Chapter 2 The Central Problems Of An Economy

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Central Problems Of An economy

1. Allocation of Resources
   - What to produce?
   - How to produce?
   - For whom to produce?

2. Fuller utilisation of Resources

3. Growth of Resources

Allocation of Resources

1. What to produce?

This is the problem of choice of goods and services . Its raise the problem of choice between certain types of goods I.e

- Consumer goods (used for self consumption)
- Capital goods (particularly the machines used in production process)
- Producer goods (capital goods + raw materials)

- Peace time goods (eatables etc.)
- War time goods (weapons etc.)
- Prestige goods (goods used for comfort)
- Luxury goods (the goods that show the living standard of a person)

Note:- Another problem that arises with the what to produce is to decide that in what quantity the goods must be produced.

2. How to produce?

   This is the problem of choice of technique. Its means which technique should be used in the process of production.

- Labour intensive technique

  It means use of more labour than capital.

  A. Less expensive
  B. More employment
  C. Low GDP growth
  D. Time consuming

- Capital intensive technique

  It means use of more capital than Labour

  A. Expensive
  B. Reduced employment
  C. High GDP growth

D. Faster production

3. For whom to produce

This is the problem of distribution between different sections of the society particularly, the rich and the poor.

- For poor :-. If government want to reduce poverty, unemployment, inequality etc. Then there will be more expenditure on social welfare schemes and programs like mid day meal, free education etc. And this will lead to no returns and profit for govt.
- For Rich :-. To improve GDP and development of the economy the government has to spend more on infrastructure, roads etc. But More expenditure on rich will lead to social inequality.

1. Types of distribution :-

- Personal (means how national income is distributed into different sections of the people of economy.)
- Functional (means how national income is distributed into different production factors)

Four production factors:-

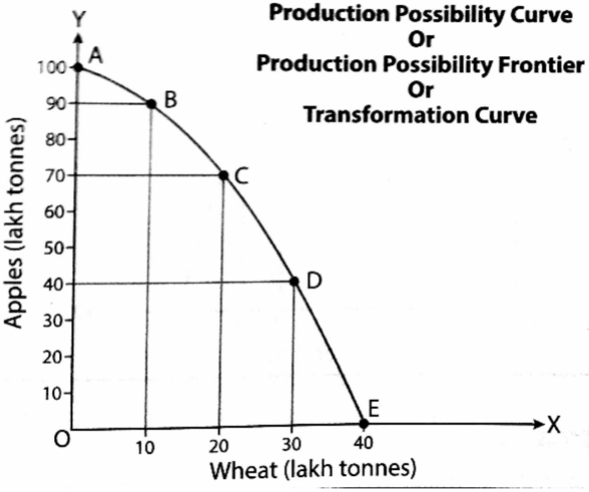
Land, labour, capital and entrepreneur.

Production Possible Curve

PPC is a Curve showing the possible combinations of the goods that can be produced at a given resource.

Assumptions:-

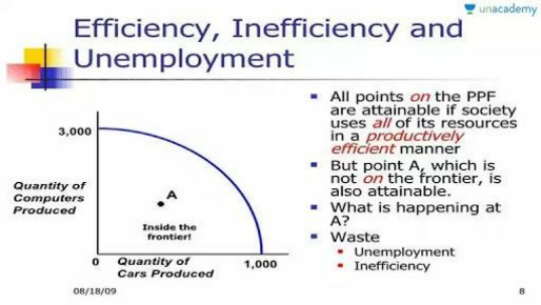
- Resources are given
- Technology remains constant
- Resources are fully and efficiently used
- Resources are not equally efficient



Production Possibility Curve
Or
Production Possibility Frontier
Or
Transformation Curve

Some important observations:--

- On PPC Curve
  1. Potential output
  2. Fuller utilisation of Resources
  3. Symbolises growth of economy
- Inside PPC Curve
  1. Attainable area
  2. Actual output< potential output
  3. Under utilisation of Resources
- Outside PPC Curve
  1. Unattainable area



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Efficiency, Inefficiency and Unemployment

- All points *on* the PPF are attainable if society uses *all* of its resources in a *productively efficient* manner
- But point A, which is not *on* the frontier, is also attainable.
- What is happening at A?
- Waste
  - Unemployment
  - Inefficiency

08/18/09

Why is PPC concave to origin?

- Incresing Marginal opportunity cost / Marginal rate of transformation

  MOC= LOSS/GAIN

  it means that loss of Apples is more than gain than wheat such that MOC goes on increasing.
- PPC is based on law of diminishing

return . For example , in above given diagram we have to sacrifice 20 lakh tonnes of Apples to produce 10 lakh tonnes of wheat... This means that the return is less than the sacrifice.

- PPC is based on the assumption that Resources are not equally efficient

Why PPC slopes downward?

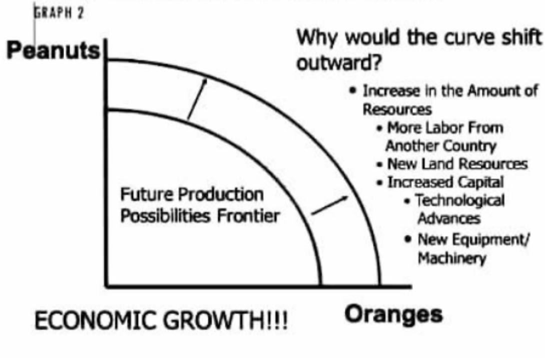
Because PPC is based on the assumption that Resources are limited and not efficient on both the sides . Resources are good at the Apples side And less efficient at wheat side . So when the Apples are sacrificed to produce wheat then the total production goes on decreasing which means that production is decreasing which gives rise to a downwards slope.

Shifting of PPC curve

PPC shifts if there is increase or decrease in Resources or technology on both the sides of PPC.

PRODUCTION POSSIBILITIES CURVE

GRAPH 2



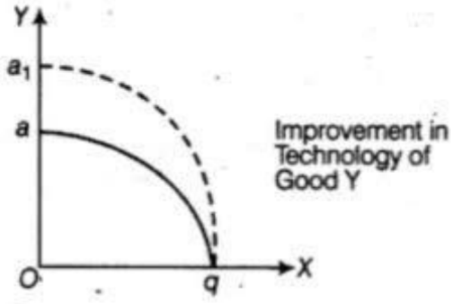
Why would the curve shift outward?

- Increase in the Amount of Resources
  - More Labor From Another Country
  - New Land Resources
  - Increased Capital
    - Technological Advances
    - New Equipment/ Machinery

ECONOMIC GROWTH!!!

Rotation of PPC curve

PPC rotates if Resources or technology increases or decreases on both sides of PPC



Improvement in Technology of Good Y

Factors affecting shifting/rotation/approaching to PPC

Factor.	Reaction
1.FDI	shift

2.GST.	No effect
3.Skill India.	Shift
4.Make in India.	Shift
5.Demonitisation.	No effect
6.Massive Unemploy.	No effect
7.Digital India.	Shift
8.Lock out.	Shift
9.Sarva siksha abhiyan.	Shift
10.Jan dhan yojana.	No effect
11.MGNREGA.	approach
12.Disaster.	Shift
13.Start up.	Shift
14.Clean India.	Shift
15.FII.	Shift

Opportunity cost

Its is cost of availing one opportunity in terms of losing other opportunity.

Total opportunity cost

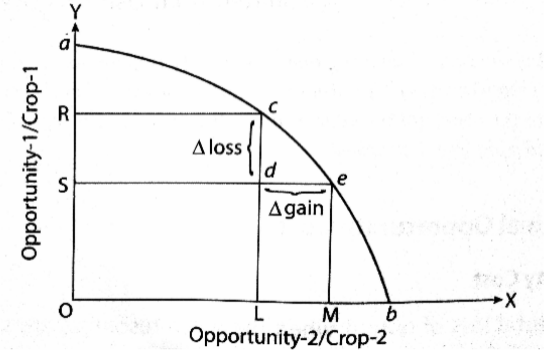
It means loss of output when given Resources are shifted from use1 to use2.

Marginal opportunity cost

Its refers to the ratio of sacrifice of one commodity to produce one more unit of another commodity.

$MOC= \Delta LOSS/\Delta GAIN$

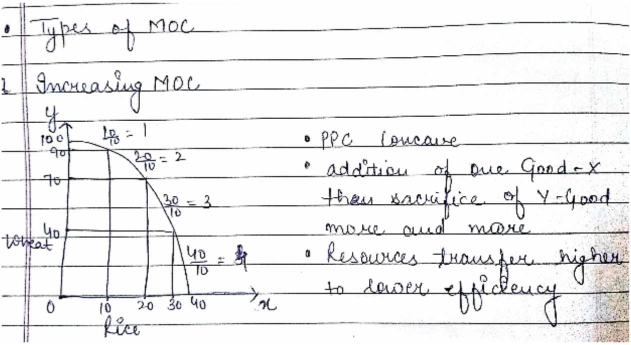
Δ= change



Here MOC= cd/de

TYPES OF MOC

A. Increasing MOC

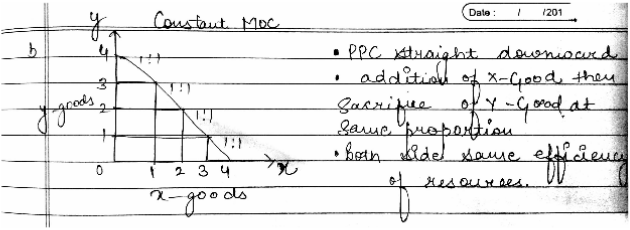

y
100
90
70
40
wheat
10/10 = 1
20/10 = 2
30/10 = 3
40/10 = 4
0
10
20
30
40
x
Rice

- Types of MOC

1 Increasing MOC

- PPC Concave
- addition of one Good-X then sacrifice of Y-Good more and more
- Resources transfer higher to lower efficiency

B.Constant MOC

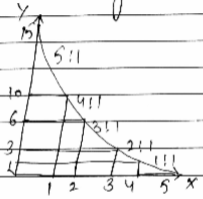

Date : / /201
b
y
4
3
2
1
y goods
1:1
1:1
1:1
1:1
0
1
2
3
4
x
x-goods

Constant MOC

- PPC straight downward
- addition of X-Good then Sacrifice of Y-Good at Same proportion
- Both side same efficiency of resources.

C.Diminishing MOC

c) Diminishing MOC



- PPC convex.
- addition of X-Good then Sacrifice of Y-Good low and low
- Resources transfer from lower to higher efficiency.

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Some help points…

A. FDI means foreign direct investment
B. FII means foreign institutional investment
C. MGNREGA means Mahatma Gandhi National Rural Employment Guarantee Act
D. GDP means gross domestic product
E. GST means goods and services tax.