

# The Economic Problem: Scarcity and Choice

*CIE 3M7 - Messere*

# Scarcity, Choice, and Opportunity Cost

- *Human wants are unlimited, but resources are not.*
  - *Constrained choice and scarcity* are the basic concepts that apply to every society
- Three basic questions must be answered in order to understand an economic system:
  - What gets produced? (consumption)
  - How is it produced? (production)
  - For whom goods get produced? (distribution)

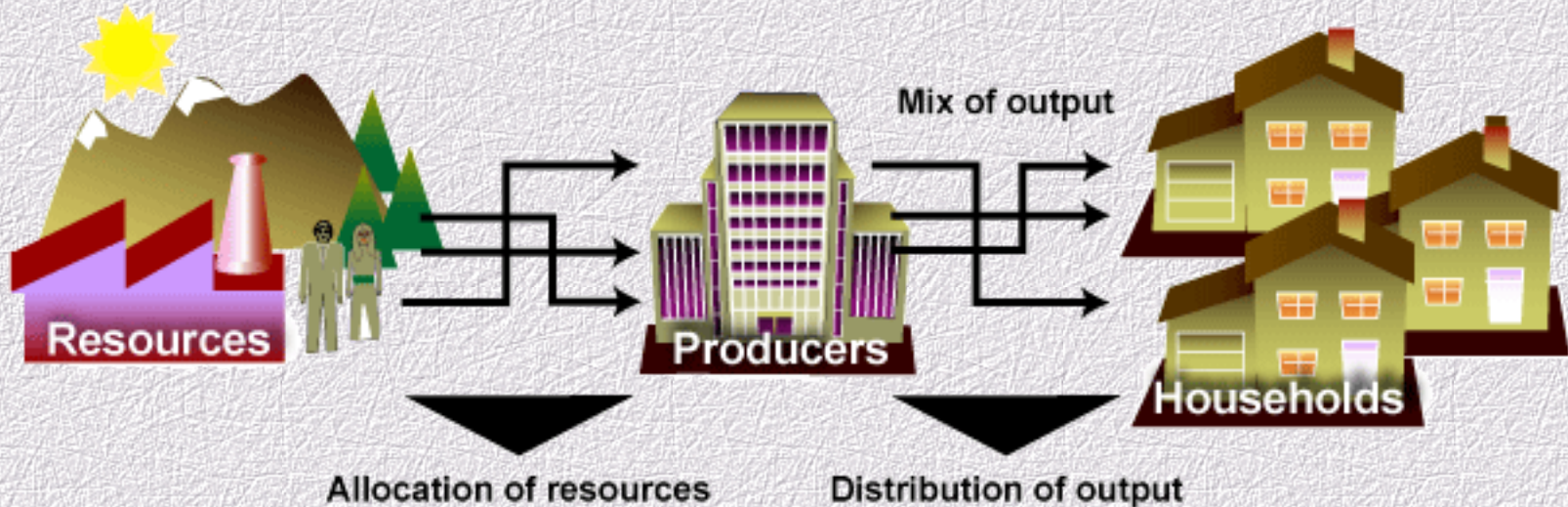
# Scarcity, Choice, and Opportunity Cost

The three basic questions:

1. What gets produced?

2. How is it produced?

3. Who gets what is produced?



- Every society has some system or mechanism that transforms its scarce resources into useful goods and services.

# Scarcity, Choice, and Opportunity Cost

- The basic resources that are available to a society are ***factors of production***:
  - ***Land (natural resources)***
  - ***Labor (human capital)***
  - ***Capital (real)***
  - ***Entrepreneurship*** (*capitalist system only*)
- ***Capital*** refers to the things that are themselves produced and then used to produce other goods and services.

# Scarcity, Choice, and Opportunity Cost

- ***Production*** is the process that transforms scarce resources into useful goods and services.
- **Resources** or **factors of production** are the ***inputs*** into the process of production; goods and services of value to households are the ***outputs*** of the process of production.

# Scarcity and Choice

- **Opportunity cost** is that which we give up or forego, when we make a decision or a choice.
  - *The next best alternative foregone*  
*i.e. if I choose to watch TV, my next best alternative may be to study for economics (I forego potential extra marks earned from studying)*

# Capital Goods and Consumer Goods

- ***Capital goods*** are goods used to produce other goods and services
- ***Consumer goods*** are goods produced for present consumption

# Capital Goods and Consumer Goods

- ***Investment*** is the process of using resources to produce new capital. Capital is the accumulation of previous investment.
  - ***Real investment*** – capital investment undertaken by firms
  - ***Financial (capital) investment*** – savings
- The opportunity cost of every investment in capital is foregone present consumption.

# Economic Systems

- **The economic problem:** Given scarce resources, how, exactly, do large, complex societies go about answering the three basic economic questions?

# Economic Systems

- ***Economic systems*** are the basic arrangements made by societies to solve the economic problem. They include:
  - Command economies
  - Laissez-faire (free enterprise) economies
  - Mixed systems

# Economic Systems

- In a ***command economy***, a central government either directly or indirectly sets output targets, incomes, and prices.
- In a ***laissez-faire (free enterprise / capitalist) economy***, individuals and firms pursue their own self-interests without any central direction or regulation.
  - Individuals seek to maximize *utility*
  - Firms seek to maximize *profits*

# Economic Systems

- The central institution of a laissez-faire economy is the ***free-market system***.
- A **market** is the institution through which buyers and sellers interact and engage in exchange.

# Economic Systems

- ***Consumer sovereignty*** is the idea that consumers ultimately dictate what will be produced (or not produced) by choosing what to purchase (and what not to purchase).

# Economic Systems

- **Free enterprise:** under a free market system, individual producers must figure out how to plan, organize, and coordinate the production of products and services.
- In a laissez-faire economy, the **distribution of output** is also determined in a decentralized way. The amount that any one household gets depends on its income and wealth.

# Economic Systems

- The basic coordinating mechanism in a free market system is price.
- **Price** is the amount that a product sells for per unit.
  - Note: *Price is not the same as cost*
- it reflects what society is willing to pay for a good or service

# Mixed Systems, Markets, and Governments

Since markets are not perfect, governments intervene and often play a major role in the economy. Some of the goals of government are to:

- Minimize market inefficiencies
- Provide public goods
- Redistribute income
- Stabilize the macroeconomy by:
  - promoting low levels of unemployment
  - promoting low levels of inflation