Chapter 1

The Economic Problem

Economic Resources

The main focus of economic thinking is the efficient allocation of scarce economic resources among competing uses in order to satisfy ever-increasing human wants. The study of economics provides us with powerful decision-making tools.

Economic resources can be classified into four major categories: land, labour, capital and entrepreneurship. They are commonly referred to as factors of production since the creation of goods and services depends on a combination of these resources.

Land includes the free gifts of nature. The natural resources constitute the main raw materials used in production and are extracted or harvested from land, sea and outer space. Some of these resources are finite or non-renewable (e.g. gold, oil, coal, and copper) while others, under certain conditions, are renewable (e.g. freshwater, forests and fish).

Labour generally refers to the mental and physical abilities of mankind that can be used for the production of goods and services. Production requires a variety of labour inputs such as those provided by accountants, stockbrokers, clerks, computer programmers, webmasters, salesmen, mechanics, builders, electricians and machine operators. The demographic characteristics of the population determine the human resource potential of a country but not everyone actively participates in the production effort. That part of the population that is willing and able to work represents collectively the labour force (the total number of people employed and unemployed).

Capital is best described as man-made tools, equipment, instruments, plant and machinery that enhance production. Fixed capital provides a stream of services over a lifetime often associated with machinery, fixtures, factories, hotels and operating establishments. Working capital incorporates stocks of raw material, semi-finished products and finished products and assists in making the production process continuous and demand fluctuations smoother. Although it is convenient to give a monetary value to these productive assets and to talk of financial capital that represent claims on wealth, what drives and furthers production are real assets.

Entrepreneurship is a special form of human activity. It involves a combination of risk-bearing and management elements. For production to occur, someone must take upon himself/herself the risks involved in business start-up and operation as well as organizing and managing the other factors of production. The entrepreneur can either manage directly the business or appoint specialists, managers and directors to run the business in his stead. If the business goes bust, the entrepreneur loses whatever he/she invested in the business. Unless they are also shareholders or business partners, managers are salaried employees, not necessarily entrepreneurs. Thus, while sole traders and shareholders are entrepreneurs, chairpersons and chief executives of large corporations who do not have any stake in the business are simply part of the labour employed (company employees).

The Economic Problem

The fundamental economic problem which is universal in nature is that the available resources (land, labour, capital and entrepreneurship) are not enough to produce goods and services to satisfy ever increasing human wants. The more firms produce goods and services, the faster consumer demand rises. No matter the scope and the incredible increase in the world capacity to produce over time, there are still too many people chasing relatively fewer goods. The problem is not that resources are in limited in supply but rather that they are scare relative to insatiable wants. Scarcity of resources highlights the inseparable elements of demand and supply aspects underlining the economic problem. Economic problems and likewise economic solutions can often be reduced to a question of supply and demand.

The fact that resources are scarce implies people have to make choices among available alternatives. Choices are normally perceived as positive decision-making opportunities. From an economic point of view, choices involve a sacrifice or a cost in terms of foregone alternatives. Income constrains force household to choose, for example, between a holiday abroad and buying a house. Choosing to buy the house would involve giving up the vacation and likewise opting for a holiday abroad incurs a cost in terms of the lost opportunity to buy a house. Similarly, a firm is always constrained by the resources at its disposal. For example, choosing to dedicate scare resources to the production of beer, a firm foregoes the potential opportunity to manufacture pyjamas and vice versa. Even national governments which have more resources available than other business organizations, are constrained to make tough choices in their unenviable pursuit to satisfy their citizens' expectations. For example, allocating more resources to education generally implies fewer resources to the provision of other goods and services. The reverse is equally applicable. Indeed, budgeting is a conscious decision-making process involving trade-offs between highly desirable objectives in an attempt to allocate available resources to their optimal use.

The opportunity cost is the economic sacrifice involved in making a choice in terms of the next best alternative. The opportunity cost incurred in decision-making is the true cost of choices. It is measured in physical and not in monetary value. It can be measured implicitly through a monetary comparison with other alternatives. Thus, the price of a commodity is revealing a relative measure of the opportunity cost. For example, the opportunity cost of an IPad costing €700 is all that could be bought for €700. There are very few goods which are not scarce (often referred as free goods). Seawater and the air that we breathe are so far free goods. When no alternative use of a resource is available, there are no decisions and choices to be made and therefore no opportunity costs involved. Similarly, single-use or product specific factors, such as a coalmine which is specific to the production of coal, have no alternative use. Consequently, they have no opportunity cost. Even in a situation when all resources are generally idle, the utilisation of the relevant unemployed resources does not imply any trade-offs and therefore have zero economic costs.

In general, economics is concerned with the study of scarce resources, economic choices and real opportunity costs. Its main focus is the optimization of scarce resources in a desperate endeavour to satisfy insatiable human wants. Given resources constraints, economists study alternative resources' use to decide on the least costly choice in terms of the next best alternative, cognizant of the fact that whenever and whatever they choose they lose.

The scope and diversity of economic choices are innumerable but a set of fundamental economic questions can facilitate our understanding of the key issues that need to be resolved in economic studies:

1. *What goods and services will be produced and in what quantities?*

Because resources are scarce, society is concerned with resource allocation decisions. Choosing to produce more of one good implies having less of another good.

2. How are these commodities to be produced?

Once society has identified its resource allocation priorities, it has to decide on methods to produce this output. There are several ways of producing the same good. Different combinations of labour and capital (production methods) are available to produce goods and services. Some poor countries may have a relative abundance of cheap labour and scarcity of expensive capital. Therefore, their production choices are characterized by labour-intensive options. In contrast, developed economies may have limited expensive labour and relative abundance of inexpensive capital.

3. Who gets the goods and services?

Finally, society has to decide for whom to produce. Since the supply of available commodities is limited relative to the people who desire them, some mechanism of allocating the available goods must exist to decide who gets what. Effectively, society has the task of rationing the available output among consumers. Thus, for example, an economy has to decide whether goods will be distributed on the basis of need or the ability to pay.

Macroeconomic Problems and Policy Objectives

The what, how and who questions are common to all economies. The problem of scarcity underlies not only business and industry decisions but also government choices in managing the economy. The rationale behind government policies to maximize their citizens' welfare and standard of living is their resolve to address the fundamental problem of scarcity. The general aims of government economic policy reflect key economic concerns which make them the subject of extensive ongoing economic studies. Although these objectives are highly desirable from an economic point of view, society must somehow choose among plausibly conflicting policy goals to maximize the citizen's welfare. Government is often forced to prioritize objectives basing any trade-off among objectives on the opportunity cost incurred. These objectives may be organised around four central issues:

1. Full Employment

If resources are scarce, how can an economy tolerate idle resources? If there are not enough resources to produce all that society wants, how can an economy afford to have unexploited natural resources, closed down factories and hotels and unemployed labour? No society can accept in principle to have wastage and inefficient use of its scarce economic resources. It is generally accepted, therefore, that one of the government's primary objectives is the achievement of full employment.

2. Price Stability

Money is an artificial resource but which has a claim on goods and services. Its role in the modern economy is pivotal with gargantuan ramifications for the real economy. It is a store of wealth, a medium of exchange, a unit of account and standard of deferred payment. Like natural resources, money is scarce denoting its relative unavailability to the ever-increasing demand for it. If it is scarce, is it desirable to allow increasing prices to erode the purchasing power of money; to reduce the real income of those living on fixed income, such as pensioners; to penalize those who save in terms of lower wealth and to reward debtors in terms of reduced debt repayments in real terms; and to make exports less price competitive? The consequences of inflation can be so harmful to society, that price stability or the control of inflation is considered a major objective of macroeconomic policy.

3. Economic Growth

If human wants are insatiable, is it possible for a society to declare that its citizens are satisfied with their welfare and standard of living to the point they seek no further improvement? The United States may have a higher income per person than Scotland or Malta but does that mean that US citizen does not want to have more and more income and goods? Because resources are scare in relation to human demand, the search for higher welfare and standard of living is ongoing. Higher employment, incomes, social services and consumer goods depend on the economy's ability to increase its productive capacity to produce more goods and services. This makes economic growth another important long term macro policy objective. It is the means of reducing poverty and bringing material benefits to millions of people. To redistribute income in favour of the less well-offs, wealth must first be created. However, the benefits gained from growth must also be seen in the light of the social costs, including environmental degradation and the depletion of non-renewable natural resources.

4. Equilibrium in the Balance of Payments

No country is self-sufficient in the production of the goods and services to match the citizens' wants. If resources are scare, does it make sense for an economy to allocate its scare economic resources to produce lower quantities, inferior quality, and expensive commodities when it can have more for less through international trade? A country that specializes in the production of commodities, in which it has a relative cost advantage, can reap the benefits of specialisation. It can exchange the surplus output to obtain the commodities it wants from the rest of the world. A country can use the receipts it receives from its export of goods and services to pay for its imports. The balance of payment (BOP) is actually an accounting exercise that attempts to keep track of the financial transactions involved in carrying out trade between one country and the rest of the word over some specific period of time (normally one year). At some point equilibrium must be achieved between payments and receipts. The objective of government policy is to achieve a balance between autonomous credits and debits arising from international trade without having to resort to measures that may seriously affect government's ability to achieve other key macroeconomic policy objectives.

5. Distribution of Income and Wealth

In addition to full employment, price stability, balance of payments equilibrium and growth, governments may have other specific objectives to deal with particular problems. A fair distribution of income and wealth, the promotion and enhancement of industry competitiveness and the reduction of disparities among regions may also be considered as important objectives of economic policy, although they can also be conceived as part of the general policy to achieve the four key objectives discussed.

Even though our understanding of macroeconomics has tremendously improved over the last decades, it is still difficult to explain why governments cannot achieve these objectives simultaneously. Is our current analysis adequate to understand the workings of a dynamic economic system? Are policy instruments available to government sufficient and appropriate to achieve a clearly defined objective? Is accurate real-time information available to allow for timely action and appropriate measure? The answers to these questions are not easy and it goes to show the complexity of macroeconomic management. Economics is an evolving social science that generates theories, builds and applies forecasting models and develop suitable instruments to address central economic problems.