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Business Economics

Nature & Scope of Business Economics

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CHAPTER-1
NATURE AND SCOPE OF BUSINESS ECONOMICS

UNIT 1

INTRODUCTION

In this chapter we will learn meaning and different definitions of economics, meaning and scope of business Economics.

(A) What is Economics about?

The term 'Economics' owes its origin to the Greek word 'Oikonomia' which means 'household'. Till 19th century, Economics was known as 'Political Economy.' The book named 'An Inquiry into the Nature and Causes of the Wealth of Nations' (1776) usually abbreviated as 'The Wealth of Nations', by Adam Smith is considered as the 1st modern work of Economics.

- In words of ***Alfred Marshall***:

  "Economics is the study of people in the ordinary business of life"

- In words of ***Lionel Robbins***:

  "Economics is the science which studies human behaviour as a relationship between given ends and scarce means which have alternative uses"

- In words of ***Paul A. Samuelson***:

  "Economics is the study of how societies use scarce resources to produce valuable commodities and distribute them among different people".

These two fundamental facts that:

(i) Human beings have unlimited wants and

(ii) The means to satisfy these unlimited wants are relatively scarce form the subject matter of Economics.

- Economics is the study of the processes by which the relatively scarce resources are allocated to satisfy the competing unlimited wants of human beings in a society. Of course, the available resources will be efficiently used when they are allocated to their highest valued uses. Economics is, thus, the study of how we work together to transform the scarce resources into goods and services to satisfy the most pressing of our infinite wants and how we distribute these goods and services among ourselves.
- Economics, therefore, concerns itself not just with the crucial concern of how a nation allocates its scarce productive resources to various uses; it also deals with the processes by which the productive capacity of these resources is increased and with the factors which, in the past, have led to sharp fluctuations in the rate of utilisation of these resources.

- The study of Economics will enable us to develop an analytical approach that helps us in understanding and analysing a wide range of economic issues. It would also provide us with a number of models and frameworks that can be applied in different situations.
- The tools of Economics assist in choosing the best course of action from among the different alternative courses of action available to the decision maker. However, it is necessary to remember that most economic problems are of complex nature and are affected by several forces, some of which are rooted in Economics and others in political set up, social norms, etc.
- The study of Economics cannot ensure that all problems will be appropriately tackled; but, without doubt, it would enable a student to examine a problem in its right perspective and would help him in discovering suitable measures to deal with the same.

((B) <u>Meaning of Business Economics (Managerial Economics) :-</u>

- As we are aware, the survival and success of any business depends on sound decisions. Decision making refers to the process of selecting an appropriate alternative that will provide the most efficient means of attaining a desired end, from two or more alternative courses of action.
- Decision making involves evaluation of feasible alternatives, rational judgement on the basis of information and choice of a particular alternative which the decision maker finds as the most suitable. As explained above, the question of choice arises because our productive resources such as land, labour, capital, and management are limited and can be employed in alternative uses. Therefore, more efficient alternatives must be chosen and less efficient alternatives must be rejected.

The management of a business unit generally needs to make **strategic, tactical and operational decisions**. A few examples of issues requiring decision making in the context of businesses are illustrated below:

- Should the firm be in this business?
- Should the firm launch a product, given the highly competitive market environment?
- If the firm decided on launching the product, which available technique of production should be used?
- From where should the firm procure the necessary inputs and at what prices so as to have competitive edge in the market?
- Should the firm make the components or buy them from other firms?
- How much should be the optimum output and at what price should the firm sell?
- How will the product be placed in the market? Which customer segment should we focus on and how to improve the customer experience? Which marketing strategy should be chosen? How much should be the marketing budget?
- How to combat the risks and uncertainties involved?

<u>Business Economics, also referred to as Managerial Economics,</u> generally refers to the integration of economic theory with business practice. While the theories of Economics provide the tools which explain various concepts such as demand, supply, costs, price, competition etc., Business Economics applies these tools in the process of business decision making. Thus, Business Economics comprises of that part of economic knowledge, logic, theories and analytical tools that are used for rational business decision making. In brief, it is Applied Economics that falls the gap between economic theory and business practice.

Business Economics has close connection with Economic theory (Micro as well as Macro-Economics), Operations Research, Statistics, Mathematics and the Theory of Decision-Making. A professional business economist has to integrate the concept and methods from all these disciplines in order to understand and analyse practical managerial problems. Business Economics is not only valuable to business decision makers, but also useful for managers of 'not-for-profit' organisations.

DEFINITIONS OF BUSINESS ECONOMICS:

- Business Economics may be defined as the use of economic analysis to make business decisions involving the best use of an organization's scarce resources.
- **Joel Dean** defined Business Economics in terms of the use of economic analysis in the formulation of business policies. Business Economics is essentially a component of Applied Economics as it includes application of selected quantitative techniques such as linear programming, regression analysis, capital budgeting, break even analysis and cost analysis.

((C) SUBJECT MATTER OF ECONOMICS

Economics has been broadly divided into two major parts i.e. Micro Economics and Macro Economics.

Micro Economicsis basically the study of the behaviour of different individuals and organizations within aneconomic system. In other words, Microeconomics examines how the individual units (consumers or firms) make decisions as to how to efficiently allocate their scarce resources. Here, the focus is on a small number of or group of units rather than all the units combined, and therefore, it does not explain what is happening in the wider economic environment.

We mainly study the following in Micro-Economics:

(i) Product pricing;

(ii) Consumer behaviour;

(iii) Factor pricing;

(iv) The economic conditions of a section of people;

(v) Behaviour of firms; and

(vi) Location of industry.

Macro Economicsis the study of the overall economic phenomena or the economy as a whole, ratherthan its individual parts. Accordingly, in Macro-Economics, we study the behaviour of the large economic aggregates, such as, the overall levels of output, total consumption, total saving and total investment and also how these aggregates shift over time. It analyses the overall economic environment in which the firms, governments and households make decisions. However, it should be kept in mind that this economic environment represents the overall effect of the innumerable decisions made by millions of different consumers and producers.

A few areas that come under Macro Economics are:

(i) National Income and National Output;

(ii) The general price level and interest rates;

(iii) Balance of trade and balance of payments;

(iv) External value of currency;

(v) The overall level of savings and investment; and

(vi) The level of employment and rate of economic growth.

While Business Economics is basically concerned with Micro Economics, Macro economic analysis also has got an important role to play. Macroeconomics analyses the background of economic conditions in an economy which will immensely influence the individual firm's performance as well as its decisions. Business firms need a thorough understanding of the macroeconomic environment in which they have to function. For example, knowledge regarding conditions of in nation and interest rates will be useful for the business economist in framing suitable policies. Moreover, the long-run trends in the business world are determined by the prevailing macroeconomic factors.

(D) Nature of Business Economics:

The following points will describe the nature of Business Economics:

- ***Business Economics is a Science:***Science is a systematized body of knowledge which establishes cause andeffect relationships. Business Economics integrates the tools of decision sciences such as Mathematics, Statistics and Econometrics with Economic Theory to arrive at appropriate strategies for achieving the goals of the business enterprises. It follows scientific methods and empirically tests the validity of the results.
- ***Based on Micro Economics***: Business Economics is based largely on Micro-Economics. A business manageris usually concerned about achievement of the predetermined objectives of his organisation so as to ensure the long-term survival and pro table functioning of the organization. Since Business Economics is concerned more with the decision making problems of individual establishments, it relies heavily on the techniques of Microeconomics.
- ***Incorporates elements of Macro Analysis***: A business unit does not operate in a vacuum. It is affected bythe external environment of the economy in which it operates such as, the general price level, income and employment levels in the economy and government policies with respect to taxation, interest rates, exchange rates, industries, prices, distribution, wages and regulation of monopolies. All these are components of Macroeconomics. A business manager must be acquainted with these and other macroeconomic variables, present as well as future, which may influence his business environment.
- **Business Economics is an art** as it involves practical application of rules and principles for the attainment of set objectives.
- ***Use of Theory of Markets and Private Enterprises***: Business Economics largely uses the theory of marketsand private enterprise. It uses the theory of the firm and resource allocation in the backdrop of a private enterprise economy.
- ***Pragmatic in Approach***: Micro-Economics is abstract and purely theoretical and analyses economicphenomena under unrealistic assumptions. In contrast, Business Economics is pragmatic in its approach as it tackles practical problems which the firms face in the real world.
- ***Interdisciplinary in nature***: Business Economics is interdisciplinary in nature as it incorporates toolsfrom other disciplines such as Mathematics, Operations Research, Management Theory, Accounting, marketing, Finance, Statistics and Econometrics.
- ***Normative in Nature***: Economic theory has developed along two lines – **positive and normative**. Apositive or pure science analyses cause and effect relationship between variables in an objective and scientific manner, but it does not involve any value judgement. In other words, it states 'what is' of the state of a airs and not what 'ought to be'. In other words, it is descriptive in nature in the sense that it describes the economic behaviour of individuals or society without prescriptions about the desirability or otherwise of such behaviour. As against this, a normative science involves value judgements. It is prescriptive in nature and suggests 'what should be' a particular course of action under given circumstances. Welfare considerations are embedded in normative science.

(E) SCOPE OF BUSINESS ECONOMICS:

The scope of Business Economics is quite wide. It covers most of the practical problems a manager or a firm faces. There are two categories of business issues to which economic theories can be directly applied, namely:

1. Microeconomics applied to operational or internal Issues
2. Macroeconomics applied to environmental or external issues

Therefore, the scope of Business Economics may be discussed under the above two heads.

1. Microeconomics applied to Operational or Internal Issues

Operational issues include all those issues that arise within the organisation and fall within the purview and control of the management. These issues are internal in nature. Issues related to choice of business and its size, product decisions, technology and factor combinations, pricing and sales promotion, financing and management of investments and inventory are a few examples of operational issues. The following Microeconomic theories deal with most of these issues.

(a) ***Demand analysis and forecasting:***Demand analysis pertains to the behaviour of consumers in themarket. It studies the nature of consumer preferences and the effect of changes in the determinants of demand such as, price of the commodity, consumers' income, prices of related commodities, consumer tastes and preferences etc.

Demand forecasting is the technique of predicting future demand for goods and services on the basis of the past behaviour of factors which affect demand. Accurate forecasting is essential for a firm to enable it to produce the required quantities at the right time and to arrange, well in advance, for the various factors of production viz., raw materials, labour, machines, equipment, buildings etc. Business Economics provides the manager with the scientific tools which assist him in forecasting demand.

(b) ***Production and Cost Analysis:***Production theory explains the relationship between inputs and output. Abusiness economist has to decide on the optimum size of output, given the objectives of the rm. He has also to ensure that the firm is not incurring undue costs. Production analysis enables the firm to decide on the choice of appropriate technology and selection of least - cost input-mix to achieve technically efficient way of producing output, given the inputs. Cost analysis enables the firm to recognise the behaviour of costs when variables such as output, time period and size of plant change. The firm will be able to identify ways to maximize profits by producing the desired level of output at the minimum possible cost.

(c) ***Inventory Management:*** Inventory management theories pertain to rules that firms can use to minimisethe costs associated with maintaining inventory in the form of 'work-in-process,' 'raw materials', and ' finished goods'. Inventory policies affect the profitability of the firm. Business economists use methods such as ABC analysis, simple simulation exercises and mathematical models to help the firm maintain optimum stock of inventories.

(d) ***Market Structure and Pricing Policies:***Analysis of the structure of the market provides information aboutthe nature and extent of competition which the firms have to face. This helps in determining the degree of market power (ability to determine prices) which the firm commands and the strategies to be followed in market management under the given competitive conditions such as, product design and marketing. Price theory explains how prices are determined under different kinds of market conditions and assists the firm in framing suitable price policies.

(e) ***Resource Allocation:***Business Economics, with the help of advanced tools such as linear programming,enables the firm to arrive at the best course of action for optimum utilisation of available resources.

For maximizing its profits, the firm has to carefully evaluateits investment decisions and carry out a sensible policy of capital allocation. Theories related to capital and investment provide scientific criteria for choice of investment projects and in assessment of the efficiency of capital. Business Economics supports decision making on allocation of scarce capital among competing uses of funds.

(f) ***Profit Analysis****:* Profits are, most often, uncertain due to changing prices and market conditions. Profittheory guides the firm in the measurement and management of profits under conditions of uncertainty. Profit analysis is also immensely useful in future profit planning.

(g) ***Risk and Uncertainty Analysis****:* Business firms generally operate under conditions of risk and uncertainty.Analysis of risks and uncertainties helps the business firm in arriving at efficient decisions and in formulating plans on the basis of past data, current information and future prediction.

2. Macroeconomics applied to environmental or external issues

Environmental factors have significant influence upon the functioning and performance of business. The major macro economic factors relate to:-

- the type of economic system
- stage of business cycle
- the general trends in national income, employment, prices, saving and investment.
- Government's economic policies like industrial policy, competition policy, monetary and social policy, price policy, foreign trade policy and globalization policies
- working of financial sector and capital market
- socio-economic organisations like trade unions, producer and consumer unions and cooperatives.
- social and political environment.

REMEMBER THE FOLLOWING POINTS

Definitions of Economics

- Adam.Smith is known as father of economics.
- Wealth definitions of economics are given by Adam Smith, J.B.Say and other classical writers.
- Welfare definitions of economics are given by Marshall, Pigou and other neo-classical writers.
- Robbins has given the scarcity definition of economics.
- Samuelson has given the growth definition of economics.
- Scarcity is a relative term which means that all the wants of all the people can never be satisfied.
- The concept of scarcity is applicable to the poor as well as the rich countries.
- According to Robbins economics is a science of choice making.
- According to Robbins economics is a positive or pure science while according to Marshall and Pigou economics is a normative science.
- A normative science is the one which is concerned with moral or value judgments.
- A positive science is the one which is concerned with objective truths and analysis of cause and effect relationship between various variables. It does not consider the ethical aspects of any law.
- According to Robbins economics should be neutral between ends which means that the economists have no right to pass value judgements regarding human economic decisions.
- Rational decision making is the fundamental premises of economics. It means that individuals choose that alternative for which they believe that their economic gain would be the greatest.
- Rational decision making is requires that choice of an economic unit should be consistent with its goal.

Methods of Studying Economics

- There are two methods of studying any science namely deductive method and inductive method.
- The deductive method is known as a priori method, axiomatic method or subjective method. It is based upon abstract reasoning and not upon actual facts. It goes from general to particular.
- The Inductive method is known as scientific method, empirical method or objective method. It is based upon actual experiments and data. It goes from particular to general.

Micro Economics and Macro Economics

- According to the modern writers the economics is divided into two parts namely micro economics and macro economics.
- Micro economics is also known is price theory and it is concerned with allocation of economic resources at the level of individual economic units.
- Micro Economics is also known as price theory. It studies allocation of resources at the level of individuals and firms.
- Macro economics was developed by Keynes. Macro economics is also known as theory of income and employment. It is concerned with the allocation of resources at the national level. It is concerned with aggregates.

UNIT : 2
BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

INTRODUCTION

In this chapter we will learn basic problems of an economy, types of economy and how different economies solve their basic problems of an Economy.

(A) **BASIC PROBLEMS OF AN ECONOMY**

Every economic system, be it capitalist, socialist or mixed, has to deal with this central problem of scarcity of resources relative to the wants for them. This is generally called **'the central economic problem'.** The central economic problem is further divided into four basic economic problems. These are:

(1) What to produce?

(2) How to produce?

(3) For whom to produce?

(4) What provisions (if any) are to be made for economic growth?

(i) What to produce?: Since the resources are limited, every society has to decide which goods andservices should be produced and how many units of each good (or service) should be produced. An economy has to decide whether more guns should be produced or more butter should be produced; or whether more capital goods like machines, equipments, dams etc., will be produced or more consumer goods such as, cell phones will be produced. Not only the society has to decide about what goods are to be produced, it has also to decide in what quantities each of these goods would be produced. In a nutshell, a society must decide how much wheat, how many hospitals, how many schools, how many machines, how many meters of cloths etc. have to be produced.

(ii) How to produce?: There are various alternative techniques of producing a commodity. For example,cotton cloth can be produced using handlooms, power looms or automatic looms. Production with handlooms involves use of more labour and production with automatic loom involves use of more machines and capital. A society has to decide whether it will produce cotton cloth using labour-intensive techniques or capital-intensive techniques. Likewise, for all goods and services, it has to decide whether to use labour- intensive techniques or capital - intensive techniques. Obviously, the choice would depend on the availability of different factors of production (i.e. labour and capital) and their relative prices. It is in the society's interest to use those techniques of production that make the best use of the available resources.

(iii) For whom to produce?: Another important decision which a society has to take is 'for whom' it shouldproduce. A society cannot satisfy each and every want of all the people. Therefore, it has to decide on who should get how much of the total output of goods and services, i.e. How the goods (and services) should be distributed among the members of the society. In other words, it has to decide about the shares of different people in the national cake of goods and services.

(iv) What provision should be made for economic growth?: A society would not like to use all itsscarce resources for current consumption only. This is because, if it uses all the resources for current consumption and no provision is made for future production, the society's production capacity would not increase. This implies that incomes or standards of living of the people would remain stagnant, and in future, the levels of living may actually decline. Therefore, a society has to decide how much saving and investment (i.e. how much sacrifice of current consumption) should be made for future progress.

(B) ECONOMIC SYSTEMS AND ITS TYPES:

An economic system refers to the sum total of arrangements for the production and distribution of goods and services in a society. In short, it is defined as the sum of the total devices which give effect to economic choice. It includes various individuals and economic institutions. Three types of economy:

(1) Capitalist Economy

(2) Socialist Economy

(3) Mixed Economy

(1) CAPITALIST ECONOMY

- It is an Economic system in which all means of production are owned and controlled by private individuals for profit.
- Private property is the mainstay of capitalism and profit motive is its driving force.
- The government has a limited role in the management of the economic affairs under this system. Some examples of a capitalist economy may include U.S., U.K., Germany, Japan, Mexico, Singapore, etc.
- An economy is called **capitalist or a free market economy or laissez-faire economy** if it has the following characteristics:

(1) ***Right to private property***: The right to private property means that productive factors such as land,factories, machinery, mines etc. can be under private ownership. The owners of these factors are free to use them in any manner in which they like and bequeath it as they desire. The government may, however, put some restrictions for the benefit of the society in general.

(2) ***Freedom of enterprise***: Each individual, whether consumer, producer or resource owner, is free to engagein any type of economic activity. For example, a producer is free to set up any type of firm and produce goods and services of his choice.

(***3)*** ***Freedom of economic choice***: All individuals are free to make their economic choices regardingconsumption, work, production, exchange etc.

(4) ***Profit motive:***Profit motive is the driving force in a free enterprise economy and directs all economicactivities. Desire for profits induces entrepreneurs to organize production so as to earn maximum profits.

(5) ***Consumer Sovereignty***: Consumer is the king under capitalism. Consumer sovereignty means that buyersultimately determine which goods and services will be produced and in what quantities. Consumers have unbridled freedom to choose the goods and services which they would consume. Therefore, producers have to produce goods and services which are preferred by the consumers. In other words, based on the purchases they make, consumers decide how the economy's limited resources are allocated.

(6) ***Competition:***Competition is the most important feature of the capitalist economy. Competition bringsout the best among buyers and sellers and results in efficient use of resources.

(7) ***Absence of Government Interference***: A purely capitalist economy is not centrally planned, controlled orregulated by the government. In this system, all economic decisions and activities are guided by self- interest and price mechanism which operates automatically without any direction and control by the governmental authorities.

How do capitalist economies solve their central problems?

A capitalist economy has no central planning authority to decide what, how and for whom to produce. In the absence of any central authority, it looks like a miracle as to how such an economy functions. If the consumers want cars and producers choose to make cloth and workers choose to work for the furniture industry, there will be total confusion and chaos in the country. However, this does not happen in a capitalist economy. Such an economy uses the impersonal forces of market demand and supply or the price mechanism to solve its central problems.

Deciding 'what to produce' The aim of an entrepreneur is to earn as much profits as possible. This causesbusinessmen to compete with one another to produce those goods which consumers wish to buy. Thus, if consumers want more cars, there will be an increase in the demand for cars and as a result their prices will increase. A rise in the price of cars, costs remaining the same, will lead to more profits. This will induce producers to produce more cars. On the other hand, if the consumers' demand for cloth decreases, its price would fall and profits would go down. Therefore, business firms have less incentive to produce cloth and less of cloth will be produced. Thus, more of cars and less cloth will be produced in such an economy. In a capitalist economy (like the USA, UK and Germany) the question regarding what to produce is ultimately decided by consumers who show their preferences by spending on the goods which they want.

Deciding 'how to produce': An entrepreneur will produce goods and services choosing that technique ofproduction which renders his cost of production minimum. If labour is relatively cheap he will use labour-intensive method and if labour is relatively costlier he will use capital-intensive method. Thus, the relative prices of factors of production help in deciding how to produce.

Deciding 'for whom to produce': Goods and services in a capitalist economy will be produced for those whohave buying capacity. The buying capacity of an individual depends upon his income. How much income he will be able to make depends not only on the amount of work he does and the prices of the factors he owns, but also on how much property he owns. Higher the income, higher will be his buying capacity and higher will be his demand for goods in general.

Deciding about consumption, saving and investment: Consumption and savings are done by consumers andinvestments are done by entrepreneurs. Consumers' savings, among other factors, are governed by the rate of interest prevailing in the market. Higher the interest rates, higher will be the savings. Investment decisions depend upon the rate of return on capital. The greater the profit expectation (i.e. the return on capital), the greater will be the investment in a capitalist economy. The rate of interest on savings and the rate of return on capital are nothing but the prices of capital.

MERITS:

Capitalism is self- regulating and works automatically through price mechanism. There is no need of incurring costs for collecting and processing of information and for formulating, implementing and monitoring policies.

1. The existence of private property and the driving force of profit motive result in greater efficiency and incentive to work.
2. The process of economic growth is likely to be faster under capitalism. This is because the investors try to invest in only those projects which are economically feasible.
3. Resources are used in activities in which they are most productive. This results in optimum allocation of the available productive resources of the economy.
4. There is usually high degree of operative efficiency under the capitalist system.
5. Cost of production is minimized as every producer tries to maximize his profit by employing methods of production which are cost-effective.

6. Capitalist system offer incentives for efficient economic decisions and their implementation.
7. Consumers are benefitted as competition forces producers to bring in a large variety of good quality products at reasonable prices. This, along with freedom of choice, ensures maximum satisfaction to consumers. This also results in higher standard of living.
8. Capitalism offers incentives for innovation and technological progress. The country as a whole benefits through growth of business talents, development of research, etc.
9. Capitalism preserves fundamental rights such as right to freedom and right to private property. Therefore, the participants enjoy maximum amount of autonomy and freedom.
10. Capitalism rewards men of initiative and enterprise and punishes the imprudent and inefficient.
11. Capitalism usually functions in a democratic framework.
12. The capitalist set up encourages enterprise and risk taking and emergence of an entrepreneurial class willing to take risks.

DEMERITS :

1. There is vast economic inequality and social injustice under capitalism. Inequalities reduce the aggregate economic welfare of the society as a whole and split the society into two classes namely the 'haves' and the 'have-nots', sowing the seeds of social unrest and class conflict.
2. Under capitalism, there is precedence of property rights over human rights.
3. Economic inequalities lead to wide differences in economic opportunities and perpetuate unfairness in the society.
4. The capitalist system ignores human welfare because, under a capitalist set up, the aim is profit and not the welfare of the people.
5. Due to income inequality, the pattern of demand does not represent the real needs of the society.
6. Exploitation of labour is common under capitalism. Very often this leads to strikes and lock outs. Moreover, there is no security of employment. This makes workers more vulnerable.
7. Consumer sovereignty is a myth as consumers often become victims of exploitation. Excessive competition and profit motive work against consumer welfare.
8. There is misallocation of resources as resources will move into the production of luxury goods. Less wage goods will be produced on account of their lower profitability.
9. Less of merit goods like education and health care will be produced. On the other hand, a number of goods and services which are positively harmful to the society will be produced as they are more profitable.
10. Due to unplanned production, economic instability in terms of over production, economic depression, unemployment etc., is very common under capitalism. These result in a lot of human misery.
11. There is enormous waste of productive resources as firms spend huge amounts of money on advertisement and sales promotion activities.
12. Capitalism leads to the formation of monopolies as large firms may be able to drive out small ones by fair means.
13. Excessive materialism as well as conspicuous and unethical consumption lead to environmental degradation.

(2) SOCIALIST ECONOMY

The concept of socialist economy was propounded by Karl Marx and Frederic Engels in their work 'The Communist Manifesto' published in 1848. In this economy, the material means of production i.e. factories, capital, mines etc. are owned by the whole community represented by the State. All members are entitled to get benefit from the fruits of such socialised planned production on the basis of equal rights. **A socialist economy is also called as "Command Economy" or a "Centrally Planned Economy".** Here, the resources are allocated according to the commands of a central planning authority and therefore, market forces have no role in the allocation of resources. Under a socialist economy, production and distribution of goods are aimed at maximizing the welfare of the community as a whole.

Some important characteristics of this economy are:

(i) **Collective Ownership:**There is collective ownership of all means of production except small farms,workshops and trading firms which may remain in private hands. As a result of social ownership, profit-motive and self- interest are not the driving forces of economic activity as it is in the case of a market economy. The resources are used to achieve certain socio-economic objectives.

(ii) **Economic planning:**There is a Central Planning Authority to set and accomplish socio- economic goals;that is why it is called a centrally planned economy. The major economic decisions, such as what to produce, when and how much to produce, etc., are taken by the central planning authority.

(iii) **Absence of Consumer Choice**:Freedom from hunger is guaranteed, but consumers' sovereignty getsrestricted by selective production of goods. The range of choice is limited by planned production. However, within that range, an individual is free to choose what he likes most.

The right to work is guaranteed, but the choice of occupation gets restricted because these are determined by the central planning authority on the basis of certain socio-economic goals before the nation.

(iv) **Relatively Equal Income Distribution:**A relative equality of income is an important feature of Socialism.Among other things, differences in income and wealth are narrowed down by lack of opportunities to accumulate private capital. Educational and other facilities are enjoyed more or less equally; thus the basic causes of inequalities are removed.

(v) **Minimum role of Price Mechanism or Market forces**: Price mechanism exists in a socialist economy; butit has only a secondary role, e.g., to secure the disposal of accumulated stocks. Since allocation of productive resources is done according to a predetermined plan, the price mechanism as such does not influence these decisions. In the absence of the profit motive, price mechanism loses its predominant role in economic decisions. The prices prevailing under socialism are 'administered prices' which are set by the central planning authority on the basis of socio-economic objectives.

(vi) **Absence of Competition**: Since the state is the sole entrepreneur, there is absence of competition undersocialism.

The erstwhile U.S.S.R. is an example of socialist economy. In today's world there is no country which is purely socialist. **North Korea**, the world's most totalitarian state, is another prominent example of a socialist economy. Other examples include **China and Cuba**.

MERITS:

1. Equitable distribution of wealth and income and provision of equal opportunities for all help to maintain economic and social justice.

2. Rapid and balanced economic development is possible in a socialist economy as the central planning authority coordinates all resources in an efficient manner according to set priorities.

3. Socialist economy is a planned economy. In a socialistic economy, there will be better utilization of resources and it ensures maximum production. Wastes of all kinds are avoided through strict economic planning. Since competition is absent, there is no wastage of resources on advertisement and sales promotion.

4. In a planned economy, unemployment is minimised, business fluctuations are eliminated and stability is brought about and maintained.
5. The absence of profit motive helps the community to develop a co-operative mentality and avoids class war. This, along with equality, ensures welfare of the society.

   Socialism ensures right to work and minimum standard of living to all people.
6. Under Socialism, the labourers and consumers are protected from exploitation by the employers and monopolies respectively.
7. There is provision of comprehensive social security under socialism and this makes citizens feel secure.

DEMERITS:

1. Socialism involves the predominance of bureaucracy and the resulting inefficiency and delays. Moreover, there may also be corruption, red- tapism, favouritism, etc.
2. It restricts the freedom of individuals as there is state ownership of the material means of production and state direction and control of nearly all economic activity.
3. Socialism takes away the basic rights such as the right of private property.
4. It will not provide necessary incentives to hard work in the form of profit.
5. Administered prices are not determined by the forces of the market on the basis of negotiations between the buyers and the sellers. There is no proper basis for cost calculation. In the absence of such practice, the most economic and scientific allocation of resources and the efficient functioning of the economic system are impossible.
6. State monopolies created by socialism will sometimes become uncontrollable. This will be more dangerous than the private monopolies under capitalism.
7. Under socialism, the consumers have no freedom of choice. Therefore, what the state produces has to be accepted by the consumers.
8. No importance is given to personal efficiency and productivity. Labourers are not rewarded according to their efficiency. This acts as a disincentive to work.
9. The extreme form of socialism is not at all practicable.

(3) <u>THE MIXED ECONOMY</u>

In a mixed economy, the aim is to develop a system which tries to include the best features of both the controlled economy and the market economy while excluding the demerits of both. It appreciates the advantages of private enterprise and private property with their emphasis on self-interest and pro t motive. Vast economic development of England, the USA etc. is due to private enterprise.

<u>Features of mixed economy</u>

(i) Co-existence of private and public sector: The first important feature of a mixed economy is theco-existence of both private and public enterprise.

In fact, in a mixed economy, there are three sectors of industries:

(a) **Private sector**: Production and distribution in this sector are managed and controlled by privateindividuals and groups. Industries in this sector are based on self-interest and pro t motive. The system of private property exists and personal initiative is given full scope. However, private enterprise may be regulated by the government directly and/or indirectly by a number of policy instruments.

((b) Public sector: Industries in this sector are not primarily pro t-oriented, but are set up by the State for thewelfare of the community.

((c) Combined sector: A sector in which both the government and the private enterprises have equal access,and join hands to produce commodities and services, leading to the establishment of joint sectors.

Mixed economy has the following merits available to capitalist economies and socialist economies.

1. Economic freedom and existence of private property which ensures incentive to work and capital formation.
2. Price mechanism and competition forces operating in the private sector promoting efficient decisions and better resource allocation.
3. Consumers are benefitted through consumers' sovereignty and freedom of choice.
4. Appropriate incentives for innovation and technological progress.
5. Encourages enterprise and risk taking.
6. Advantages of economic planning and rapid economic development on the basis of plan priorities.
7. Comparatively greater economic and social equality and freedom from exploitation due to greater state participation and direction of economic activities.
8. Disadvantages of cut-throat competition averted through government's legislative measures such as environment and labour regulations.

However, mixed economy is not always a 'golden path' between capitalism and socialism. It suffers from substantial uncertainties. Mixed economy is characterised by excessive controls by the state resulting in reduced incentives and constrained growth of the private sector, poor implementation of planning, higher rates of taxation, lack of efficiency, corruption, wastage of resources, undue delays in economic decisions and poor performance of the public sector. Moreover, it is very di cult to maintain a proper balance between the public and private sectors. In the absence of strong governmental initiatives, the private sector is likely to grow disproportionately.

REMEMBER THE FOLLOWING POINTS :

Central Economic Problems

- There are five central economic problems before any economy; what to produce, how to produce, how to distribute, how to provide for growth and the division of production of private and public goods. **However, when to produce is not an economic problem.**
- Economics is a science as well as an art.

Economic systems

- There are three most important features of a capitalist economy; private property, allocation of resources through market and production of goods and services according to the choice of private consumers.
- There are three most important features of a socialist economy; collective ownership of means of production, allocation of resources through centralised planning and production of goods and services according to the needs of the community.
- There are three most important features of a mixed economy; co-existence of private sector and public sector, limited economic planning and presence of economic controls side by side economic freedoms.
- The greatest limitation of allocating resources through the use of market system is that economic resources are wasted.
- In capitalist society production takes place according to market demand while in socialist economy it takes place according to need of the society.
- In a mixed economy there is planning by inducement or financial planning.
- In a mixed economy the role of the state is that of preventing undesirable competition and promoting a rational allocation of resources.
- In a mixed economy the public sector and private sector exist side by side and both of them are complementary.
- In a mixed economy there is a dual system of pricing.
- Consumer's sovereignty is found in a free market economy and it means that the allocation of resources as between various activities is decided by consumer's choices and preferences.
- In socialist society cost benefit analysis is used to decide allocation of resources.
- In capitalist society the national income is more unevenly distributed than in socialist society.

CLASS WORK

1. Economists regard decision making as important because:
   (a) The resources required to satisfy our unlimited wants and needs are finiteor scarce.
   (b) It is crucial to understand how we can best allocate our scarce resources to satisfy society's unlimited wants and needs.
   (c) Resources have alternative uses.
   (d) All the above.
2. Business Economics is
   (a) Abstract and applies the tools of Microeconomics.
   (b) Involves practical application of economic theory in business decision making.
   (c) Incorporates tools from multiple disciplines.
   (d) ((b) and ((c) above.
3. In Economics, we use the term scarcity to mean;
   (a) Absolute scarcity and lack of resources in less developed countries.
   (b) Relative scarcity i.e. scarcity in relation to the wants of the society.
   (c) Scarcity during times of business failure and natural calamities.
   (d) Scarcity caused on account of excessive consumption by the rich.
4. What implication(s) does resource scarcity have for the satisfaction of wants?
   (a) Not all wants can be satisfied.
   (b) We will never be faced with the need to make choices.
   (c) We must develop ways to decrease our individual wants.
   (d) The discovery of new natural resources is necessary to increase our ability to satisfy wants.
5. Which of the following is a normative statement?
   (a) Planned economies allocate resources via government departments.
   (b) Most transitional economies have experienced problems of falling output and rising prices over the past decade.
   (c) There is a greater degree of consumer sovereignty in market economies than planned economies.
   (d) Reducing inequality should be a major priority for mixed economies.
6. In every economic system, scarcity imposes limitations on
   (a) households, business firms, governments, and the nation as a whole.
   (b) households and business firms, but not the governments.
   (c) local and state governments, but not the federal government.
   (d) households and governments, but not business firms.
   e) business firms, governments, and the nation as a whole.
7. Macroeconomics is also called——— economics.
   (a) applied
   (b) aggregate
   (c) experimental
   (d) none of the above
8. An example of 'positive' economic analysis would be:
   (a) an analysis of the relationship between the price of food and the quantity purchased.
   (b) determining how much income each person should be guaranteed.
   (c) determining the 'fair' price for food.
   (d) deciding how to distribute the output of the economy.
9. A study of how increases in the corporate income tax rate will affect the national unemployment rate is an example of
   (a) Macro-Economics.
   (b) Descriptive Economics.
   (c) Micro-economics.
   (d) Normative economics.

10. Which of the following does not suggest a macro approach for India?
(a) Determining the GNP of India.
(b) Finding the causes of failure of ABC Ltd.
(c) Identifying the causes of inflation in India.
(d) Analyse the causes of failure of industry in providing large scale employment

11. Ram: My corn harvest this year is poor.
Krishan: Don't worry. Price increases will compensate for the fall in quantity supplied.
Vinod: Climate affects crop yields. Some years are bad, others are good.
Madhu: The Government ought to guarantee that our income will not fall.
In this conversation, the normative statement is made by
(a) Ram (b) Krishan
(c) Vinod (d) Madhu

12. Consider the following and decide which, if any, economy is without scarcity:
(a) The pre-independent Indian economy, where most people were farmers.
(b) A mythical economy where everybody is a billionaire.
(c) Any economy where income is distributed equally among its people.
(d) None of the above.

13. Which of the following is not a subject matter of Micro-economies?
(a) The price of mangoes.
(b) The costofproducing a truck for the fire department of Delhi, India.
(c) The quantity of mangoes produced for the mangoes market.
(d) The national economy's annual rate of growth.

14. The branch of economic theory that deals with the problem of allocation of resources is
(a) Micro-Economic theory. (b) Macro-economic theory.
(c) Econometrics.
(d) none of the above.

15. Which of the following is not the subject matter of Business Economics?
(a) Should our firm be in this business?
(b) How much should be produced and at price should be kept?
(c) How will the product be placed in the market?
(d) How should we decrease unemployment in the economy?

16. Which of the following is a normative economic statement?
(a) Unemployment rate decreases with industrialization
(b) Economics is a social science that studies human behaviour.
(c) The minimum wage should be raised to ' 200/- per day
(d) India spends a huge amount of money on national defence.

17. Which of the following would be considered a topic of study in Macroeconomics?
(a) The effect of increase in wages on the profitability of cotton industry
(b) The effect on steel prices when more steel is imported
(c) The effect of an increasing inflation rate on living standards of people in India
(d) The effect of an increase in the price of coffee on the quantity of tea consumed

18. The difference between positive and normative Economics is:
(a) Positive Economics explains the performance of the economy while normative Economics finds out the reasons for poor performance.
(b) Positive Economics describes the facts of the economy while normative Economics involves evaluating whether some of these are good or bad for the welfare of the people.
(c) Normative Economics describes the facts of the economy while positive Economics involves evaluating whether some of these are good or bad for the welfare of the people.
(d) Positive Economics prescribes while normative Economics describes.

19. Which of the following is not within the scope of Business Economics?

(a) Capital Budgeting
(b) Risk Analyses
(c) Business Cycles
(d) Accounting Standards

20. Which of the following statements is incorrect?
(a) Business economics is normative in nature.
(b) Business Economics has a close connection with statistics.
(c) Business Economist need not worry about macro variables.
(d) Business Economics is also called Managerial Economics.

21. Economic goods are considered scarce resources because they
(a) cannot be increased in quantity.
(b) do not exist in adequate quantity to satisfy the requirements of the society.
(c) are of primary importance in satisfying social requirements.
(d) are limited to man made goods.

22. In a free market economy the allocation of resources is determined by
(a) voting done by consumers
(b) a central planning authority.
(c) consumer preferences.
(d) the level of profits of firms.

23. A capitalist economy uses ____________________ as the principal means of allocating resources.
(a) demand (b) supply
(c) efficiency (d) prices

24. Which of the following is considered as a disadvantage of allocating resources using the market system?
(a) Income will tend to be unevenly distributed.
(b) People do not get goods of their choice.
(c) Men of Initiative and enterprise are not rewarded.
(d) Profits will tend to be low.

25. Which of the following statements does not apply to a market economy?
(a) Firms decide whom to hire and what to produce.
(b) Firms aim at maximizing profits.
(c) Households decide which firms to work for and what to buy with their incomes.
(d) Government policies are the primary forces that guide the decisions of firms and households.

26. In a mixed economy
(a) all economic decisions are taken by the central authority.
(b) all economic decisions are taken by private entrepreneurs.
(c) economic decisions are partly taken by the state and partly by the private entrepreneurs.
(d) None of the above.

27. The central problem in economics is that of
(a) comparing the success of command versus market economies
(b) guaranteing that production occurs in the most efficient manner.
(c) guaranteing a minimum level of income for every citizen.
(d) allocating scarce resources in such a manner that society's unlimited needs or wants are satisfied inthe best possible manner.

28. Capital intensive technique would get chosen in a
(a) labour surplus economy where the relative price of capital is lower.
(b) capital surplus economy where the relative price of capital is lower.
(c) developed economy where technology is better.
(d) developing economy where technology is poor.

29. Which of the following is not one of the four central questions that the study of economics is supposed to answer?
(a) Who produces what?
(b) When are goods produced?
(c) Who consumes what?
(d) How are goods produced?

30. Larger production of ____goods would lead to higher production in future.
(a) consumer goods
(b) capital goods
(c) agricultural goods
(d) public goods

31. The economic system in which all the means of production are owned and controlled by private individuals for profit.
(a) Socialism
(b) Capitalism
(c) Mixed economy
(d) Communism

32. Macro Economics is the study of ______________________.
(a) all aspects of scarcity.
(b) the national economy and the global economy as a whole.
(c) big businesses.
(d) the decisions of individual businesses and people.

33. Freedom of choice is the advantage of
(a) Socialism (b) Capitalism
(c) Communism (d) None of the above

34. Exploitation and inequality are minimal under:
(a) Socialism (b) Capitalism
(c) Mixed economy (d) None

35. Administered prices refer to:
(a) Prices determined by forces of demand and supply
(b) Prices determined by sellers in the market
(c) Prices determined by an external authority which is usually the government
(d) None of the above

HOME WORK

1. Right to own private property is found in:
(a) Socialism (b) Capitalism
(c) Mixed economy (d) Both b and c

2. Macro economics doesn't include one example from the following:
(a) National income and output
(b) Study of firms
(c) General price level
(d) Saving and Investment

3. With the same amount of resources a farmer can feed following combinations of goats and horses

	Goats	Horses
OPTION 1	168	44
OPTION2	150	50

Given the option available with him, what is the opportunity cost to the farmer of feeding one horse?
(a) 1 goat (b) 3 horses
(c) 3 goats (d) 18 goats

4. Price of essential goods are decided by the Government and prices of normal goods are decided by market forces of demand and supply. This concept is called-
(a) Pricing mechanism
(b) Market mechanism
(c) Dual system of pricing
(d) Unregulated pricing

5. Micro economics is also called
(a) Price theory
(b) Income theory
(c) Irrelevant theory
(d) Development theory

6. Economic laws are essentially _______ and _______
(a) hypothetical, conditional
(b) hypothetical, unconditional
(c) neutral, rigid
(d) neutral, flexible

7. Which type of economic system does the United States have?
   (a) traditional
   (b) Command
   (c) Free
   (d) Mixed
8. The tribe relied on hunting and farming for food. The boy knew he would be a farmer just like his dad had been. What kind of economic system does this describe?
   (a) Mixed economy
   (b) Free economy
   (c) Traditional economy
   (d) Command economy
9. In the former Soviet Union consumers had to wait in long lines to buy everyday items like bread. They did not have many choices and the government controlled factories. What type of economy did they live in?
   (a) Mixed economy
   (b) Command economy
   (c) Free economy
   (d) Traditional economy
10. There is little or no government control in a _____________ economy.
    (a) Mixed economy
    (b) Free economy
    (c) Controlled economy
    (d) Traditional economy
11. The fundamental economic problem faced by all societies is:
    (a) unemployment (b) inequality
    (c) poverty (d) scarcity
12. If you were working full-time now, you could earn $20,000 per year. Instead, you are working part-time while going to school. In your current part-time job, you earn $5,000 per year. At your school, the annual cost of tuition, books, and other fees is $2,000. The opportunity cost of completing your education is:
    (a) $2,000 (b) $5,000
    (c) $17,000 (d) $20,000
    (e) $22,000
13. Economics is the study of
    (a) production technology
    (b) consumption decisions
    (c) how society decides what, how, and for whom to produce
    (d) the best way to run society
14. Scarcity is a situation in which
    (a) wants exceed the resources available to satisfy them
    (b) something is being wasted
    (c) people are poor
    (d) none of the above
15. Oikonomia means
    (a) Aikonomia (b) Wikipedia
    (c) household (d) None
16. ___________________ refers to the process of selecting an appropriate alternative that will provide the most efficient means of attaining a desired end, from two or more alternative courses of action.
    (a) Organisation
    (b) Management
    (c) Decision making
    (d) Supervision
17. The concept of socialist economy was propounded by
    (a) Karl Marx and Frederic Engels
    (b) Marshall
    (c) Adam Smith
    (d) None of the above
18. Economics is
    (a) Science only
    (b) Science and an art both
    (c) An art
    (d) None of the above
19. The concept of per-capita income is concept of
    (a) Public economics
    (b) International economics
    (c) micro economics
    (d) macro economics

20. Which of the following is an economic activity?
   (a) Seeing TV
   (b) Teaching one's own son at home
   (c) Medical facilities rendered by a hospital
   (d) A housewife preparing food for household

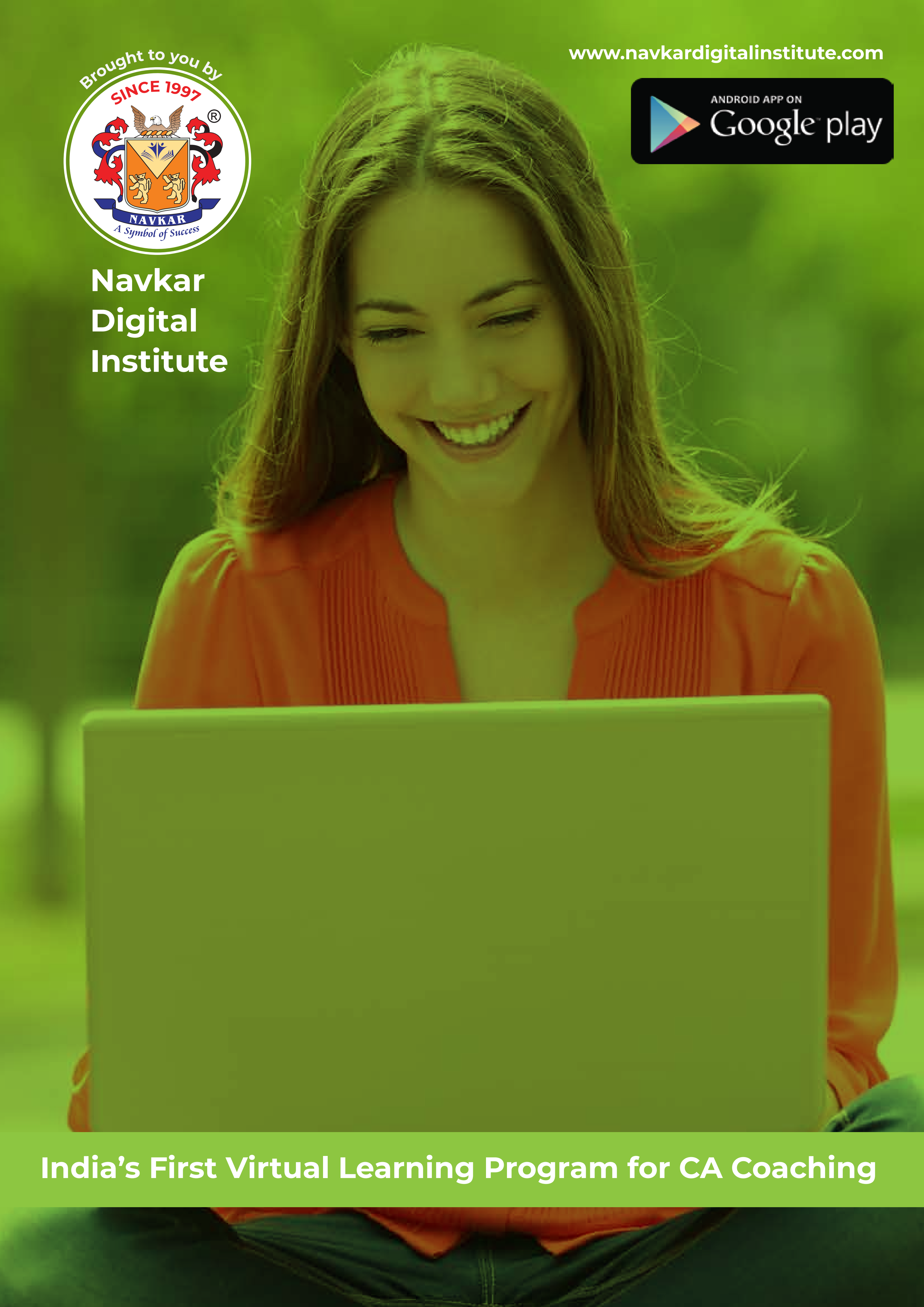
21. Economic laws can be compared with the laws of
   (a) physics (b) biology
   (c) chemistry (d) tides

22. India has adopted
   (a) socialist economy
   (b) capitalistic economy
   (c) mixed economy
   (d) Russian type economy

23. Economic laws are
   (a) very accurate
   (b) less accurate than the laws of management
   (c) less accurate than the laws of physical sciences
   (d) universal

ANSWER KEY

1.	(d)	2.	(b)	3.	(c)
4.	(c)	5.	(a)	6.	(a)
7.	(c)	8.	(b)	9.	(b)
10.	(b)	11.	(d)	12.	(c)
13.	(c)	14.	(a)	15.	(c)
16.	(c)	17.	(a)	18.	(b)
19.	(d)	20.	(c)	21.	(d)
22.	(c)	23.	(c)		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