

Chapter 2

Introduction to the Economic Problem

- Resources, time and knowledge are finite at any given point in time
- Wants are “unlimited”
- Relative scarcity necessitates:
 - Allocation
 - Provisioning
- Humans deal with the scarcity problem through the use of technology and social organization

Allocation Problem

- Every society must allocate or choose how to use “scarce” resources to satisfy “unlimited” wants
- Ideally, resources should be allocated to “highest valued use”
- Five Basic Questions:
 - What to produce?
 - How much to produce?
 - How to produce?
 - When to produce?
 - Who gets it?

Provisioning Problem

- Process of the structure and evolution of the infrastructure (rules of the game) to solve the allocation problem
- Provisioning includes:
 - The choice of allocation mechanisms
 - Moral values
 - Knowledge/technology
 - Social institutions
 - Definitions and enforcement of property rights

Allocation - Utility Maximization and Neoclassical Economics

- Objective to maximize the satisfaction or utility of the members of society

$$U_S = f_S(U_A, U_B, \dots, U_N)$$

A is Adam, B is Barbara, N is the Nth individual

U_A is Adam's Utility, U_B is Barbara's

- Questions about whether individuals' utilities are additive or interdependent
- Individual A's utility function:

$$U_A = f_{SA}(Q_{XA}, Q_{YA}, \dots, Q_{NA})$$

Q_{XA} is the quantity of good X that Adam gets

Q_{YA} is the quantity of good Y that Adam gets

Underlying assumptions

- Goods (and services) have positive utility (i.e. goods satisfy wants), therefore “more is preferred to less”
- Individuals have independent utility functions, i.e. property rights are “exclusive”
- Utility is primarily a function of goods (and services) consumed by individual
- Conclusion is that the solution to the scarcity problem is for each individual to have more goods to consume

Alternative Approaches to Scarcity

- Economic growth – more goods (and services)
- Alter the mix of goods (and services)
 - “What is produced?” - Produce things that are more highly valued
 - Alter who gets the goods produced so those who get the greatest utility get them
- Alter the nature of preferences and expectations of the individuals

Allocative Mechanisms

- Allocative processes are required to distribute and transfer the rights to control the use of resources and goods – to transfer property rights
- Private property rights, public property rights and common property rights -

Taxonomy of Allocative Mechanisms

- Exchange
- Reciprocity
- Eminent Domain
- Philanthropy
- Inheritance
- Theft

Exchange

- A voluntary transfer of private property rights between individual agents where the terms of the exchange are specified
- Quid pro quo – “one thing in return for another”
- Contract between two or more agents that transfers exclusive, private property rights

Reciprocity

- Obligatory gift giving
- Nature and timing of the gift and obligation is unspecified
- Based on sense of community that uses social forces to ensure the fulfillment of obligation

Eminent Domain

- Redistribution of property rights through the authority of an organization
- Authority based on government, religion, military etc.
- Not voluntary

Philanthropy and Inheritance

- Philanthropy is anonymous gift giving that is voluntary and nothing is received in return
 - Blood
 - Organ transplantation
- Inheritance can take various forms;
 - Primogeniture – forms
 - Division

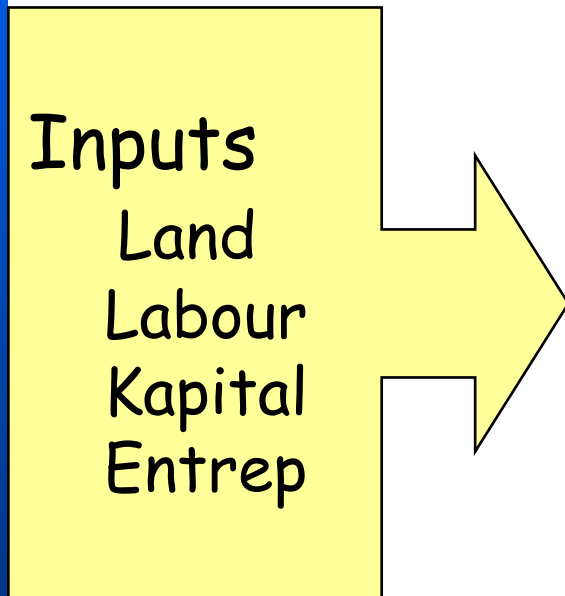
Provisioning

- Evolution of the structure of society to facilitate approaches to solutions of scarcity problem
 - Social infrastructure and interaction
 - Social Institutions
 - Markets, laws, mores, custom, tradition
 - Property rights
 - Organizations
 - Knowledge and Technology

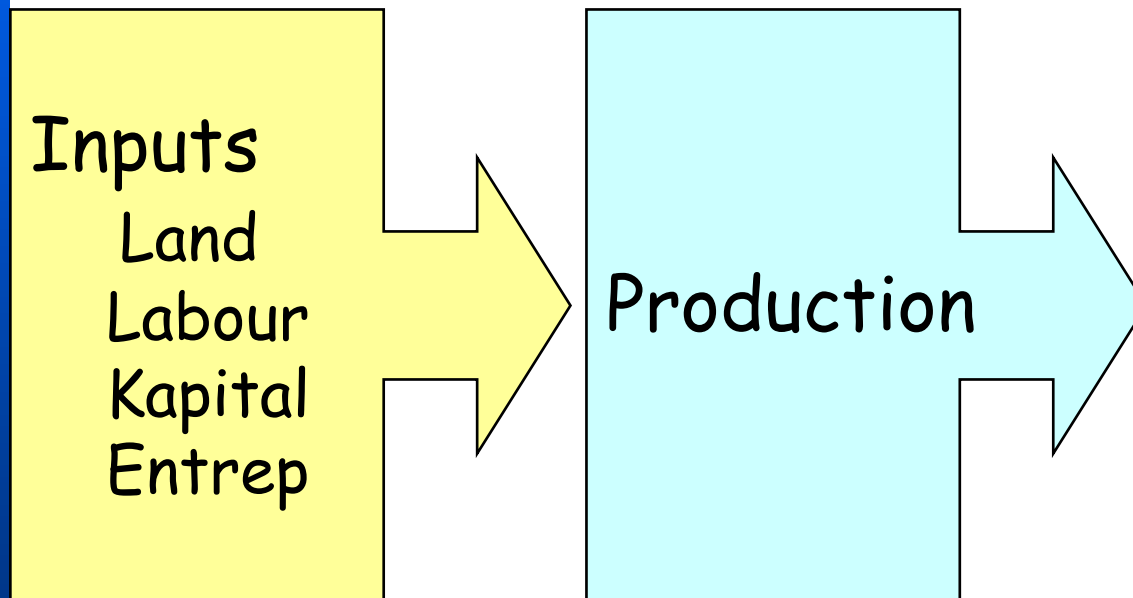
Social Interaction

- **It is possible that individuals acting together can accomplish more than when they act alone**
 - Organizations and Institutions
 - Cooperation, Competition, Conscription
- **Specialization**
 - Plato and the origins of the city state
- **Division of Labour**
 - Adam Smith – economic growth and excess of the division of labour

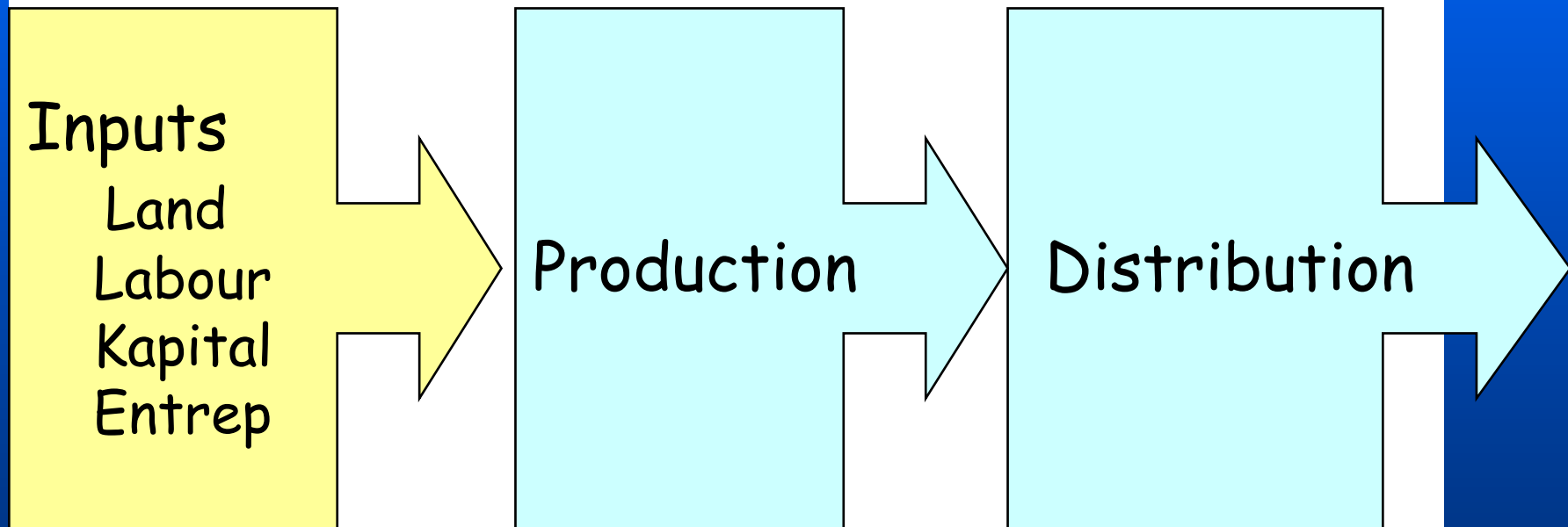
Economic Activities



Economic Activities



Economic Activities



Economic Activities

- Consumption is the end purpose of economic activity
- The goal is to produce the goods and services to improve the welfare of individuals living in a society
- Consumption Patterns are influenced by:
 - Individual tastes or preferences (a utility function)
 - Incomes, income distribution, wealth, wealth distribution
 - Relative prices of goods
 - Social institutions
 - Age, gender, religion
- Consumption, distribution, production are interrelated

Technology

- Knowledge about how individuals and organization interact with the natural and built environment to provide goods
- Mokyr describes knowledge as;
 - Prescriptive knowledge – Instructions about how we do things
 - Propositional knowledge - takes two forms: one is the observation, classification, measurement, and cataloging of natural phenomena. The other is the establishment of regularities, principles, and “natural laws” that govern these phenomena and allow us to make sense of them.

Technology

- Technological change is pervasive
 - Change driven by profits?
 - Change is self generating
 - Change is cumulative
- Provisioning and allocation processes are interrelated

Allocation and the “Rules of the Game”

Each society must devise a set of implicit and explicit rules of the game to coordinate the allocative choices made by individuals

Each society must answer the questions:

- What goods and services should be produced?
- How many unit of each should be produced?
- How should they be produced?
- When should they be produced?
- Who should get the goods and services produced?