

# 1 Economic methodology and the economic problem — answers

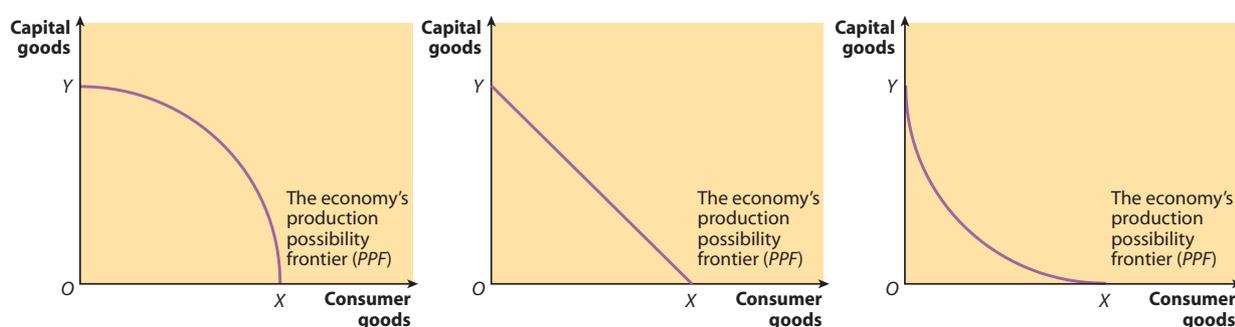
## Test yourself

### Test yourself 1.1

A factor in real life which may prevent a person from making a rational decision is ‘gambler’s fallacy’. For example, if the gambler throws a coin five times and it lands as ‘heads’ in each case, he may believe that the next throw will also be ‘heads’, or the opposite, that a ‘tails’ is about due. In reality, each throw is an independent event with a 50/50 likely outcome.

### Test yourself 2.1

Consider the three production possibility frontiers set out below:



The production possibility frontier (*PPF*) in the left-hand panel of the diagram is the ‘standard’ textbook diagram, showing — as explained in Book 1, page 12 — an increasing opportunity cost in terms of lost output of the other type of good as output of either capital goods or consumer goods is increased. The *PPF* curve in the middle panel of the diagram, which is similar to that in Book 1, page 16, shows a constant opportunity cost, again as output of either capital goods or consumer goods is increased. Finally, the *PPF* curve in the right panel of the diagram, which ‘bows’ inward towards origin, provides the answer to this ‘Test Yourself’ question, namely a falling opportunity cost as output of either capital goods or consumer goods is increased. Though mathematically possible, a *PPF* curve with this shape is highly unlikely in the real world. Can you think why?

## Case studies

### Case study 1.1

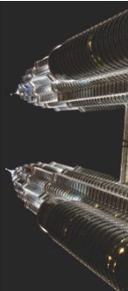
- 1 A pure market economy would be one in which markets exist for all goods and services and in which no goods or services are provided ‘outside the market’ — for example, by the state. Such economies do not actually exist, at least in the developed world. In more developed economies, such as the UK, market and non-market sectors exist side by side — though in the UK at the present time the market sector is growing and the non-market sector is declining. The market sector is the part of the economy in which markets exist, and in which goods and services are bought and sold with prices being charged.
- 2 Planned economies are also known as command economies. In such an economy the state would be responsible for production, making all or most of the decisions about which goods and services to produce. It is worth remembering that few if any real-world economies are either complete command economies or pure market economies.

## Case study 1.2

- 1 Private enterprise, which is often called free enterprise, occurs when the means of production are privately owned. For some, this may conjure up a picture of the economy depicted by Napoleon Bonaparte when describing Britain as a ‘nation of small shopkeepers’. Millions of small businesses do, of course, exist in a private enterprise economy, typified by sole traders or individual proprietorships, and small partnerships. However, private enterprise in the UK is dominated by companies, where the means of production are owned by company shareholders. Private companies can be recognised by the letters ‘Ltd’ in the business name, while the name of a public company contains the letters ‘PLC’.
- 2 Privatisation and marketisation are two processes through which the size of the market sector of the economy has increased in the UK, and is continuing to increase. Privatisation, which relates to the changing ownership of firms or indeed whole industries, occurs when the state sells previously state-owned firms or industries to the private sector. The private sector grows at the expense of the public sector or state sector of the economy. Marketisation, by contrast, occurs when prices are charged for goods or services previously provided free at the point of consumption, with their cost of provision previously borne by taxpayers.

## Questions

- 1 A positive statement is a statement of fact which can be tested against evidence to see if it is true. An example is the statement: ‘By the year 2050, on average, women will live to 90 years of age.’ Obviously, this statement cannot be tested at the time you are answering this question, but if you were still around in 2050, you could test the statement then. A normative statement contains at least one value judgement, which means that it cannot be tested against evidence. The statement ‘Non-fiction is better than fiction’ is a normative statement.
- 2 A need is a requirement for survival, e.g. housing in a cold climate. A want is a desire for something which is not necessary for survival, e.g. a 30-bedroom mansion.
- 3 An economy exists, first, because human wants for goods and services are unlimited, and second, because the resources needed for the production of goods and services are scarce. Wants being unlimited, and our productive resources being limited, this means that it is impossible to meet all people’s wants. For the economy to use its scarce resources to provide maximum economic welfare for society’s members, it faces the fundamental economic problem of *what to produce, for whom to produce, how to produce, when to produce, where to produce* and how to allow its inhabitants to *exercise consumer choice*.
- 4 Because goods and services are scarce in relation to demand, in a market economy or the market sector of a mixed economy, the price mechanism operates to equate supply with demand. Consumers consider the range of prices being charged for the goods that might meet their wants, and then choose the ‘bundle’ of goods they wish to buy. When making consumption decisions and exercising economic choice, consumers are operating within a budget constraint (or income constraint). Choice in conditions of scarcity always involves opportunity costs, namely the ‘second-best’ alternatives which are sacrificed when choosing to buy the ‘first best’ alternative.
- 5 In his famous treatise *Principles of Economics*, published in 1890, the great neoclassical economist Alfred Marshall asserts that there are four factors of production: land, labour, capital and organisation. The latter is known as ‘enterprise’ or the entrepreneurial factor of production. The entrepreneur is the coordinating factor of production. Entrepreneurs, who respond to the first four of the questions posed in the answer to question 3 above, bring together the other factors of production, deciding for example how much labour and capital to employ. Marshall believed that entrepreneurship is the driving force in the organisation of production.



- 6 An environmental resource is a resource such as the natural fertility of the soil, the minerals in the crust of the earth, a benign climate and the fish in the oceans. In a way, such resources are ‘God-given’ or the fruits of the natural environment. Renewable environmental resources are those which, as they are used, are not depleted, and therefore are available to be used again. River water used in a hydroelectric scheme to produce electricity is an example. By contrast, the coal, oil or gas which are burnt to produce electricity in a fossil-fuel burning power station, are used up as they are used. Although they are natural resources, they are non-renewable and subject to depletion as they are used.
- 7 The production possibility frontier drawn in the diagram below, which appears as Figure 3.1 in Book 1, page 12, illustrates the choice between producing capital goods and producing consumer goods. Assuming a limited supply of resources or factors of production, a given state of technical progress benefited from to the full, and full employment of available resources (including labour), the economy produces on its *PPF* curve at a position such as *A*. This means that  $K_1$  capital goods and  $C_1$  consumer goods are being produced. The diagram also assumes that factors of production can be switched very quickly from the production of capital goods to the production of consumer goods, and vice versa, for example from point *A* to point *B*. It follows that, unless economic growth moves the *PPF* curve outwards, production of capital goods can only increase to  $K_2$  if a certain amount of consumer goods ( $C_1$  minus  $C_2$ ) are given up. This is the opportunity cost, in terms of production, of producing  $K_2$  minus  $K_1$  more capital goods.

