

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.

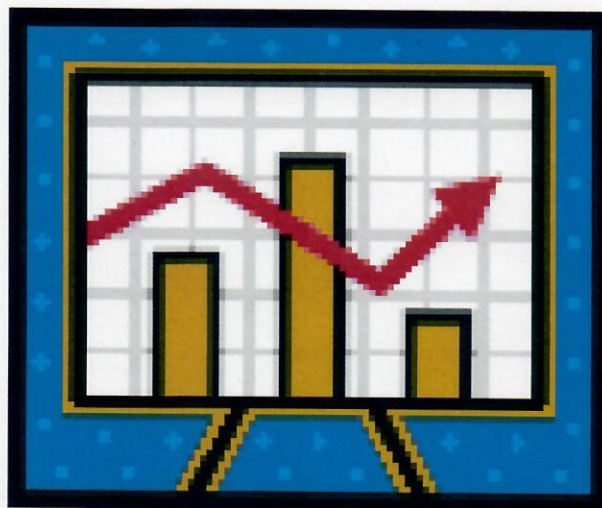
Traditional Economies: In a **traditional economy**, economic decisions are based on custom and historical precedent. For example, in tribal cultures or in cultures characterized by a caste system, people in particular social strata or holding certain positions often perform the same type of work as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



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Three Economic Questions: What, How, For Whom?

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Three Economic Questions: What, How, For Whom?

What It Means

In order to meet the needs of its people, every society must answer three basic economic questions:

- What should we produce?
- How should we produce it?
- For whom should we produce it?

A society (or country) might decide to produce candy or cars, computers or combat boots. The goods might be produced by unskilled workers in privately owned factories or by technical experts in government-funded laboratories. Once they are made, the goods might be given out for free to the poor or sold at high prices that only the rich can afford. The possibilities are endless.

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Although every society answers the three basic economic questions differently, in doing so, each confronts the same fundamental problems: resource allocation and scarcity.

Resources are all of the ingredients needed for production, including physical materials (such as land, coal, or timber), labor (workers), technology (not just computers but, in a broader sense, all the technical ability and knowledge that is necessary to produce a given commodity), and capital (the machinery and tools of production). *Scarcity* refers to the essential fact that people's wants or desires are always going to be greater than the resources available to fulfill those wants.

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Simply put, scarcity means that resources are limited. No country can produce everything, no matter how rich its mines, how massive its forests, or how advanced its technology. Because of the constraints of scarcity, then, decisions must be made about resource allocation (that is, how best to allocate, or distribute, resources for the maximum benefit of the society).

When Did It Begin

Questions of scarcity and resource allocation are as old as human civilization. Throughout history every society—whether society is defined as a nation, a tribe, or a single family—has had to determine what to produce, how, and for whom. While indirect attempts to answer these questions can be found in the writings of the ancient Greek philosophers Plato (c. 427–c. 347 bc) and Aristotle (384–322 bc), the questions were not articulated in their current form until economics was introduced as a discipline of study more than a thousand years later.

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Modern economic theory as we know it today is founded on the writings of the Scottish philosopher [Adam Smith \(/people/social-sciences-and-law/economics-biographies/adam-smith\)](#) (1723–90), especially his best-known work, a five-book treatise called *An Inquiry into the Nature and Causes of the Wealth of Nations*. Ever since this groundbreaking work was published in 1776, many competing economic theories have been presented, but all of them have been organized around the attempt to answer the three basic questions.

More Detailed Information

For every society the answers to the three basic questions depend on what kind of economic system it uses. The term *economic system* refers to the way in which a society organizes the production and distribution of good and services. The system that a society chooses reflects the philosophical and political ideas on which that society is founded. Historically, there have been three basic types of economic system: traditional, command, and market.

Traditional Economic System:

A traditional economy is rooted in long-standing cultural customs. Resources (especially land) are allocated through inheritance or by decisions of cultural leaders, and the new generation performs the same economic roles as their parents and grandparents before them. Traditional economies are founded on a strong philosophy of social interdependence and community. They usually revolve around subsistence farming, in which food is grown to feed the members of the community, not to sell or trade in markets. Although most traditional economies have been replaced by more modern economic systems, they can still be found in the agricultural areas of developing countries in Asia, Africa, and [South America \(/places/oceans-continents-and-polar-regions/oceans-and-continents/south-america\)](#).

Command Economic System:

A command economy (also called a planned economy or centrally planned economy) is one in which economic decisions are controlled by a central authority, usually the state (government). The state controls the society's capital (means of production) and decides how resources should be allocated (including what should be produced, how prices should be set, and how much people should be paid for their work). Command economies go hand in hand with socialist or communist political philosophies, which emphasize the equal distribution of wealth but do not support individual entrepreneurship or the acquisition of private property. The [Soviet Union \(/places/commonwealth-independent-states-and-baltic-nations/cis-and-baltic-political-union-philosophy/soviet\)](#) was the most prominent planned economy of the twentieth century.

Market Economic System:

A market (also called capitalist) economy is one in which answers to the three basic questions are the cumulative result of many individual decisions about what to buy and what to sell in the public marketplace. Buyers express their preference for certain goods and services, thereby influencing what is produced. The means of production are privately owned by sellers, who try to produce things as cheaply and efficiently as possible in order to make a profit (meaning that they sell an item for more than it cost to produce). In its purest form a market economy should function without any government intervention. Market economies are founded on the idea that the good of the whole society depends upon freedom of choice, competition, and the right of every individual to pursue private wealth. The [United States \(/places/united-states-and-canada/us-political-geography/united-states\)](/places/united-states-and-canada/us-political-geography/united-states) is the largest market economy in the world.

In reality, most countries employ some mix of economic systems. For example, although the [United States \(/places/united-states-and-canada/us-political-geography/united-states\)](/places/united-states-and-canada/us-political-geography/united-states) identifies itself as a market economy, the government controls public education, the [postal service \(/social-sciences-and-law/economics-business-and-labor/businesses-and-occupations/postal-service\)](/social-sciences-and-law/economics-business-and-labor/businesses-and-occupations/postal-service), and a number of other enterprises that are integral to the functioning of the economy. The U.S. government also imposes various business regulations that supersede market forces, such as a [minimum wage \(/social-sciences-and-law/economics-business-and-labor/labor/minimum-wage\)](/social-sciences-and-law/economics-business-and-labor/labor/minimum-wage) that all businesses must pay their workers, emissions standards that limit pollution, and [excise taxes \(/social-sciences-and-law/economics-business-and-labor/taxation/excise-taxes\)](/social-sciences-and-law/economics-business-and-labor/taxation/excise-taxes) designed to offset the negative social impact of certain goods, such as cigarettes. Implicit in such regulations is the idea that freedom to profit (in a pure, unregulated market) is not the only measure of public good. In the United States there is constant debate about how much or how little the government should intervene in the market.

Recent Trends

In the 1980s most of the world's command economies began to embrace elements of the market system. In 1985, for example, President Mikhail Gorbachev (b. 1931) introduced in the [Soviet Union \(/places/commonwealth-independent-states-and-baltic-nations/cis-and-baltic-political-geography/soviet\)](/places/commonwealth-independent-states-and-baltic-nations/cis-and-baltic-political-geography/soviet) an economic-reform program called perestroika (the Russian word for "restructuring"). The reforms led to economic upheaval, however, and the Soviet Union collapsed in 1991. Since then Russia and other former Soviet countries have continued to gravitate toward a market economic system, but the process has been fraught with difficulties.

In the late twentieth century the country that had transitioned most successfully from a command to a market economy was China. Beginning in the late 1970s, reforms in China were carried out as the government began to relinquish its control over the means of production and allow market forces to exert an increasing influence over the three basic economic questions: what gets produced, how it gets produced, and for whom it gets produced. Despite these changes, in the early years of the twenty-first century China still described itself as a "socialist market economy."

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