CHAPTER 1: Central Problem of Economics

THE ABOUT

CHAPTER ANALYSIS

TIME

- Relatively straight forward chapter
- Memory work

EXAM

- Hardly tested alone in essays
- Understanding of PPC & how it works
- Usually ties in with Market Failure, Resource Allocation, Demand & Supply

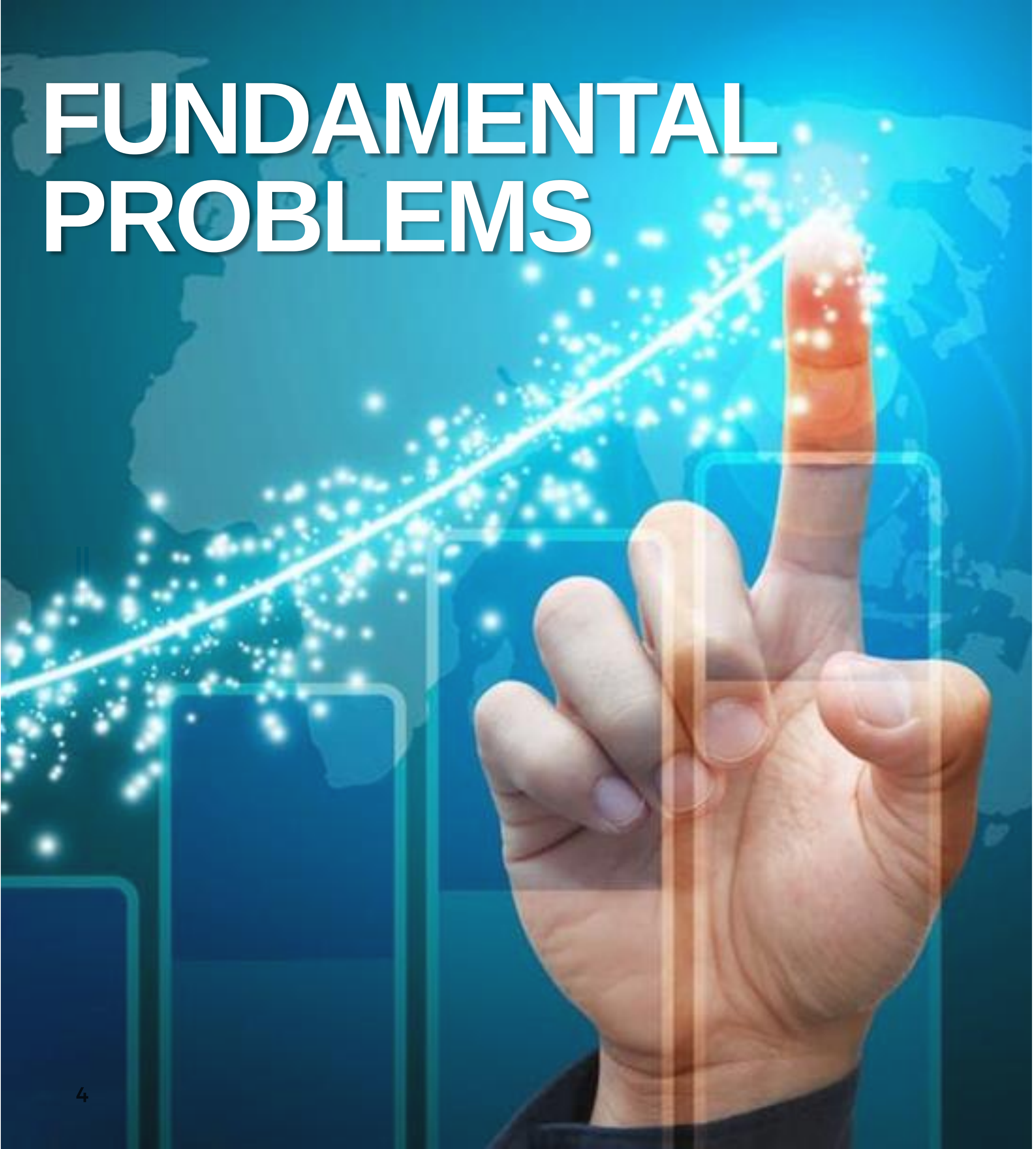
WEIGHTAGE

- Light overall weightage
- Independent 10 marks essay (rarely)

KEY CONCEPT

CENTRAL PROBLEM OF ECONOMICS
FUNDAMENTAL PROBLEMS
MARKET ECONOMY
SELF INTEREST IN RESOURCE ALLOCATION
Production Possibility Curve [Essay]

FUNDAMENTAL PROBLEMS



SCARCITY

Limited resources available are unable to satisfy unlimited human wants.

- ***Unlimited human wants*** *: the desire for higher levels of consumption that are satisfied through consumption of goods and services*
- ***Resources*** *are means of production and are finite in amount which limit quantity of output*

CHOICE

what to produce; how and how much to produce; and for whom to produce the goods and services for.

- As resources are scarce, they have alternative uses.
- Individuals and society must make choices among the alternative uses to maximise use of resources to achieve the highest possible satisfaction.

OPPORTUNITY COST

Opportunity cost measures the cost of making a choice in terms of the next best alternative foregone

MARKET ECONOMY

1

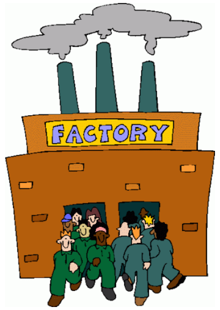
All economic agents (individuals, firms, resource owners) seek to promote their own self-interests

Consumers

Aim to maximise utility from consumption of goods and services given their limited disposable income

Producers

Aim to maximise profits with a given amount of expenditure on resources



Resource Owners

Aim to maximise their factor income on the unit of factors that they own

2 Price Mechanism

- Means by which decisions taken by consumers and businesses interact to determine allocation of scarce resources between competing use.
- Price mechanism serves to signal and ration

Consumer

- Indicate to producers what and how much they desire through the price they are willing and able to pay.
- **Self-interest** of consumers to pay according to the satisfaction they derive from each additional unit of good to maximise utility.

Producer

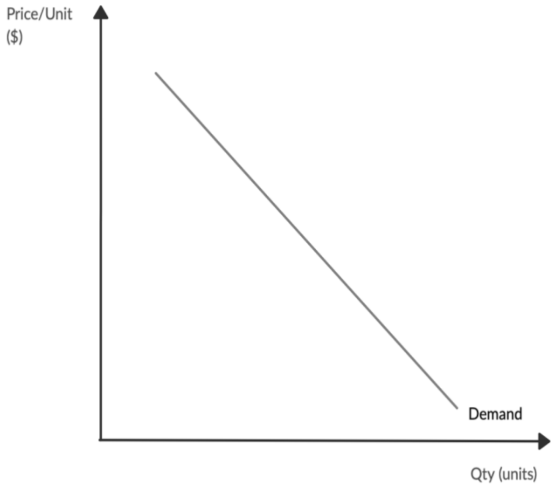
- Higher price signal higher profits for producers
  - Producers' self-interest to maximise profits
  - Incentive to produce goods and services that command high prices.
- Aim to maximise revenue, minimize cost
  - Hence need to maximise use of each factor to achieve highest return

- Consumers must be willing & able to pay for the good
- Supply usually insufficient to meet demands of those who have the **ability** to pay for it
  - Competition amongst consumers → drives up prices
  - Eliminate those unable to pay the higher prices → **ration** goods to those who can afford

MARKET ECONOMY

INTEREST IN RESOURCE ALLOCATION

Demand Curve

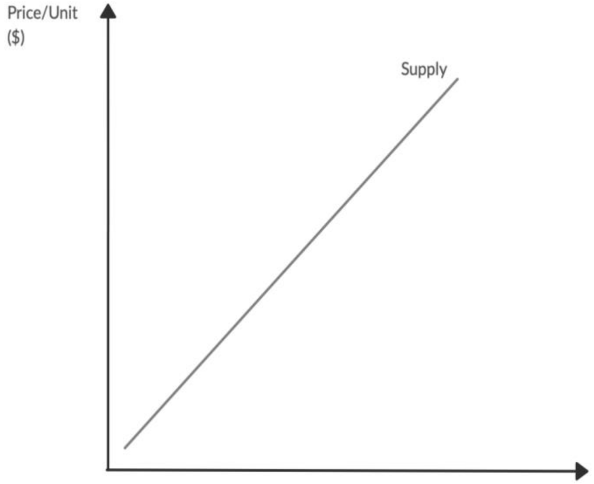


Consumer self-interest:

Maximizing consumer surplus from consumption of G&S, given their limited disposable income.

- Constrained by **ability and willingness** to pay for G&S → must make choices since unable to consume everything.
  - Opportunity costs incurred, because the spending of disposable income on one type of good or service means that another type of good or service must be forgone.
- It is in the self-interest of consumers to pay only according to the satisfaction they receive from each additional unit of output.
- As marginal utility falls, price that consumers are willing to pay also falls. Hence demand curve slopes downwards.

Supply Curve



Producer self-interest:

Revolves around maximizing producer surplus they derive from the sales of goods and services, given limited resources and cost constraints.

- Producers must make choices since it is impossible to produce everything.
- Opportunity costs incurred because the usage of resources to produce one type of good or service means that the production of another type of good or service has to be forgone.
- Producers need to decide *what to produce*, *how to produce* and *for whom to produce*, given the consumers' ability and willingness to pay.
- It is in the self-interest of producers to charge more as marginal cost rises in order to max profits. Hence, supply curve slopes upwards.

Using the PPC, explain the concepts of scarcity, choice and opportunity cost. [10]

Introduction	• Explain how scarcity → Choice → Opportunity cost • **[Reason for scarcity]** Limited resources, unlimited human wants • Relevant definitions
Introduction to PPC	• **[Address point]** PPC reflects scarcity, choice & Opportunity cost • Definition of PPC
Overview of PPC	• Diagram and explanation (Refer to page 9, Figure 1)
Explanation and elaboration on how the PPC reflect scarcity	• **[Address point]** ↑ production capacity in economy → outward shift in PPC → ↓ scarcity, vice versa • **[Explain & Elaborate]** Increase in quantity & Quality of FOP • **[Example]** Education & Training → greater human capital • Hence PPC shifts outwards
Explanation on how the PPC reflect choice	• **[Address point]** Change in taste & preference → movement along PPC → change in choice • **[Explain & Elaborate]** Change due to technological advancement • **[Example]** Invention of smartphones & tablets → consumers prefer electronic publications → market more inclined to produce more electronic publications
Explanation on how the PPC reflect opportunity cost	• **[Address Point]** PPC is concave to the origin because opportunity cost of producing good increases as its quantity increase • **[Explain & Elaborate]** As economy produces more of a good, it has to use resources not equally suitable for production of different goods → give up producing more units of other goods to produce each additional unit of the good • **[Example]** Farmer had to use less fertile land to increase production of strawberries → yield of strawberries/ acre of land ↓ • Hence PPC is concave

**FOP : Factor Of Production*

PPC CURVE

Figure 1: The PPC

Figure 2: Outward shift of PPC Curve

Outward Shift (↑ Productive Capacity)	Inward Shift (↓ Productive Capacity)
Improvement in technology ↑ Quantity & Quality of FOP	↓ Quantity & Quality of FOP

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