produce both goods X and Y in equal quantity.

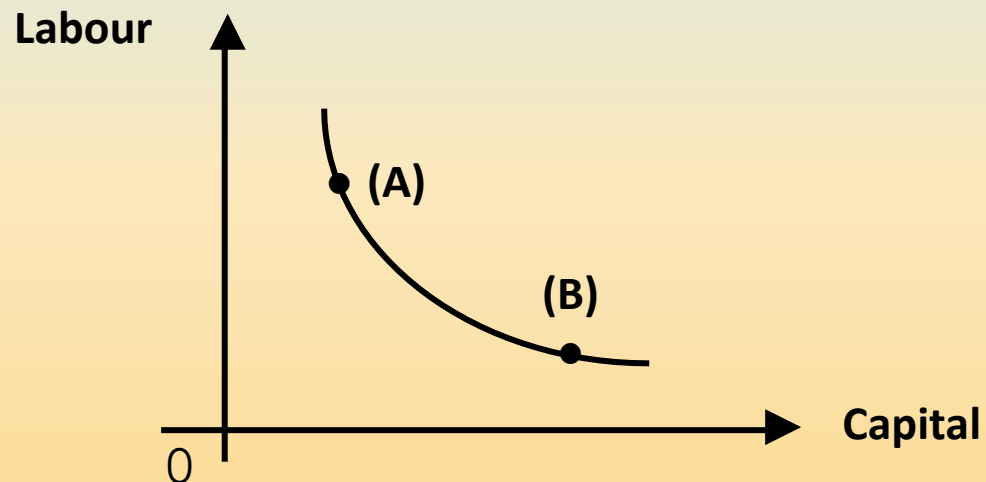
There are two main methods of production that can be used by countries, which can be given as follows.

**(A) Labour intensive technique**

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

**(B) Capital intensive technique**

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



## Answer Input [PQ: 43]

**Outline** how each of the following **Economic Systems'** solve the **Basic Economic Problems** of a society

- (A) Market Economic System
- (B) Command Economic System
- (C) Mixed Economic System

### **(A) Market Economic System**

#### **What to Produce [Solving the Allocation Problem]:**

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.

### **How to Produce [Solving the Production Problem]:**

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.

### **Whom to Produce [Solving the Distribution Problem]:**

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.

## **(B) Command (Centrally Planned) Economic System**

### **What to Produce [Solving the Allocation Problem]:**

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.

## How to Produce [Solving the Production Problem]:

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).

## **Whom to Produce [Solving the Distribution Problem]:**

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**.

## (C) Mixed Economic System

### What to Produce [Solving the Allocation Problem]:

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.

## How to Produce [Solving the Production Problem]:

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.

## Whom to Produce [Solving the Distribution Problem]:

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.



**Answer Input [PQ: 44]**

**State the Criteria to Evaluate the Performance of an Economic System**

**[05 marks]**

- Status of Full employment
- Status of **Economic efficiency**
- Trends in **Economic growth**
- **Price Stability**
- **Faire Distribution of income**
- **External stability**
- Qualitative and conducive environment
- Level of Economic freedom