

Fundamental Concept of Economics and Allocations of Resources

Unit 1

Long answer questions

1. Define allocation of resources. Discuss the concept of scarcity and choice.

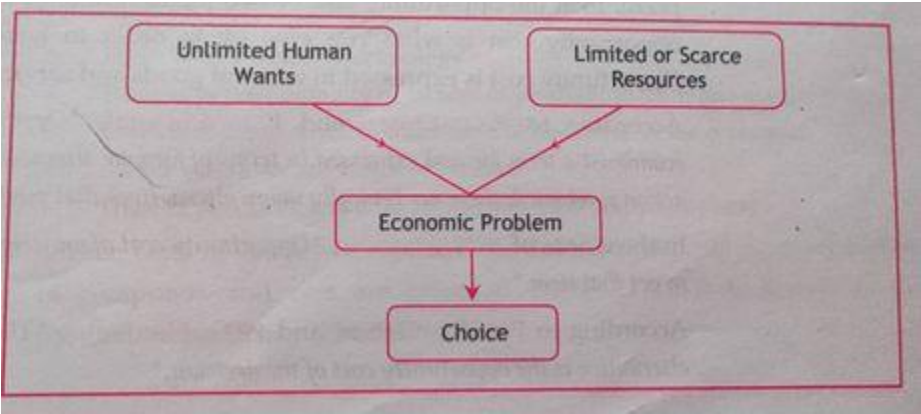
➔ In economics, resource allocation is the assignment of available resources to various uses. In the context of an entire economy, resources can be allocated by various means, such as markets, or planning. In other words, it is the central problem related to the scarcity of resources and unlimited human wants. This problem has been faced by all economies of the world, whether rich and poor. Therefore, sometimes economics is defined as the science of allocation of resources.

Scarcity

Economics is the study of economic problems that arise due to scarce or limited resources and unlimited human wants. This concept was first introduced by Prof. Lionel Robbins in his book 'An Essay on the Nature and Significance of Economic Science' published in 1932 AD. In his opinion, economics is the science which studies unlimited human wants, scarce resources and alternative uses of scarce resources. Scarcity means people do not get anything as much as they want. Since resources are not enough to satisfy all human wants, they have to choose which wants to satisfy now and which want to satisfy later. If we want to have one thing, we will have to sacrifice something else. With limited resources and unlimited wants, people always try to make best use of their resources. If resources were not scarce, it would be possible to satisfy all human wants. This is the basic fact of all economic problems arising in the world. In economics, the word scarcity is a relative concept. For example, there are many motor cars in the Kathmandu valley at present. A common man thinks that there is no scarcity of car. However, it is certain that not everyone who wants car because they all cannot afford to buy a car. Their ability to purchase car is mainly influenced by their income.

Choice

Choice is the process of selection from the available limited alternatives. Economics is the science of choice. It deals with how the resources of society are allocated for the satisfaction of different human wants. An economy cannot produce all goods and services. Whenever the resources are scarce and the human wants are unlimited, the question of choice arises. As a human cannot satisfy all his wants due to the limited resources, s/he has to make a choice. Hence, choice is essential for human beings. If resources were unlimited, there would have been no problem of choice. In case of unlimited resources, we can have all things we want. To satisfy wants, we require the production of various goods and services. But goods and services which satisfy human wants are available in limited quantities because of the scarcity of resources. Therefore, we can not satisfy all wants of people for goods and services. Consequently, we have to make choice among the goods and services in order to maximize our satisfaction. The concept of choice is shown in Figure 1.1.



2. What is division of labour? Discuss the advantages and disadvantages.

➔ Division of labour is the separation of task into different jobs for different workers according to their specialization. There are many examples of division of labour. Let us take an example of construction of building. While constructing a building some labours are assigned to carry bricks, sand, and cement; some are assigned to mix up cement and sand; some are assigned to build walls; some are assigned to plaster the walls., etc. This division of labour leads to repetition of same work and this repetition results specialization in their assigned work. Adam Smith has given the example of making a pin in his time. It was split up into as many as eighteen distinct processes. It increased the production of pins from 20 to 4800 per day person.

The division of labour has both advantages and disadvantages. These are explained below:

Advantages

1. **Right person at the right place:** Since the work is divided into a number of operations, the correct job can be given to a man according to her/his capacity. Operations requiring good physical handling are given to physically strong workers, while those requiring skill are given to specially trained workers.
2. **Improvement in skills:** Practice makes a man perfect. When a man does a certain work over and over again, he is bound to improve his skills.
3. **Increase in productivity:** Productivity will remain very low if there is no division of labour. Division of -labour also helps in increasing the use of machines, there by increasing production and productivity.

4. **Inventions:** When a worker is doing same work over and over again, some new ideas are bound to occur. This leads to inventions. Many of the inventions in the industrial revolution were made by practical workers.
5. **Less time and expenditure required for training:** As the worker has to do only a part of the job, s/he needs to learn only that much. The time needed for training in a part of a job is less than the whole job.

Disadvantages

1. **Monotony of work:** Due to the division of labour, the labour performs same work over and over again. This makes the work monotonous.
2. **Lack of responsibility:** Division of labour means division of responsibility. There is no single person to own the responsibility for over all manufacturing defects. When the result is bad, everybody tries to shift responsibility to somebody else.
3. **Risk of unemployment:** Due to the specialization under the division of labour, worker finds difficulty in finding same job in another industry when s/he is unemployed.
4. **Increase in dependency:** Due to the division of labour, no worker is independently employed. One is dependent on another. If one is absent, the whole production process stops. Such type of dependency is harmful.
5. **Loss of efficiency:** Under the division of labour, a labour is made to work in only one process of the whole production. So, s/he cannot take pleasure and credit for producing any good. Her/his contribution is not

3. What is meant by an economy? Give the major characteristics of a capitalist economy.

- ➔ An economy is a complex system of interrelated production, consumption, and exchange activities that ultimately determines how resources are allocated among all the participants. The production, consumption, and distribution of goods and services combine to fulfill the needs of those living and operating within the economy. An economy encompasses all of the activities related to the production, consumption, and trade of goods and services in an entity, whether the entity is a nation or a small town.

The major characteristics of capitalist economic system are as follows :-

1. **Private property and ownership :** A market economic system always has the institution of private property. An individual can accumulation property and use it according to her/his will. Government protects the right to property. After the death of every person, her/his property goes to her/his successors.
2. **Price mechanism:** This type of economy has freely working price mechanism to guide consumers. Price mechanism means the free working of the supply and demand forces without any intervention. Producers are also helped by the price mechanism in deciding what to produce, how to produce and for whom to produce.
3. **Profit motive:** In this economy, the desire to earn profit is the most important inducement for any economic activity. All entrepreneurs try to start those industries or occupations in which they hope to earn the highest profit. Such industries that are expected to go under a loss are abandoned. Profit is such an inducement that the entrepreneurs are prepared to undertake high risks. We can say that profit motive is the soul of a market economic system.
4. **Competition and co-operation:** A market economic system is characterized by free competition because entrepreneurs compete for getting the highest profit. On the other side, buyers also compete for purchasing goods and services. Workers compete among themselves as well as with machines for taking up a particular work. To produce goods of the required type and quality, workers and machines are made to co-operate so that the production line runs according to schedule. In this way, competition and cooperation go side by side.
5. **Freedom of enterprise, occupation and contract:** Every person is free to start any enterprise of her\his choice. People can follow occupations of their ability and taste. Moreover, there is the freedom of entering into a contract. Employers may contract with trade unions, suppliers with a firm and one firm with another.
6. **Consumers' sovereignty:** In a market economic system a consumer is compared to a sovereign king. The whole production frame works according to her\his directions. Consumers' taste governs the whole production line because entrepreneurs have to sell their products. If a particular type of product is produced according to the preference of consumers, the producer gets higher profit.
7. **Important role of the entrepreneur:** The entrepreneurial class is the foundation of market economic system. The whole of the economic structure of the market economic system is based on this class. Entrepreneurs play the role of leaders in different fields of production. Presence of good entrepreneurs is a must for healthy competition. Entrepreneurs are the main source of dynamism of the market economic system.
8. **Limited role of the government:** Since the market economic system functions through price mechanism, there is obviously little role for the government to play. Thus, the role of government is to maintain law and order and create infrastructures that help to increase production and overall economic development.

4. Explain the concept of production possibility curve ? Explain with suitable diagram.

- ➔ Production possibility curve is defined as the locus of different combinations of any two goods that an economy can produce by the full utilization of its existing resources. In other words, production possibility curve is the graphical explanation of scarcity, choice and opportunity cost. Production possibility curve is also known as the production possibility frontier. The production possibility curve is useful to show the concept of scarcity, choice, and opportunity cost among other things.

According to P.A. Samuelson, "Production possibility curve is that curve which represents the maximum amount of a pair of goods and services that can both be produced with an economy's given resources and technique, assuming that all resources are fully employed."

In the words of N.G. Mankiw, "Production possibility curve is a graph that shows the combinations of output that the economy can possibly produce given the available factors of production and available production technology." Thus, production possibility curve is the graphical representation of any two goods that an economy can produce with the full utilization of all its resources and state of technology.

Assumptions

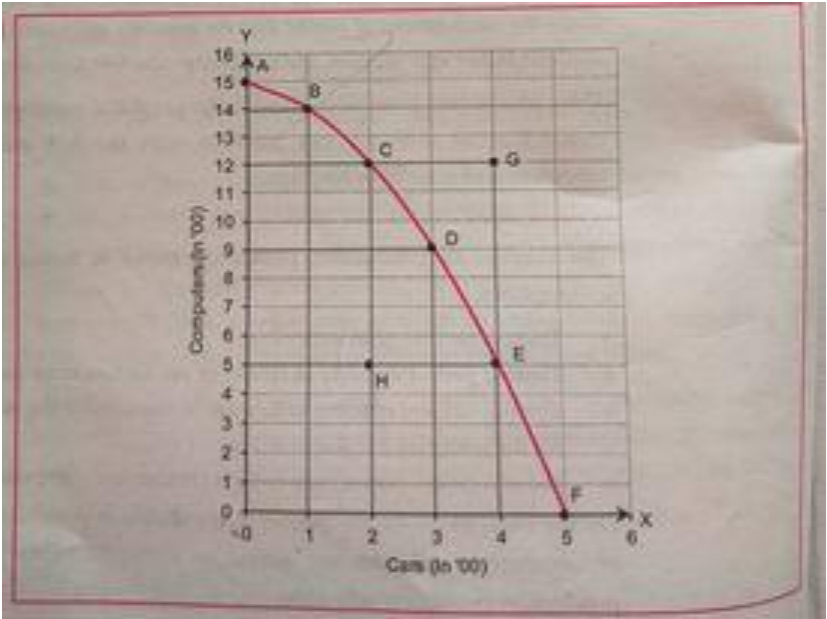
- The concept of production possibility curve is based on the following assumptions:
- There is no change in technology.
- There is perfect mobility of factors of production from one use to another.
- There is full and efficient utilization of resources in the economy.
- All the resources are scarce or limited.
- There is production of only two goods (cars and computers).

On the basis of above assumptions, the different possibilities of production of computers and cars are given in Table 1.1. This is known as the production possibility schedule.

Production Possibilities	Cost	Computers
A	0	15
B	1	14
C	2	12
D	3	9
E	4	5
F	5	0

Table 1.1 shows the different combinations of cars and computers that an economy can produce by the full utilization of its existing resources. If the economy uses all of its resources in the production of computers only, there will be production of 1500 units of computers and no cars (combination A). On the other hand, if the economy uses of all of its resources in the production of cars only, there will be production of 500 units of car and no computers (combination F). Between these extreme limits, there are many other production possibilities. For example, production possibility B, C, D and E show 100 units of cars and 1400 units of computers, 200 units of cars and 1200 units of computers, 300 units of cars and 900 units of computers; and 400 units of cars and 500 units of computers respectively.

We can represent these various production possibilities on a graph and get production possibility curve as shown in Figure 1.2.

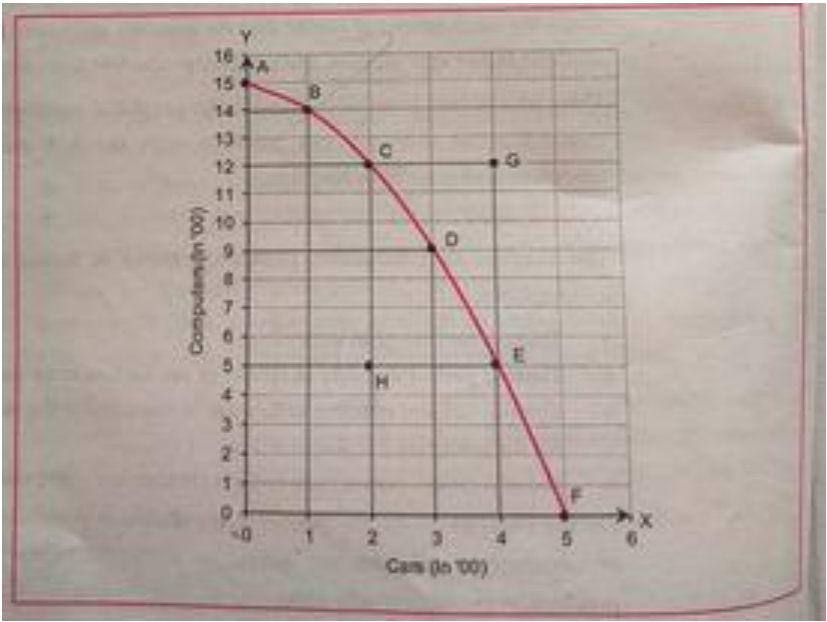


In Figure 1.2, X-axis represents production of cars and Y-axis represents production of computers. The point A shows the production of 1500 units of computers and no cars. Similarly, the point B shows 100 units of car and 1400 units of computers. When we move to point C, D and E the production of computers decreases and the production of cars increases. The point F shows 500 units of cars and no computer. When we join the points A, B, C, D, E, and F, we get the curve AF, which is the production possibility curve. With the given technology, and fully and efficiently utilized resources, the combination of two goods produced can lie anywhere on the production possibility curve AF. The economy cannot produce any combination outside the PPC, i.e. at point G. To produce outside PPC, the economy requires more resources or improved technology. The economy can produce any combination inside PPC, i.e. at point H but this means that some resources are unemployed or inefficient methods of production are being used.

Short answer questions.

1. Define production possibility curve. Explain with production possibility curve.

➔ Production possibility curve is defined as the locus of different combinations of any two goods that an economy can produce by the full utilization of its existing resources. In other words, production possibility curve is the graphical explanation of scarcity, choice and opportunity cost. Production possibility curve is also known as the production possibility frontier. The production possibility curve is useful to show the concept of scarcity, choice, and opportunity cost among other things.



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2. Define division of labour. What are its merits and demerits.

➔ Division of labour is the separation of task into different jobs for different workers according to their specialization. There are many examples of division of labour. Division of labor combines specialization and the partition of a complex production task into several, or many, sub-tasks. Its importance in economics lies in the fact that a given number of workers can produce far more output using division of labor compared to the same number of workers each working alone.

Merits

- Right person at the right place
- Improvement in skills
- Increase in productivity
- Inventions
- Less time and expenditure required for training
- Economy of tools
- Saving of time
- Quality product
- Cheaper things

Demerits

- Monotony of work
- Lack of responsibility
- Risk of unemployment
- Increase in dependency
- Loss of efficiency
- Fear of over production
- Exploitation of women and children
- Growth of slums

3. Explain any five features of mixed economic system.

1. Co-existence of the public and the private sectors: In mixed economic systems, the role of the public sector and the private sector is clearly defined. These two sectors cannot operate in the absence of another. The co-operation between these two sectors is considered important. Mixed economic system encourages a healthy competition between these two sectors of the economy. For example, in Nepal, the government operates the distribution of electricity throughout the country, while the private sector is also involved in the production of electricity.
2. Price mechanism and controlled price: In a mixed economic system, both price mechanism and price control are in operation. Generally, price of consumer goods that are produced by private industries are left to be determined by the market itself. But in the condition of national crisis or huge shortage, price is controlled by the government and public distribution system is made effective. The government can arrange grants, levy taxes, implement rules and regulations as needed.
3. Profit motive and social welfare: Economic activities in mixed economic system are conducted for both the purpose of profit and social welfare as in capitalist and socialist economic systems respectively.
4. Check on economic inequality: In a mixed economic system, the government takes various measures to reduce the gap between the rich and the poor. For example: progressive tax on income and property, grants and allowances for the poor and needy, employment opportunities, different types of subsidies, old age allowances, free health care, free education, etc. These policies help the lower class population to increase their living standard and decrease the income inequality.
5. Economic Planning: Most of the mixed economic systems of the world have taken economic planning as an instrument for rapid economic development and growth. For example, in Nepal the National Planning Commission has been set up by the government. Its main function is to formulate plans in order to allocate and effectively mobilize the resources of the nation.

Very Short answer questions.

1. Why does PPC shift downward?

- ➔ PPC slopes downwards from left to the right. It is because in a situation of fuller utilization of given resources production of both the goods cannot be increased. More of Good X can be produced only with less of Good Y.

2. Define scarcity and choice.

- ➔ Scarcity means the situation in which people do not get anything as much as they want. It is the fundamental fact that gives rise to economic problems. If resources were not scarce, it would be possible to satisfy all human wants.
- ➔ Choice is the process of selection from the available limited alternatives. Economics is the science of choice. It deals with how the resources of society are allocated for the satisfaction of different human wants. An economy cannot produce all goods and services.

3. Define Specialization.

- ➔ Specialization is the process of assigning labour to a specific task within a production process. In the modern times, its importance has increased too much. It is leading to the increased use of machines and large scale production. With the help of specialized equipment, division of labour is implemented by dividing a task into number of jobs for different workers. This is called a division of labour. Division of labour and specialization of labour are similar concepts.

4. Define production possibility curve.

- ➔ Production possibility curve is defined as the locus of different combinations of any two goods that an economy can produce by the full utilization of its existing resources. Production possibility curve is also known as the production possibility frontier.