

STUDY COURSE MATERIAL

SESSION-2020-
21CLASS-XI

TOPIC: CENTRAL PROBLEMS OF AN
ECONOMY

DAY-1

❖ **TEACING MATERIAL**

Central Problems of an Economy -

- What to Produce ?
- How to Produce ?
- For Whom to Produce?
- Solution of Central Problems in Different Economies
- Production Possibility Curve (PPC)
- PPC and Opportunity Cost

1. Central Problems of an Economy

Rich or poor, developed or undeveloped, every economy must face three central problems. These are:

- (i) What to produce?
- (ii) How to produce? and
- (iii) For whom to produce?

Following is a brief description of these problems.

What to Produce?

This problem has two dimensions:

- (i) What goods are to be produced, and
- (ii) In what quantity goods are to be produced.

(i) What goods are to be produced

Broadly, goods are classified as:

- (a) capital goods, (Plant & Machinery, Equipments)
- (b) consumer goods. (Durable goods, Perishable goods, clothing etc)

Production of both capital and consumer goods is essential for the economy. Capital goods (like plant and machinery) are needed for further production and future growth. Consumer goods are needed for present consumption. If the limited resources are largely used for the production of consumer goods, the present generation will enjoy good quality of life. But, lack of capital goods would mean lack of future growth. The future generations would suffer.

Likewise, if the limited resources are largely used for the production of capital goods, the future growth would be high. But, the lack of consumer goods would mean that the present generation will have low standard of living.

Hence, the problem called the 'problem of choice' or the problem of allocation of limited resources' to different uses.

Production of consumer goods is essential to raise standard of living of the present generations.

Production of capital goods is essential for future growth.

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(ii) In what quantity goods are to be produced

Once, we understand that the production of both consumer goods and capital goods is essential, another question arises. How much of consumer goods and how much of capital goods? Because, (owing to limited resources) more of consumer goods would mean less of capital goods and more of capital goods would mean less of consumer goods.

Here, it is important to understand that the loss of quantity of consumer goods is the cost of producing more of capital goods. Likewise, loss of quantity of capital goods is the cost of producing more of consumer goods. In economics, this is called opportunity cost. While shifting resources from one use to the other, we must find out the opportunity cost of doing it. (The concept of opportunity cost is explained in detail in the later section.)

How to Produce?

'How to produce' refers to the technique of production.

Broadly, there are two techniques of production:

- (i) Labour-intensive technique, and
- (ii) Capital-intensive technique.

Labour-intensive technique implies greater use of labour than capital, while capital-intensive technique implies greater use of capital (machines, etc.) than labour. Capital-intensive technique promotes efficiency. It accelerates the pace of growth.

On the other hand, labour-intensive technique promotes employment. The choice between the labour-intensive and capital-intensive techniques becomes a problem because labour-intensive technique helps reduce unemployment, while capital intensive technique accelerates GDP growth. Here again, the root cause of the problem is 'scarcity of resources'. In countries like India, capital is so scarce that fuller utilisation of labour is not possible (Note: Employment of labour needs capital). In rich countries, labour is so scarce that fuller utilisation of capital becomes a problem.

Labour-intensive technique promotes employment. Capital-intensive technique promotes efficiency. If labour-intensive technique is adopted, it solves the problem of unemployment, but efficiency would suffer. Low efficiency would mean low GDP growth.

(iii) For Whom to Produce?

Owing to limited resources, an economy cannot produce goods for all sections of the society to the extent desired. Broadly, every economy has two sections of the society: (i) the rich, and (ii) the poor.

Social justice is promoted if more goods are produced for the poor. It would reduce inequality or promote equality.

But, there is a hidden cost of doing it. By producing poor, the profits of the producers would remain low. Low profits would mean low investment. Implying low GDP growth. The economy would remain backward for a long time to come. Thus, there is a problem of choice: social equality or GDP growth.

Q. 1. Why do the central problems arise in all economies, rich or poor?

Ans. Because, (i) resources are scarce in all economies, rich or poor, and (ii) resources have alternative uses

Q.2. What happens, if resources do not have alternative uses?

Ans. There would not be any problem of choice, or the problem of rational management of resources.

Example: If farming land could be used only for the production of rice (and no other crop) then where is the problem. Just grow rice and relax! The problem arises because farming land can be used for the production of different crops, like rice and bajra.

DAY-3

2. Solution of Central Problems in Different Economies

Different economies solve the central problems differently, as under:

Market Economy

Market economy is a free economy. It means that producers are free to decide 'what, how and for whom to produce'. On what basis do they take their decisions? It is on the basis of supply and demand forces in the market. The decisions are taken as under:

(1) What to Produce? The producers will produce those goods which offer them high profits.

(2) How to Produce? The producers will always use that technology which maximises efficiency and minimises cost.

(3) For Whom to Produce? In a free economy, the producers will produce goods for those people who can afford to pay high price. Poorer sections of the society are often ignored. It causes the problem of Economic Divide

Briefly, in a market economy, the decisions relating to 'what, how and for whom to produce' are taken with a view to maximising profits.

Centrally Planned Economy

In a centrally planned economy, decisions relating to 'what, how and for whom to produce' are taken by some central authority of the government.

All decisions are taken to maximise social welfare, not to maximise profits. Those goods and services will be produced which the central authority (or the government) finds as most useful for the society. That technique of production will be adopted which is socially most desirable. In a situation of mass unemployment, for example, labour-intensive technology will be preferred (rather than capital-intensive technology) so that unemployment is reduced. Enough goods will be produced for poorer sections of the society even when production of such goods is not profitable. Social justice is given priority over profit maximisation.

Briefly, in a centrally planned economy, the decisions relating to 'what, how and for whom to produce' are taken with a view to maximising social welfare.

Mixed Economy

Mixed economy shares the merits of market economies as well as centrally planned economies. Decisions regarding 'what, how and for whom to produce' are taken both to maximise profits as well as social

welfare. In certain areas of production, producers are free to take their decisions with a view to maximising profits. In certain other areas, decisions are taken entirely on the basis of social considerations. Example: In India, producers are free to produce cloth or steel to maximise their profits. But 'railways' are the monopoly of the government. The government provides transport services at nominal rates so that poorer sections of the society can avail them.

Briefly, in a mixed economy, the decisions relating to 'what, how and for whom to produce' are neither left entirely to the market forces nor to any central authority. Both 'market forces' as well as 'central authority' play their role. While market forces tend to maximise profits, the central authority focuses on social welfare.

- In market economies, the central problems are solved through the market forces of supply and demand.
- In centrally planned economies, the central problems are solved by the central authority. In mixed economies, both 'market forces' as well as 'central authority' play their role. While market forces tend to maximise profits, the central authority focuses on social welfare.

DAY-4

3. Production Possibility Curve (PPC) and Central Problems

To illustrate and analyse the central problems, the economists use the technique of PPC (production possibility curve), also called transformation curve or transformation line.

What is Production Possibility Curve (PPC)?

Resources are limited and have alternative uses. Let us assume that the given resources (along with given technology) are used in the production of apples and wheat.

If all the resources are used for the production of apples, 100 lakh tonnes of apples can be produced. And, if all the resources are used for the production of wheat, 40 lakh tonnes of wheat can be produced. If we decide to produce both apples and wheat, the various possible combinations of the two goods are as shown in Table 1. The table showing different possibilities of production of apples and wheat is called production possibility schedule.

Table 1. Production Possibility Schedule

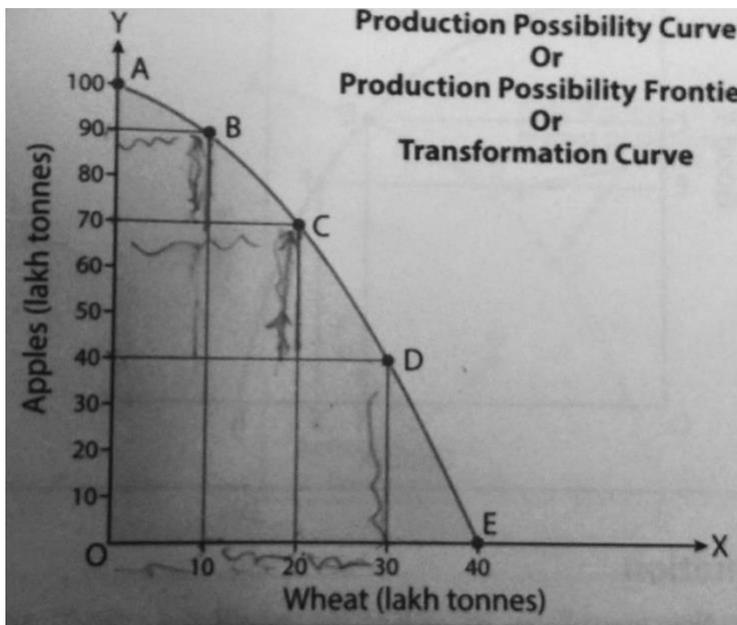
Goods	A	B	C	D	E
Apples (lakh tonnes)	100	90	70	40	0
Wheat (lakh tonnes)	0	10	20	30	40

This table is drawn on the following assumptions:

- (i) resources are given,
- (ii) given resources are fully & efficiently utilised, and
- (iii) technology remains constant.

- Combination A shows that 100 lakh tonnes of apples can be produced without any production of wheat.
- Likewise, combination E shows that 40 lakh tonnes of wheat can be produced without any production of apples. Combination B shows that 90 lakh tonnes of apples and 10 lakh tonnes of wheat can be produced with the given resources and technology.
- Likewise, combination C shows that 70 lakh tonnes of apples and 20 lakh tonnes of wheat can be produced with the given resources and technology.
- Combination D shows that 40 lakh tonnes of apples and 30 lakh tonnes of wheat can be produced with the given resources and technology.
- Representing these various production possibilities on a graph, we get production possibility curve as in Fig.

Production Possibility Curve Or Production Possibility Frontier Or Transformation Curve



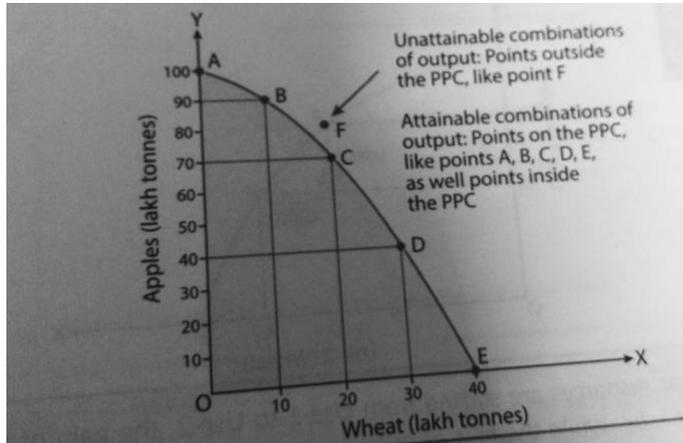
Quantity of wheat is shown on X-axis (horizontal axis) and quantity of apples is shown on Y-axis (vertical axis). Points A, B, C, D and E show different possibilities of production, with the given resources and technology. Joining all these points, we get AE curve. It is the production possibility curve.

We can now define production possibility curve as under:

Production possibility curve is a curve showing different possible combinations of two goods which can be produced with the available resources. The construction of PPC is based on these assumptions:

- (i) resources are given,
- (ii) given resources are fully & efficiently utilised, and
- (iii) technology

PPC helps identify attainable and non-attainable combinations of output.



PPC: Attainable and Non-attainable Combinations

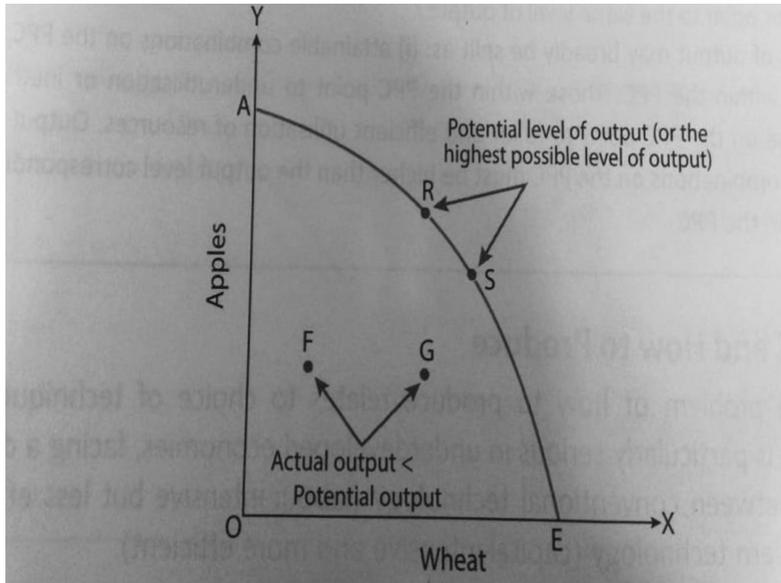
Unattainable combinations of output: Points outside the PPC, like point F

Attainable combinations of output: Points on the PPC, like points A, B, C, D, E, as well points inside the PPC

(ii) PPC helps identify potential level of output. It refers to the maximum

level of output attainable with the available resources. It is related to fuller and efficient utilisation of resources. Actual level of output may be different from the potential level of output. It refers to that level of output which we actually attain. It is less than the potential level of output if the resources are not fully and efficiently utilised. Thus:

Actual Level of Output = Potential Level of Output (always)



If resources are not fully and efficiently utilised

Actual Level of Output < Potential Level of Output

Actual Output = Potential Output, if the economy is operating on the PPC (points R and S, in the Fig. 4).
 Actual Level of Output < Potential Level of Output, if the economy is operating inside the PPC (points F and G in the fig).