Chapter Two – The Economizing Problem

1. The Foundation of Economics

Two Fundamental Facts constitute the economizing problem:

• Societies *wants* are virtually *unlimited*

• Economic *resources are scarce* or limited

1. Unlimited Wants

* Economic wants – the desire of consumers to obtain and use various goods and services that provide pleasure or satisfaction (utility)
  + Such wants comprise *necessities* (food, shelter, clothing) to *luxuries* (perfumes, yachts, race cars)
  + Certain desires have biological roots, while others are rooted in the trends and customs of society.
  + Over time wants tend to change and multiply, fueled by new products
    - Black and White›Color›HD›3D…
    - Beta›VCR›DVD›Blue Ray…
  + Services, as well as products, satisfy our wants – oil change, legal advice, haircuts…
  + Businesses and government also have wants, although they generally reflect the desires of their constituents – schools, highways, equipment…
  + While a desire for a particular good can be satisfied, Wants in general are insatiable, or unlimited, meaning they cannot be satisfied.
  + Institutions and individuals have innumerable unfilled wants. *The objective of all economic activity is to fulfill wants.*

1. Scarce Resources

* Economic resources mean natural, human, and manufactured resources that go into production of goods and services
* These resources are classified as either *property resources* (land, raw materials, and capital) or *human resources* (labor and entrepreneurial ability)
* *Factors of Production* (Resource Categories):
  + *Land* – includes all natural resources such as land, forests, mineral and oil deposits, and water resources;
  + *Capital* – includes all manufactured aids in producing consumer goods (tools, machinery, equipment)
    - Capital goods differ from consumer goods because consumer goods satisfy wants directly, while capital goods do so indirectly.
    - Capital as used in economics refers not to money, but to real capital, such as tools…
    - Money produces nothing; it is not an economic resource. Money, or financial capital, is simply a means for purchasing real capital.
  + *Labor* – all physical and mental talents of individuals usable in producing goods and services. Simply put, the source of all wealth derives from labor.
  + *Entrepreneurial Ability*:
    - Taking the indicative in combining the resources of land, capital, and labor to produce a good or service;
    - Makes strategic business decisions that set the course of the enterprise;
    - The entrepreneur is an innovator – see, Bill Gates, Henry Ford, Buck Duke
    - The entrepreneur is a risk bearer with no guarantee of profit.
  + Resource Payment – The income received from supplying raw materials and capital equipment is called *rental* income and *interest* income. The income accruing to those supplying labor is called *wages*. Entrepreneurial income is called *profits* or, if negative, *losses*.
  + Relative Scarcity – The factors of production (*inputs*) noted above have one thing in common; they are scarce or limited in supply. Their scarcity constrains productive activity and *output*.

1. Economics: Employment and Efficiency

* Economics is the social science that examines efficiency – the best use of scarce resources.
* Society wants to use its limited resources efficiently; it desires to produce as many goods and services as possible from its available resources, thereby maximizing total satisfaction.
* Full employment: Using Available Resources
  + To realize the best use of scarce resources, a society must achieve both full employment and full production.
  + Full employment – the use of all available resources. No workers should be out of work if they are willing and able to work. Nor should capital equipment or arable land sit idle (unless through conservation measures).
* Full Production – Using Resources Efficiently
  + Full Production – all employed resources must be used so that they provide the maximum possible satisfaction of our economic wants. If full production is not realized, our resources are said to be *underemployed*.
  + Full Production implies two kids of efficiency:
    - Productive Efficiency – The production of any particular mix of goods and services in the least costly way;
      * i.e., Production in small amounts of CDs, versus large scale production of other desired products.
    - Allocative Efficiency – The least-cost production of that particular mix of goods and services most wanted by society;
      * Requires that the economy produce the “right” mix of goods and services, with each item being produced at the lowest-possible unit cost.
        + This means apportioning limited resources among firms and industries in such a way that society obtains the combination of goods and services that it wants the most. How do we determine this? Demand – to be discussed later.
* Production Possibilities
  + Because resources are scarce, a full-employment, full-production economy cannot have an unlimited output of goods and services.
  + People must choose which goods and services to produce (just as they decide which goods to purchase).
  + There is a need for Choice – Society must choose among varied alternatives. If we produce more of this, then less of that. I can buy this now, but must wait until next week for that.
  + Goods satisfy our wants directly.
  + Society chooses to forgo current consumption, thereby freeing up resources that can be used to increase production of other goods.
  + At any point in time, an economy achieving full employment and productive efficiency must sacrifice some of one good to obtain more of another good.
    - Scarce resources prohibit such an economy from having more of both goods.
* Law of Increasing Opportunity Cost
  + Because resources are scarce relative to the virtually unlimited wants they can be used to satisfy, people must choose among alternatives.
  + More pizzas mean fewer robots…. The amount of other products that must be forgone or sacrificed to obtain 1 unit of a specific good is called the marginal *opportunity cost* of that good.
    - Opportunity costs are measured in real terms - in actual goods rather than in money terms.
    - The *Law of Increasing Opportunity Costs* – The more of a product that is produced, the greater is its opportunity cost (the more that is sacrificed to produce it).
      * Why? Because economic resources are not completely adaptable to alternative uses.
      * Many resources are better at producing one good than at producing others. i.e., Fertile farmland is highly suited to producing ingredients needed to make food, while land rich in mineral deposits is better suited to producing materials necessary to make technology.
      * Sometimes resources needed for technology need to be used to produce food, or vice versa. i.e., a greater sacrifice in ethanol production to produce more grain.
      * This lack of perfect flexibility on the part of resources is the cause of increasing opportunity costs.
* Allocative Efficiency
  + Allocative efficiency requires that the economy produce at the most valued, or *optimal*, point.
    - What specific quantities of resources should be allocated to producing ethanol and what specific quantities to grain in order to maximize satisfaction?
  + Economic decisions center on comparisons of marginal benefits and marginal costs. Any economic activity should be *expanded* as long as marginal benefit exceeds marginal cost and should be *reduced* if marginal cost exceeds marginal benefit.
    - The optimal amount of the activity occurs where MB (marginal benefit) = MC (marginal cost).
  + When MB outweighs MC, underallocating has occurred; Where MC › MB, then overallocating has occurred.
  + Resources are being efficiently allocated to any product when the MB and MC of its output are equal (MB=MC).
* Increases in Resource Supplies
  + Resource supplies can and do change over time.
    - i.e., a nation’s growing population will bring about increases in the supply of *labor* and/or *entrepreneurial ability* (two factors of production).
  + The net result of these increased supplies of the factors of production is the ability to produce more. The greater abundance of resources will result in a greater potential output. Society will have achieved economic growth in the form of expanded potential output.
  + Such changes, however, does not guarantee that these gains will automatically be made.
    - i.e., 137 million jobs might give the United States full employment now, but 10 or 20 years from now its labor force will be larger, and 137 million jobs will not be sufficient for full employment.
      * With increased unemployment, the economy will produce less.
  + Technology will also assist:
    - i.e., the development of irrigation programs adds to the supply of arable land.
    - Advancing technology brings new and better goods and improved methods of production, thereby allowing society to produce more goods with fixed resources.
    - Consequently, when supplies of resources increase or an improvement in technology occurs, the ability to produce a larger total output expands.
      * Again, this growth is the result of:
        + Increases in supplies of resources;
        + Improvements in resource quality; and
        + Technological advances
    - While a static, no-growth economy must sacrifice some of one product in order to get more of another, a dynamic, growing economy can have larger quantities of both products.
  + Specialization and Trade will enable a nation to get more of a desired good at less sacrifice of some other good.
    - Specialization and trade have the same effect as having more and better resources or discovering improved production techniques; both increase the quantities of capital and consumer goods available.
    - It enables a nation to obtain more goods than its production possibilities indicate.

1. Economic Systems

* Every society needs to develop an economic system - a particular set of institutional arrangements and a coordinating mechanism – to respond to the economizing problem.
  + The **Market System** (Capitalism) is characterized by the private ownership of resources and the use of markets and prices to coordinate and direct economic activity.
    - In the Market System, each participate acts in his or her own self-interest; each individual or business seeks to maximize its satisfaction or profit.
    - The system allows for the private ownership of capital, communicates through prices, and coordinates economic activity through *markets* – places where buyers and sellers come together.
    - Goods and services are produced and resources supplied by whoever is willing to do so. The result is competition.
    - Economic decision making is widely dispersed.
    - In pure Capitalism – or *laissez-faire* capitalism – government’s role is limited to protecting private property and establishing an environment appropriate to the operation of the market system.
      * The term *laissez-faire* means “let it be,” or keep the government from interfering with the economy.
    - The capitalism practiced in the United States and most other countries is not laissez-faire in that the government does play a substantial role in the economy.
      * The government not only sets the rules, but promotes economic stability and growth. The government, however, is not the dominant economic force in deciding what to produce, how to produce it, and who will get it. That force is the market.
  + The **Command System** is also known as socialism or communism.
    - Government owns most property resources and economic decision making through a central economic plan.
    - A central planning board appointed by the government makes nearly all the major decisions concerning the use of resources, the composition and distribution of output, and the organization or production.
    - A pure command economy relies exclusively on a central plan to allocate the government owned property resources.
      * In reality, however, even the former Soviet Union tolerated some private ownership and incorporated some markets before its demise in 1992.
      * Recent reforms in China and Eastern Europe have to one degree or other transformed their command economies to capitalistic, market oriented economies.
      * China’s reforms have not gone as far, but they have reduced the reliance on central planning.
      * North Korea and Cuba are the last remaining examples of largely centrally planned economies.