Economic Problem

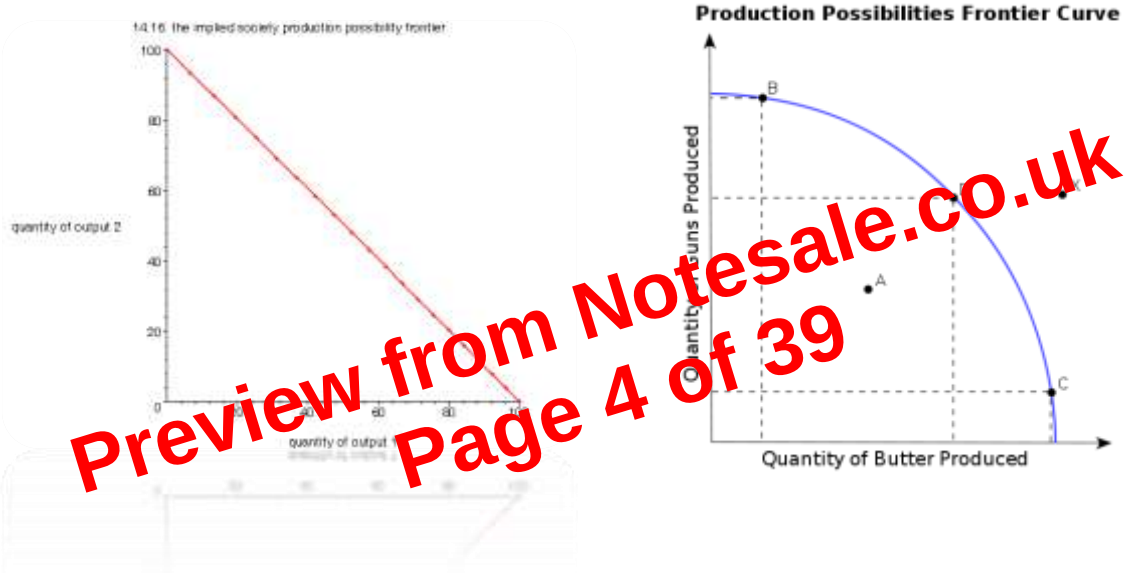
Scarcity

- Unlimited Wants
- Limited Resources
- Alternative Use

Thus decision has to be made of what should be produced, how should be produced and for whom should it be produced.

Opportunity Cost

- Due to scarcity choice has to be made and when a choice is made some goods are foregone for the other, the next best alternative forgone is the opportunity cost.
- This can be represented on a diagram of production possibility curve



- In considerations we take the curve as first one, as in examples of comparative advantage however the production possibility curve can never be linear.
- It will always be as shown in the second diagram, a curve like shape
- This is because all resources that are removed from A cannot be used to produce B, for example workers in a diamond factory cannot be removed and utilised with same productivity and skill in cheese factory, there would be the extra costs of retraining.
- Machines required to make diamonds also cannot be replaced by machines of cheese
- Therefore there is never 100% efficiency in transfer of resources from 2 goods thus curve cannot be linear
- This extent is also known as the mobility of the factors of production, the more immobile the less the efficiency in the transfer of resources
- Example at beginning the more able resources for B good or less able for A good is transferred so opp cost is low, however nearing the end the more able resource for A are transferred to B thus opp cost is high

The system in which the invisible hand is most often assumed to work is the free market. Adam Smith assumed that consumers choose for the lowest price, and that entrepreneurs choose for the highest rate of profit. He asserted that by thus making their excess or insufficient demand known through market prices, consumers "directed" entrepreneurs' investment money to the most profitable industry. Remember that this is the industry producing the goods most highly valued by consumers, so in general economic well-being is increased.

One extremely positive aspect of a market-based economy is that it forces people to think about what other people want. Smith saw this as a large part of what was good about the invisible hand mechanism. He identified two ways to obtain the help and co-operation of other people, upon which we all depend constantly. The first way is to appeal to the benevolence and goodwill of others. To do this a person must often act in a servile and fawning way, which Smith found repulsive, and he claimed it generally meets with very limited success. The second way is to appeal instead to other people's self-interest. In one of his most famous quotes:

Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their own advantage to do for him what he requires of them. Whoever offers to another a bargain of any kind, proposes to do this. Give me what I want, and you shall have this which you want, is the meaning of every such offer; and it is the manner that we obtain from one another the far greater part of those good offices which we stand in need of. It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love.

For Smith, to propose an exchange is to attempt to show another that what you can do, or what you have, can be of use to the other. When you carry out the exchange, it means the other person recognises that what you can do or that what you have is of value. This is why so much of a person's self-esteem is bound up in their job - a well-paid job is supposed to be a sign that others value your contribution and finds it worth exchanging their own resources for.

- Market Failure
- Inequality of Income, rich will get richer
- Instability
- Dominant Firms
- Welfare, those who are fortunate will only get the provision

Command Economy

- Government take responsibility for
    - Allocation of resources
    - Determination of production targets for all sectors of the economy
    - Distribution of income and determination of wages
    - Ownership of most productive resources and poverty
    - Planning long term growth of the economy
- Problems
    - Allocative inefficiency
    - High Costs
    - Tends to act like ‘jail’ effect
    - Firms not as successful as profit motive is not target so individual would not be spirited to work as hard

market supply curve at the efficient quantity. Finally, Panel (d) shows the case of a monopoly firm that produces Q_m units and charges a price P_1. The efficient level of output, Q_e, could be achieved by imposing a price ceiling at P_2. As is the case in each of the other panels, the potential gain from such a policy is the elimination of the deadweight loss shown as the shaded area in the exhibit.

Panel (a) of Figure 15.3, "Correcting Market Failure" illustrates the case of a public good. The market will produce some of the public good; suppose it produces the quantity Q_m. But the demand curve that reflects the social benefits of the public good, D_1, intersects the supply curve at Q_e; that is the efficient quantity of the good. Public sector provision of a public good may move the quantity closer to the efficient level.

Panel (b) shows a good that generates external costs. Absent government intervention, these costs will not be reflected in the market solution. The supply curve, S_1, will be based only on the private costs associated with the good. The market will produce Q_m units of the good at a price P_1. If the government were to confront producers with the external cost of the good, perhaps with a tax on the activity that creates the cost, the supply curve would shift to S_2 and reflect the social cost of the good. The quantity would fall to the efficient level, Q_e, and the price would rise to P_2.

Panel (c) gives the case of a good that generates external benefits. The demand curve revealed in the market, D_1, reflects only the private benefits of the good. Incorporating the external benefits of the good gives us the demand curve D_2 that reflects the social benefit of the good. The market's output of Q_m units of the good falls short of the efficient level Q_e. The government may seek to move the market solution toward the efficient level through subsidies or other measures to encourage the activity that creates the external benefit.

Finally, Panel (d) shows the case of imperfect competition. A firm facing a downward-sloping demand curve such as D_1 will select the output Q_m at which the marginal cost curve MC_1 intersects the marginal revenue curve MR_1. The government may seek to move the solution closer to the efficient level, defined by the intersection of the marginal cost and demand curves.

While it is important to recognize the potential gains from government intervention to correct market failure, we must recognize the difficulties inherent in such efforts. Government officials may lack the information they need to select the efficient solution. Even if they have the information, they may have goals other than the efficient allocation of resources. Each instance of government intervention involves an interaction with utility-maximizing consumers and profit-maximizing firms, none of whom can be assumed to be passive participants in the process. So, while the potential exists for improved resource allocation in cases of market failure, government intervention may not always achieve it.

The late George Stigler, winner of the Nobel Prize for economics in 1982, once remarked that people who advocate government intervention to correct every case of market failure reminded him of the judge at an amateur singing contest who, upon hearing the first contestant, awarded first prize to the second. Stigler's point was that even though the market is often an inefficient allocator of resources, so is the government likely to be. Government may improve on what the market does; it can also make it worse. The choice between the market's allocation and an allocation with government intervention is always a choice between imperfect alternatives. We will examine the nature of public sector choices later in this chapter and explore an economic explanation of why government intervention may fail to move market solutions closer to their efficient levels.

Cyclical Disequilibrium:

Cyclical disequilibrium occurs because of two reasons First two countries may be passing through different paths of business cycle. Second, the countries may be following the same path but the income elasticity's of demand or price elasticity's of demand are different. f prices rise in prosperity and decline in depression, a country with price elasticity for imports greater than unity will experience a tendency for decline in the value of imports in prosperity; while those for which import price elasticity is less than one will experience a tendency for increase. These tendencies may be overshadowed by the effects of income changes, of course. Conversely, as prices decline in depression, the elastic demand will bring about an increase in imports, the inelastic demand a decrease

Secular Disequilibrium:

Sometimes, the balance of payments disequilibrium persists for a long time because of certain secular trends in the economy. For instance, in a developed country, the disposable income is generally very high and, therefore, the aggregate demand, too, is very high. At the same time, production costs are very high because of the higher wages. This naturally results in higher prices. These two factors - high aggregate demand and higher domestic prices may result in the imports being much higher than the exports. This could be one of the reasons for the persistent balance of payments deficits of the USA.

Structural Disequilibrium:

Structural changes in the economy may also cause balance of payments disequilibrium. Such structural changes include the development of alternative sources of supply, the development of better substitutes, the exhaustion of productive resources, the changes in transport routes and costs, etc.

Political Factors:

Certain political factors may also produce balance of payments disequilibrium. For instance, a country plagued with political instability may experience large capital outflows, inadequacy of domestic investment and production, etc. These factors may, sometimes, cause disequilibrium in the balance of payments. Further, factors like war, changes in world trade routes, etc., may also produce balance of payments difficulties.

Social Factors:

Certain social factors influence the balance of payments. For instance, changes in tastes, preferences, fashions, etc. may affect imports and exports and thereby affect the balance of payments

General Level Of Prices; Inflation

Difference between CPI and RPI

- The RPI (Retail price index) includes mortgage interest payments. Thus changes in the interest rates affect the RPI. If interest rates are cut, it will reduce mortgage interest payments. Thus the RPI will fall but not the CPI.
- The RPI also includes council tax and some other housing costs not included in CPI
- The CPI includes some financial services not included in the RPI
- The CPI is based on a wider sample of the population for working out weights.

Main Stages in Calculation

- Base Year chosen, index values 100
- 7000 households asked to keep a record of their expenditure over a period
- Used to decide goods to be included and their relevant weight according to the percentage of consumer expenditure spent on it
- Then every year, average prices of 600 goods chosen , are found and RPI is calculated
- % change in price is multiplied by weight
- Calculates weighted index. , to which we find the average and RPI is determined

Cost of Living

$$\frac{W \times P\ of\ next\ year}{W \times P\ of\ base\ year} = Cost\ of\ Living$$