

Economics: Chapter 2 section: 1

The Basic Economic Problem

The existence of scarcity creates the **basic economic problem** faced by every society, rich or poor: how to make the best use of limited productive resources to satisfy human needs and wants.

To solve this basic problem, every society must answer these three basic questions:

1. **What** goods and services will be produced?

For example, an economy must decide whether they should produce kitchen appliances or weapons, build and fix roads or buy textbooks for schools.



2. **How** will goods and services be produced?

For example, should we use copper or plastic to make pipes? Should machines be used to make clothing or should workers make it by hand? Should the power plant be built close to the ocean or inland? Which fertilizer is best for growing strawberries? There are millions of decisions that need to be made to figure out how to produce goods and services.

3. **Who** will consume the goods and services?

Once the goods and services are produced, who will get to consume them? Will people consume them on a first-come, first-served basis? Should goods be allocated or given out by height, weight, religion, age, gender race, looks, strength, health or wealth? How should the goods and services be distributed among the people?

Economic Goals and Societal Values

Societies or communities answer the economic questions in different ways. Societies look at economic goals and make decisions based on what is most valued.

Some economic goals that are considered are:

Economic Efficiency

Making the most of resources without waste is an economic goal.

Economic Freedom

Being able to make choices about which goods and services to produce and distribute without government interference or intervention is an economic goal. This freedom allows entrepreneurs to take risks and make choices to start various businesses.

Economic security

Knowing that goods and services will be available when needed. Having a safety net that protects individuals in a time of economic disaster.

Economic Equity

A fair distribution of wealth.

Economic Growth and innovation

Using new ideas and ways of creating goods and services leads to growth and a higher standard of living or way of life for all.

Economic Systems

An **economic system** is the method used by a society to produce and distribute goods and services.

Several fundamental types of **economic systems** exist to answer the three questions of what, how, and for whom to produce: traditional, command, market, and mixed.

Traditional Economies: In a **traditional economy**, economic decisions are based on custom and historical precedent. For example, in tribal cultures or in cultures characterized by a caste system, people in particular social strata or holding certain positions often perform the same type of work as their parents and grandparents, regardless of ability or potential.

Command Economies: In a **command economy**, governmental planning groups make the basic economic decisions. They determine such things as which goods and services to produce, their prices, and wage rates. Cuba and North Korea are examples of command economies.

Market Economies: In a **market economy**, economic decisions are guided by the changes in prices that occur as individual buyers and sellers interact in the market place. As such, this type of economy is often referred to as a **price system**. Other names for the market system are **free enterprise, capitalism,** and **laissez-faire**. The economies of the United States, Singapore, and Japan are identified as market economies since prices play a significant role in guiding economic activity.

Mixed Economies: There are no pure command or market economies. To some degree, all modern economies exhibit characteristics of both systems and are, therefore, often referred to as **mixed economies**. For example, in the United States the government makes many important economic decisions, even though the price system is still predominant. Even in strict command economies, private individuals frequently engage in market activities, particularly in small towns and villages.

*The key point to remember is that every individual and every society must contend with the problem of scarcity. Every society, regardless of its political structure, must develop an **economic system** to determine how to use its limited productive resources to answer the three basic economic questions of what, how, and for whom to produce.*

