Unit 1: Introduction to Economics

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Assessment Objectives

SL/HL Content: Learning Objectives	
AO2	Identify and explain the three basic economic questions
AO2	Distinguish between the role of markets and government intervention in designing and proposing solutions to the basic economic questions
AO2	Distinguish between economic systems: the free market economy, planned economy and mixed economy

The basic economic questions

Scarcity forces every economy in the world to answer three basic questions.

- **What/how much to produce?**
  - All economies must choose what particular goods and services and what quantities of these they wish to produce.
- **How to produce?**
  - All economies must make choices on how to use their resources in order to produce goods and services.
  - Goods and services can be produced by use of different combinations of factors of production, by using different skill levels of labour, by using different technologies or by using different raw materials.
- **For whom to produce?**
  - All economies must make choices about how the gods and services produced are to be distributed among the population.

Test your understanding

Question(s): Read the statements below. Determine whether each statement refers to a market or command system and which economic decision the statements reflect (What?, How? and For whom?)

1. Goods and services are distributed primarily according to ability and willingness of the buyers to pay.
2. Resources are distributed primarily by competitive bidding among producers.
3. The use to which resources are put is determined by the goals set for society.
4. Signals are sent through chains of markets indicating the pattern of consumer choices.
5. Decisions about whether to produce more cars and refrigerators rather than more factories are made by a central authority.

Test your understanding

6. A significant number of goods and services are made available without cost to all citizens.

7. Competitions among producers, stimulated by the desire for profit, motivates producers to keep their costs as low as possible in order to appeal to consumers.

8. The motivation for increased productivity is the desire to reach output goals rather than to make the largest possible profit.

9. The use to which resources are put is determined by the desire for profit.

10. Consumers have choices in the market, but their choices do not act as signals in determining what will be produced.

Resource allocation

Resource allocation refers to assigning available resources or factors of production, to specific uses chosen among many possible alternatives.

- Involves answering the "What/how much to produce?" and "How to produce?" questions.
- If a decision is made to change the amount of goods produced, this involves a **reallocation of resources**.
- If too many units are being produced there is an **overallocation** of resources to production of these units.
- If too few socially desirable goods and services are being produced, we say there is **underallocation** of resources to the production of these.

Test your understanding

Question: Consider the following, and identify each one as referring to output/income distribution or redistribution; or to resource allocation, reallocation, overallocation or under-allocation (note there may be more than one answer.

1. Evidence suggest that over two decades in many countries around the world the rich are getting richer and the poor are getting poorer
2. In Brazil, the rich 10% of the population receive 48% of total income
3. If countries around the world spend less on defence, they would be in a position to expand provision of social services, including health care and education.
4. Pharmaceutical companies spend most of their research funds on developing medicines to treat diseases common in rich countries, while ignoring the treatment of diseases common in poor countries.

Output/Income distribution

The third basic economic question "For whom to produce" involves the **distribution of output**.

- Concerned with how much output different individuals or different groups in the population receive.
- The amount of output people can get depends on how much of it they can buy, which in turn depends on the amount of income they have.
- **Redistribution of income** involves changes in the distribution of income or output so that different social groups now receive more, or less, income and output than previously.

Markets versus government intervention

In the **market method**, resources are owned by private individuals or groups, and it is mainly consumers and firms who make economic decisions by responding to prices that are determined in markets.

In the **command method**, resources are owned by the government, which makes economic decisions by commands.

Government intervention changes the allocation of resources and distribution of output and income from what markets would have achieved working on their own.

1. **Perspective 1:** Markets are able to work reasonably well on their own, and can produce outcomes that generally support society's well-being.
2. **Perspective 2:** Markets have the potential to work well, but in the real world their imperfections may be so important that they make government intervention necessary.

Schools of economic thought

Classical economics follows the belief that a self-regulating economy is the most efficient and maintains that government involvement in managing the economy should be limited as much as possible.

- The free-market economy will allocate scare resources in the most efficient manner to meet the needs of individuals and businesses.

Keynesian Economics follows the view that government should take an active role in managing the economy, particularly in depression/recession like periods.

- Maintains the view that government spending is necessary and important in stimulating economic activity.

Test your understanding

Question: Identify some more examples of command methods (government intervention) in market economies.

Question: Outline the main source of disagreement between those who argue there should be little government intervention in the economy and those who argue the government intervention should be more extensive.

Economic systems

Free market economies are based on the market approach.

- Households and firms are the resource owners and economic decision-makers.
- Product and resource markets determine prices of goods, services and resources.
- **Example(s):** USA, Hong Kong, Singapore

Planned economies is based on the command approach.

- Government makes all allocation and distribution decisions through non-price rationing
- Characterized by the absence of markets or the limited operation of markets
- **Example(s):** North Korea, Cuba, Russia

Economic systems

Mixed economies combine mixed and command elements.

- **Example(s):** Canada, Sweden, Norway

The ideal-type free market and planned economies are distinguished from each other on the basis of three criteria.

Criteria	Free market	Planned economy	Mixed economy
Resource ownership	private	public	both
Decision-making	private	public	both
Rationing system	price	non-price	both