
Nature and Scope of Business Economics

- ❖ *Unit 1: Introduction*
 - ❖ *Unit 2: Nature and Scope of Business Economics*
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WHAT IS ECONOMICS ABOUT?

- ❑ The term 'Economics' owes its origin to the Greek word 'Oikonomia' which means 'household'.
- ❑ 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 first modern work of Economics.
- ❑ There are 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
- ❑ Till 19th century, Economics was known as 'Political Economy.'
- ❑ 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.
- ❑ Economics is 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 is not just about how a nation allocates its scarce productive resources to various uses; it also deals with
 - (a) the processes by which the productive capacity of these resources is increased and
 - (b) with the factors which have led to sharp fluctuations in the rate of utilisation of these resources.

DECISION MAKING

- ❑ We all know that, 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 judgment on the basis of information and choice of a particular alternative which the decision maker finds as the most suitable.
- ❑ 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.

- ❑ Few examples of issues requiring decision making in the context of businesses are illustrated below:
 - Should our 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?
 - 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?
- ❑ Decision making is not simple and straightforward as the economic environment in which the firm functions is highly complex and dynamic.
- ❑ Most of the time, decisions are to be taken under conditions of imperfect knowledge and uncertainty.
- ❑ Decision making requires that the management be equipped with proper methodology and appropriate analytical tools and techniques.
- ❑ Business Economics meets these needs of the management (Helps Management In Decision Making) by providing a huge corpus of theory and techniques.

BUSINESS ECONOMICS

- ❑ As per Joel Dean, 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.
- ❑ Business Economics is also referred to as Managerial Economics (i.e. The integration of economic theory with business practice)
- ❑ 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.
- ❑ Business Economics comprises of that part of economic knowledge, logic, theories and analytical tools that are used for rational business decision making.
- ❑ In Short, it is Applied Economics that fills the gap between economic theory and business practice.
- ❑ The economic world is extremely complex as there is a lot of interdependence among the decisions and activities of economic entities.
- ❑ Economic theories are hypothetical and simplistic in character as they are based on economic models built on simplifying assumptions. Therefore, usually, there is a gap between the propositions of economic theory and happenings in the real economic world in which the managers make decisions.

- ❑ Business Economics enables application of economic logic and analytical tools to bridge the gap between theory and practice.

MICRO AND MACRO ECONOMICS

MICROECONOMICS

- ❑ Adam Smith is considered to be the founder of the field of microeconomics.
- ❑ The term micro has been derived from Greek word *mikros* which means small.
- ❑ Microeconomics deals with analysis of behaviour and economic actions of small and individual units of the economy, like a particular consumer, a firm or a small group of individual units.
- ❑ For example, Individual income, individual output, price of a commodity, etc. Its main tools are Demand and Supply.

MACROECONOMICS

- ❑ The term macro has been derived from the Greek word *makros* which means large.
- ❑ Macroeconomics is that part of economic theory which studies the behaviour of aggregates of the economy as a whole.
- ❑ For example, National income, aggregate output, aggregate consumption, etc. Its main tools are Aggregate Demand and Aggregate Supply.

| Basis | Micro Economics | Macro Economics |
|-----------------------|--|--|
| Meaning | Microeconomics is that part of economic theory which studies the behaviour of individual units of an economy. | Macroeconomics is that part of economic theory which studies the behaviour of aggregates of the economy as a whole. |
| Tools | Demand and Supply. | Aggregate Demand and Aggregate Supply. |
| Basic Objective | It aims to determine price of a commodity or factors of production. | It aims to determine income and employment level of the economy. |
| Degree of Aggregation | It involves limited degree of aggregation. For example, market demand is derived by aggregating individual demands of all buyers in the particular market. | It involves the highest degree of aggregation. For example, aggregate demand is derived for the entire economy. |
| Basic Assumptions | It assumes all the macro variables to be constant, i.e., it assumes that national income, consumption, savings, etc. are constant. | It assumes that all the micro variables, like decisions of households and firms, prices of individual products, etc. are constant. |
| Other Name | It is also known as 'Price Theory'. | It is also known as 'Income and Employment Theory'. |
| Examples | Individual income, individual output. | National Income, National output. |

- ❑ While Business Economics is basically concerned with Micro Economics, Macro economic analysis also has got an important role to play.
- ❑ Macroeconomics analyzes the background of economic conditions in an economy which will immensely influence the individual firm's performance as well as its decisions.
- ❑ For example, knowledge regarding conditions of inflation and interest rates will be useful for the business economist in framing suitable policies.

TRY YOUR UNDERSTANDING 1.1.1

1. Macro-economics is also known as

| | |
|------------------------------------|-------------------------------|
| (i) Method of Lumping | (ii) Price Theory |
| (iii) General equilibrium analysis | (iv) Aggregative Economics |
| (a) (i) and (ii) only | (b) (iii) and (iv) only |
| (c) (i), (iii) and (iv) only | (d) (ii), (iii) and (iv) only |
2. Micro economics covers the study of

| | |
|-----------------------------------|-----------------------------|
| (i) Consumer's behavior | (ii) Producer's equilibrium |
| (iii) Fiscal system of an economy | (iv) Factor pricing |
| (a) (i) and (iii) only | (b) (ii) and (iv) |
| (c) (i), (ii) and (iii) | (d) (i), (ii) and (iv) |
3. Micro economics does not cover:

| | |
|-------------------------|---------------------|
| (a) Consumer behaviour | (b) Factor Pricing |
| (c) General price level | (d) Product Pricing |
4. Micro economics deals with:

| |
|---|
| (a) Inflation in the contry |
| (b) The economics behavior of an individual unit |
| (c) The per capita income |
| (d) The problems of poverty and unemployment in the country |
5. The objective of macro-economics is to study about:

| |
|--|
| (a) Problems, principles and policies relating to full employment of available resources |
| (b) Problems, Principles and policies relating to optimum allocation of resources |
| (c) Growth of resources |
| (d) Both (a) and (c) |
6. Business economics is also known as

| | |
|-----------------------|--------------------------|
| (a) Micro economics | (b) Macro economics |
| (c) Applied economics | (d) Managerial economics |

Answer Key

1. (b) 2. (d) 3. (d) 4. (c) 5. (c) 6. (d)

NATURE OF BUSINESS ECONOMICS

The following points will describe the nature of Business Economics:

1. Business Economics is a Science:

- Science is a systematized body of knowledge which establishes cause and effect 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.

2. Business Economics is also an Art as it involves practical application of rules and principles for the attainment of set objectives.

3. Based on Micro Economics:

- Business Economics is based largely on Micro-Economics.
- A business manager is usually concerned about achievement of the predetermined objectives of his organisation so as to ensure the long-term survival and profitable functioning of the organization.

4. Incorporates elements of Macro Analysis:

- A business unit does not operate in a vacuum. It is affected by the external environment of the economy in which it operates.
- 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/ her business environment.

5. Use of Theory of Markets and Private Enterprises: Business Economics largely uses the theory of markets and private enterprise. It uses the theory of the firm and resource allocation in the backdrop of a private enterprise economy.

6. Pragmatic in Approach:

- Micro-Economics is abstract and purely theoretical and analyses economic phenomena 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.

7. Interdisciplinary in Nature: Business Economics is interdisciplinary in nature as it incorporates tools from other disciplines such as Mathematics, Operations Research, Management Theory, Accounting, marketing, Finance, Statistics and Econometrics.

8. Normative in Nature:

- Business Economics is generally normative or prescriptive in nature.
- It suggests the application of economic principles with regard to policy formulation, decision-making and future planning.

- However, if the firms are to establish valid decision rules, they must thoroughly understand their environment. This requires the study of positive or descriptive economic theory. Thus, Business Economics combines the essentials of normative and positive economic theory, the emphasis being more on the former than the latter.

POSITIVE ECONOMICS AND NORMATIVE ECONOMICS

POSITIVE ECONOMICS

- Positive economics studies the facts of life, i.e., it deals with 'things as they are'. Positive Economics deals with what are the economic problems and how are they actually solved. For example, India is an overpopulated country or prices are constantly rising.
- Positive statements describe what was, what is or what will be under the given state of circumstances. These statements do not pass any value judgements
- Positive economics statements should not be confused as statements of truth. They may be true or false.
- For example, If Anurag says that India is the most populated country in the world and Pratham says that China is the most populated country, then both are positive statements. However, Anurag is wrong and Pratham is right.

NORMATIVE ECONOMICS

- Normative economics tells us 'what ought to be'.
- Normative Economics deals with what ought to be or how the economic problems should be solved.
- For example, India should not be an overpopulated country or prices should not rise.
- Normative economics discusses what are desirable things and should be realised and what are undesirable things and should be avoided. It gives decisions regarding value judgements.

| ECONOMICS AS A SCIENCE | |
|------------------------|------------------------------|
| POSITIVE SCIENCE | NORMATIVE SCIENCE |
| □ What is? | □ What ought to be? |
| □ What was? | □ What should happen? |
| □ What will be? | □ What should have happened? |

Difference between Positive Economics and Normative Economics

| Basis | Positive Economics | Normative Economics |
|--------------|---|---|
| Meaning | It deals with what is or how the economic problems are actually solved. | It deals with what ought to be or how the economic problems should be solved. |
| Verification | It can be verified with actual data. | It cannot be verified with actual data. |

| Basis | Positive Economics | Normative Economics |
|------------------|--|---|
| Purpose | It aims to make real description of an economic activity. | It aims to determine the ideals. |
| Suggestive | It is based upon facts, and thus, not suggestive. | It is based upon individual opinion and therefore, it is suggestive in nature. |
| Value Judgements | It does not give any value judgements, i.e. it is neutral between ends. | It gives value judgements. |
| Examples | 1. Prices in Indian economy are constantly rising 2. There are inequalities of income in our economy. | 1. India should take steps to control rising prices. 2. Income inequalities should be reduced. |

TRY YOUR UNDERSTANDING 1.1.2

- Business economics is:
 - Art
 - Science
 - Both (a) and (b)
 - None of the above
- Positive economics deals with:
 - What is
 - What ought to be
 - Both (a) and (b)
 - None of these
- Economics is a science because _____
 - Systematised study
 - Scientific laws
 - Has its own methodology
 - All of the above
- Positive statements concern what is; normative statements concern:
 - What was
 - What is the normal situation
 - What will be
 - What ought to be
- Which of the following statements are positive statements?
 - India is overpopulated
 - Agricultural income should be taxed.
 - Service-class people should be exempted from income tax
 - There is tremendous tax evasion in India,
 - (i) and (ii)
 - (i) and (iii)
 - (i) and (iv)
 - (iii) and (iv)
- Business Economics has a Pragmatic Approach which means it is not
 - Practical
 - Realistic
 - Abstract
 - All of the above

Answer Key

1. (c) 2. (a) 3. (d) 4. (d) 5. (d) 6. (c)

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:

- I. Internal issues or operational issues (this can be solved using Micro Economics)
- II. External issues or environmental issues (this can be solved using Macro Economics)

1. **Microeconomics applied to Internal or Operational Issues:** Operational issues include all those issues that arise within the organization (i.e. internal in nature) and fall within the purview and control of the management.

For example, 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.

The following Microeconomics theories deal with most of these issues.

(a) Demand Analysis:

- Demand analysis pertains to the behaviour of consumers in the market.
- 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.

(b) Demand Forecasting:

- 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.

(c) Production and Cost Analysis:

- Production theory explains the relationship between inputs and output.
- A business economist has to decide on the optimum size of output, given the objectives of the firm.
- 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.

(d) Inventory Management:

- Inventory management theories pertain to rules that firms can use to minimise the 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.

(e) Market Structure and Pricing Policies:

- Analysis of the market structure provides information about the 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.

(f) 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.

(g) Theory of Capital and Investment Decisions: For ness Economics supports decision making on allocation of scarce capital among competing uses of funds.

(h) Profit Analysis:

- Profits are, most often, uncertain due to changing prices and market conditions.
- Profit theory guides the firm in the measurement and management of profits under conditions of uncertainty.
- Profit analysis is also immensely useful in future profit planning.

(i) 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 External or Environmental Issues: Environmental factors have significant influence upon the functioning and performance of business. The major macro-economic factors relate to:

- (a) The type of economic system.
- (b) Stage of business cycle.
- (c) The general trends in national income, employment, prices, saving and investment.
- (d) Government's economic policies like industrial policy, competition policy, monetary and fiscal policy, price policy, foreign trade policy and globalization policies.
- (e) Working of financial sector and capital market.
- (f) Socio-economic organizations like trade unions, producer and consumer unions and cooperatives.

(g) Social and political environment.

Note: Study of Inventory Management, Product and Promotion Policy, Resource Allocation, Capital Budgeting, Risk and Uncertainty Analysis are outside the scope of this book. They will be taught in other subjects – Financial Management, Strategic Management etc. at higher levels of CA course.

TRY YOUR UNDERSTANDING 1.1.3

1. All of the following are within the scope of Business Economics except_____
 - (a) Capital Budgeting
 - (b) Risk Analysis
 - (c) Business Cycles
 - (d) Accounting Standards
2. Operational issues of a firm can be solved through
 - (a) Micro-economics
 - (b) Macro economics
 - (c) Normative economics
 - (d) Positive economics

Answer Key

1. (d) 2. (a)



Nature and Scope of Business Economics

BASIC PROBLEMS OF AN ECONOMY

- ❑ All countries, without exceptions, face the problem of scarcity.
- ❑ Their resources (natural productive resources, man-made capital goods, consumer goods, money and time etc.) are limited and these resources have alternative uses.
- ❑ For example, coal can be used as a fuel for the production of industrial goods; it can be used for producing electricity, for domestic cooking purposes and for many other purposes.
- ❑ If the resources were unlimited, people would be able to satisfy all their wants and there would be no economic problem.
- ❑ Also, if a resource has only a single use, then also the economic problem would not arise.
- ❑ 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:
 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?

CENTRAL ECONOMIC PROBLEM

1. What to produce?

- Since the resources are limited, every society has to decide which goods and services should be produced and how many units of each good (or service) should 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.

2. How to produce?

- There are various alternative techniques of producing a commodity.
- Society 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.

3. For whom to produce?

- Another important decision which a society has to take is 'for whom' it should produce.
- 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.

4. What provision should be made for economic growth?

- A society would not like to use all its scarce resources for current consumption only.
- If Society 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.

TRY YOUR UNDERSTANDING 1.2.1

1. 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
2. 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
3. Human wants are in response to satisfy their wants?
 - (a) Unlimited
 - (b) Limited
 - (c) Scarce
 - (d) Multiple
4. The central problems of an economy arises because of—
 - (a) Unlimited wants
 - (b) Scarce resources having alternative uses
 - (c) Limited wants and unlimited resources
 - (d) Both (a) and (b)
5. The central problem of an economy is
 - (a) Assigning limited resources in a way that unlimited desires and needs of the society are satisfied
 - (b) Ensuring a minimum income for each citizen.
 - (c) Assuring that production happens in the most effective way.
 - (d) Analyzing the demand with market economies.

Answer Key

1. (b) 2. (a) 3. (a) 4. (d) 5. (a)

TYPES OF ECONOMIES

We divide all the economies into three broad classifications based on their mode of production, exchange, distribution and the role which their governments plays in economic activity. These are:

- ❑ Capitalist Economy
- ❑ Socialist Economy
- ❑ Mixed Economy

CAPITALIST ECONOMY (OR A FREE MARKET ECONOMY OR LAISSEZ-FAIRE ECONOMY)

- ❑ It is an economic system in which all means of production are owned and controlled by private individuals for profit.
- ❑ Decisions of consumers and businesses determine economic activity.
- ❑ The government has a limited role in the management of the economic affairs under this system.

Characteristics of Capitalist Economy

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 (Leave or pass on to other person) 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 engage in 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 regarding consumption, work, production, exchange etc.

4. Profit motive:

- Profit motive is the driving force in a free enterprise economy and directs all economic activities.
- Desire for profits induces entrepreneurs to organize production so as to earn maximum profits.

5. Consumer Sovereignty:

- Consumer is supposed to be the king under capitalism.

- Consumer sovereignty means that buyers ultimately determine which goods and services will be produced and in what quantities.
 - Consumers have unbridled (not Controlled) 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 brings out 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 or regulated 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.

Merits of Capitalist Economy

1. Self-regulating and works automatically through price mechanism.
2. The existence of private property and profit motive result in greater efficiency and incentive to work.
3. Economic growth is likely to be faster because the investors try to invest in only those projects which are economically feasible.
4. Resources are used in activities in which they are most productive. This results in optimum allocation of the available productive resources of the economy.
5. High degree of operative efficiency
6. Cost of production is minimized as every producer tries to maximize his profit by employing methods of production which are cost-effective.
7. Competition forces producers to bring in a large variety of good quality products at reasonable prices. Also, freedom of choice ensures maximum satisfaction to consumers, which leads to higher standard of living.
8. Capitalism offers incentives for innovation and technological progress.
9. Capitalism rewards men of initiative and enterprise and punishes the imprudent and inefficient.
10. Preservation of fundamental rights such as right to private property is preserved under capitalism
11. Encourages enterprise and risk taking.

Demerits of Capitalism

1. There is vast economic inequality and social injustice. Inequalities reduce the aggregate economic welfare of the society and split the society into two classes namely the 'haves' and the 'have-nots', sowing the seeds of social unrest and class conflict.
2. 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. Ignores human welfare because, 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 which leads to strikes and lock outs. Also, there is no security of employment. This makes workers more vulnerable.
7. Consumer sovereignty is a myth. 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.
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 or foul means.
13. Excessive materialism as well as conspicuous and unethical consumption leads to environmental degradation.

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. It uses the impersonal forces of market demand and supply or the price mechanism to solve its central problems.

1. What to produce?

- In a capitalist economy the question regarding what to produce is ultimately decided by consumers who show their preferences by spending on the goods which they want.
- The aim of an entrepreneur is to earn as much profits as possible.
- 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.

2. How to produce?

- An entrepreneur will produce goods and services choosing that technique of production 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.

3. For Whom to produce?

- Goods and services in a capitalist economy will be produced for those who have 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.

4. Consumption, Saving And Investment?

- Consumption and savings are done by consumers and investments are done by entrepreneurs.
- Consumers' savings, among other factors, are governed by the rate of interest prevailing in the market. Higher the level of income and 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.

SOCIALIST ECONOMY (COMMAND ECONOMY OR A CENTRALLY PLANNED 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.
- ❑ The resources are allocated according to the commands of a central planning authority and therefore, market forces (Demand & Supply) have no role in the allocation of resources.

Characteristics Of Socialist Economy

Some important characteristics of this economy are:

1. 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, profitmotive 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.

2. 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.

3. Absence of Consumer Choice:

- Freedom from hunger is guaranteed, but consumers' sovereignty gets restricted 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.

4. Relatively Equal Income Distribution:

- A relative equality of income is an important feature of Socialism.
- 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.

5. Minimum role of Price Mechanism or Market forces:

- The prices prevailing under socialism are 'administered prices' which are set by the central planning authority on the basis of socio-economic objectives.
- Price mechanism exists in a socialist economy; but it 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.

6. Absence of Competition: Since the state is the sole entrepreneur, there is absence of competition under socialism.

Note:

- ❑ The erstwhile U.S.S.R. was an example of socialist economy from 1917 to 1990.
- ❑ In today's world there is no country which is purely socialist.
- ❑ Other examples include Vietnam, China and Cuba. North Korea, the world's most totalitarian state, is another example of a socialist economy.

Merits of Socialism

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. 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. 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 better welfare of the society.
6. Socialism ensures right to work and minimum standard of living to all people
7. Under socialism, the labourers and consumers are protected from exploitation by the employers and monopolies respectively
8. There is provision of comprehensive social security (healthcare, education, housing, unemployment benefits, pensions, and other forms of assistance) under socialism and this makes citizens feel secure.

Demerits of Socialism

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. 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. It becomes more difficult to regulate than the private monopolies under capitalism.
7. The consumers have limited freedom of choice, they have to accept what the state produces.
8. 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.

THE MIXED ECONOMY

- ❑ The mixed economic system depends on both markets and governments for allocation of resources.
- ❑ Every economy in the real world makes use of both markets and governments and therefore is mixed economy in its nature.
- ❑ Mixed economy includes merit 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 profit motive.

- ❑ The state imposes necessary measures to control and to regulate the private sector to ensure that they function in accordance with the welfare objectives of the nation.
- ❑ For this purpose, the Government itself must run important and selected industries and eliminate the free play of profit motive and self-interest.
- ❑ In a mixed economy, there are three sectors of industries:
 - (a) **Private sector:** Production and distribution in this sector are managed and controlled by private individuals and groups. Industries in this sector are based on self-interest and profit 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 profit-oriented, but are set up by the State for the welfare 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.

Merits of Mixed Economy

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.
2. Price mechanism and competition forces the private sector to promote efficient decision-making 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.

Demerits of Mixed Economy

1. Mixed economy is not always a 'golden path' between capitalism and socialism. It could also suffer from substantial uncertainties.
2. Excessive controls by the state resulting in reduced incentives and constrained growth of the private sector
3. 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.
4. In the absence of strong governmental initiatives, the private sector is likely to grow disproportionately.

TRY YOUR UNDERSTANDING 1.2.2

1. A mixed economy to solve its central problems relies on -
(a) Economic planning (b) Price mechanism
(c) Price fixing (d) Both (a) and (b)
2. In a socialist economy, the basic force of economic activity is profit. This statement is -
(a) Correct (b) Incorrect
(c) Partially correct (d) None of these
3. The interference of the government is very limited in -
(a) Socialist economy (b) Capitalist economy
(c) Mixed economy (d) All the above
4. In a competitive economy, the uncrowned king is -
(a) Government (b) Producer (c) Consumer (d) Sell
5. Wastes of competition are found in -
(a) Capitalist economy (b) Socialist economy
(c) Mixed economy (d) None of these
6. A dual system of pricing exists in -
(a) Capitalist economy (b) Socialist economy
(c) Mixed economy (d) None of these
7. One of the important features of capitalist economy is -
(a) Economic planning (b) Price mechanism
(c) Economic qualities (d) Social welfare

Answer Key

1. (d) 2. (b) 3. (b) 4. (c) 5. (a) 6. (a) 7. (c)

EXERCISE

1. Economists regard decision making as important because:
(a) The resources required to satisfy our unlimited wants and needs are finite, or 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.
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 cost of producing a fire 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.

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) guaranteeing that production occurs in the most efficient manner.
- (c) guaranteeing 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 in the 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 of the above

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

36. In Economics, the central economic problem means:

- (a) Output is restricted to the limited availability of resources
- (b) Consumer do not have as much money as they would wish
- (c) There will always be certain level of unemployment
- (d) Resources are not always allocated in an optimum way

37. Scarcity definition of Economics is given by-

- (a) Alfred Marshall (b) Samuelson (c) Robinson (d) Adam Smith

38. The definition "Science which deals with wealth of Nation" was given by:

- (a) Alfred Marshall (b) A C Pigou (c) Adam Smith (d) J B Say

39. Which of the following is not one of the features of capitalist economy?

- (a) Right of private property (b) Freedom of choice by the consumers
- (c) No profit, No Loss motive (d) Competition

40. There is need of economic study, because-

- (a) The resources are limited (b) The wants are unlimited
- (c) The resources are unlimited (d) Both a and b

41. The benefit of economic study is-

- (a) It ensure that all problems will be appropriately tackled
- (b) It helps in identifying problems
- (c) It enable to examine a problem in its right perspective
- (d) It gives exact solutions to every problem

42. The managerial economics-

- (a) Is Applied Economics that fills the gap between economic theory and business practice
- (b) Is just a theory concept
- (c) Trains managers how to behave in recession
- (d) Provides the tools which explain various concepts

43. Which of the following statements is correct?

- (a) Micro economics is important for study of a particular household and a particular firm
- (b) Macro economics is important for study of economic conditions of a country
- (c) None of the above
- (d) Both (a) and (b)

44. Mr. Satish hired a business consultant to guide him for growth of his business. The consultant visited his factory and suggested some changes with respect to staff appointment, loan availability and so on. Which approach is that consultant using?
 (a) Micro economics (b) Macro economics
 (c) None of the above (d) Both (a) and (b)
45. Profit motive is a merit of
 (a) Socialism (b) Capitalism (c) Mixed economy (d) None of the above
46. _____ is also called as command economy
 (a) Socialist (b) Capitalist (c) Mixed economy (d) None of the above

Answer Key

1. (d) 2. (d) 3. (b) 4. (a) 5. (d) 6. (a) 7. (b) 8. (a) 9. (a) 10. (b)
 11. (d) 12. (d) 13. (d) 14. (a) 15. (d) 16. (c) 17. (c) 18. (b) 19. (d) 20. (c)
 21. (b) 22. (c) 23. (d) 24. (a) 25. (d) 26. (c) 27. (d) 28. (b) 29. (b) 30. (b)
 31. (b) 32. (b) 33. (b) 34. (a) 35. (c) 36. (a) 37. (c) 38. (c) 39. (c) 40. (d)
 41. (c) 42. (a) 43. (d) 44. (a) 45. (b) 46. (a)



Nature and Scope of Business Economics

BASIC PROBLEMS OF AN ECONOMY

- All countries, without exceptions, face the problem of scarcity.
- Their resources (natural productive resources, man-made capital goods, consumer goods, money and time etc.) are limited and these resources have alternative uses.
- For example, coal can be used as a fuel for the production of industrial goods; it can be used for producing electricity, for domestic cooking purposes and for many other purposes.
- If the resources were unlimited, people would be able to satisfy all their wants and there would be no economic problem.
- Also, if a resource has only a single use, then also the economic problem would not arise.
- 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:
 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?

Central Economic Problem

i. What to produce?

- Since the resources are limited, every society has to decide which goods and services should be produced and how many units of each good (or service) should 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.

ii. How to produce?

- There are various alternative techniques of producing a commodity.
- Society 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 should produce.
- 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.

iv. What provision should be made for economic growth? :

- A society would not like to use all its scarce resources for current consumption only.
- If Society 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.

TRY YOUR UNDERSTANDING 2.1

1. 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
2. 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
3. Human wants are in response to satisfy their wants?

| | |
|---------------|--------------|
| (a) Unlimited | (b) Limited |
| (c) Scarce | (d) Multiple |
4. The central problems of an economy arises because of—
 - (a) Unlimited wants
 - (b) Scarce resources having alternative uses
 - (c) Limited wants and unlimited resources
 - (d) Both (a) and (b)

5. The central problem of an economy is

- (a) Assigning limited resources in a way that unlimited desires and needs of the society are satisfied
- (b) Ensuring a minimum income for each citizen.
- (c) Assuring that production happens in the most effective way.
- (d) Analyzing the demand with market economies.

ANSWER

1. (b) 2. (a) 3. (a) 4. (d) 5. (a)

TYPES OF ECONOMIES

We divide all the economies into three broad classifications based on their mode of production, exchange, distribution and the role which their governments plays in economic activity. These are:

- Capitalist economy
- Socialist economy
- Mixed economy

Capitalist Economy (Or a Free Market Economy or Laissez- Faire Economy)

- It is an economic system in which all means of production are owned and controlled by private individuals for profit.
- Decisions of consumers and businesses determine economic activity.
- The government has a limited role in the management of the economic affairs under this system.

Characteristics of Capitalist Economy

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 (Leave or pass on to other person) 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 engage in 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 regarding consumption, work, production, exchange etc.

4. Profit motive:

- Profit motive is the driving force in a free enterprise economy and directs all economic activities.
- Desire for profits induces entrepreneurs to organize production so as to earn maximum profits.

5. Consumer Sovereignty:

- Consumer is supposed to be the king under capitalism.
- Consumer sovereignty means that buyers ultimately determine which goods and services will be produced and in what quantities.
- Consumers have unbridled (not Controlled) 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 brings out 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 or regulated 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.

Merits of Capitalist Economy

1. Self-regulating and works automatically through price mechanism.
2. The existence of private property and profit motive result in greater efficiency and incentive to work.
3. Economic growth is likely to be faster because the investors try to invest in only those projects which are economically feasible.
4. Resources are used in activities in which they are most productive. This results in optimum allocation of the available productive resources of the economy.
5. High degree of operative efficiency
6. Cost of production is minimized as every producer tries to maximize his profit by employing methods of production which are cost-effective.

7. Competition forces producers to bring in a large variety of good quality products at reasonable prices. Also, freedom of choice ensures maximum satisfaction to consumers, which leads to higher standard of living.
8. Capitalism offers incentives for innovation and technological progress.
9. Capitalism rewards men of initiative and enterprise and punishes the imprudent and inefficient.
10. Preservation of fundamental rights such as right to private property is preserved under capitalism
11. Encourages enterprise and risk taking.

Demerits of Capitalism

1. There is vast economic inequality and social injustice. Inequalities reduce the aggregate economic welfare of the society and split the society into two classes namely the 'haves' and the 'have-nots', sowing the seeds of social unrest and class conflict.
2. 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. Ignores human welfare because, 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 which leads to strikes and lock outs. Also, there is no security of employment. This makes workers more vulnerable.
7. Consumer sovereignty is a myth. 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.
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 or foul means.
13. Excessive materialism as well as conspicuous and unethical consumption leads to environmental degradation.

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. It uses the impersonal forces of market demand and supply or the price mechanism to solve its central problems.

a. what to produce:

- In a capitalist economy the question regarding what to produce is ultimately decided by consumers who show their preferences by spending on the goods which they want.
- The aim of an entrepreneur is to earn as much profits as possible.
- 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.

b. How to produce?

- An entrepreneur will produce goods and services choosing that technique of production 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.

c. For Whom to produce?

- Goods and services in a capitalist economy will be produced for those who have 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.

d. Consumption, Saving And Investment?

- Consumption and savings are done by consumers and investments are done by entrepreneurs.
- Consumers' savings, among other factors, are governed by the rate of interest prevailing in the market. Higher the level of income and 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.

SOCIALIST ECONOMY (Command Economy or a Centrally Planned 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.
- ❑ the resources are allocated according to the commands of a central planning authority and therefore, market forces (Demand & Supply) have no role in the allocation of resources.

Characteristics Of Socialist Economy

Some important characteristics of this economy are:

(a) 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, profitmotive 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.

(b) 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.

(c) Absence of Consumer Choice:

- Freedom from hunger is guaranteed, but consumers' sovereignty gets restricted 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.

(d) Relatively Equal Income Distribution:

- A relative equality of income is an important feature of Socialism.
- 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.

(e) Minimum role of Price Mechanism or Market forces:

- The prices prevailing under socialism are 'administered prices' which are set by the central planning authority on the basis of socio-economic objectives.
- Price mechanism exists in a socialist economy; but it 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.

(f) Absence of Competition:

- Since the state is the sole entrepreneur, there is absence of competition under socialism.

Note:

- ❑ The erstwhile U.S.S.R. was an example of socialist economy from 1917 to 1990.
- ❑ In today's world there is no country which is purely socialist.
- ❑ Other examples include Vietnam, China and Cuba. North Korea, the world's most totalitarian state, is another example of a socialist economy.

Merits of Socialism

- (a) Equitable distribution of wealth and income and provision of equal opportunities for all help to maintain economic and social justice.
- (b) 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.
- (c) 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.
- (d) Unemployment is minimised, business fluctuations are eliminated and stability is brought about and maintained.
- (e) The absence of profit motive helps the community to develop a co-operative mentality and avoids class war. This, along with equality, ensures better welfare of the society.
- (f) Socialism ensures right to work and minimum standard of living to all people
- (g) Under socialism, the labourers and consumers are protected from exploitation by the employers and monopolies respectively
- (h) There is provision of comprehensive social security (healthcare, education, housing, unemployment benefits, pensions, and other forms of assistance) under socialism and this makes citizens feel secure.

Demerits of Socialism

- (a) Socialism involves the predominance of bureaucracy and the resulting inefficiency and delays. Moreover, there may also be corruption, red tapism, favouritism, etc.
- (b) 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.
- (c) Socialism takes away the basic rights such as the right of private property.
- (d) It will not provide necessary incentives to hard work in the form of profit.
- (e) Administered prices are not determined by the forces of the market. In the absence of such practice, the most economic and scientific allocation of resources and the efficient functioning of the economic system are impossible.
- (f) State monopolies created by socialism will sometimes become uncontrollable. It becomes more difficult to regulate than the private monopolies under capitalism.
- (g) The consumers have limited freedom of choice, they have to accept what the state produces.
- (h) Labourers are not rewarded according to their efficiency. This acts as a disincentive to work.
- (i) The extreme form of socialism is not at all practicable.

THE MIXED ECONOMY

- ❑ The mixed economic system depends on both markets and governments for allocation of resources.
- ❑ Every economy in the real world makes use of both markets and governments and therefore is mixed economy in its nature.
- ❑ Mixed economy includes merit 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 profit motive.
- ❑ The state imposes necessary measures to control and to regulate the private sector to ensure that they function in accordance with the welfare objectives of the nation.
- ❑ For this purpose, the Government itself must run important and selected industries and eliminate the free play of profit motive and self-interest.
- ❑ In a mixed economy, there are three sectors of industries:
 - (a) **Private sector:** Production and distribution in this sector are managed and controlled by private individuals and groups. Industries in this sector are based on self-interest and profit 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 profit-oriented, but are set up by the State for the welfare 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.

Merits of Mixed Economy

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

- (a) Economic freedom and existence of private property which ensures incentive to work.
- (b) Price mechanism and competition forces the private sector to promote efficient decision-making and better resource allocation.
- (c) Consumers are benefitted through consumers' sovereignty and freedom of choice
- (d) Appropriate incentives for innovation and technological progress.
- (e) Encourages enterprise and risk taking.
- (f) Advantages of economic planning and rapid economic development on the basis of plan priorities.
- (g) Comparatively greater economic and social equality and freedom from exploitation due to greater state participation and direction of economic activities.
- (h) Disadvantages of cut-throat competition averted through government's legislative measures such as environment and labour regulations.

Demerits of Mixed Economy

- (a) Mixed economy is not always a 'golden path' between capitalism and socialism. It could also suffer from substantial uncertainties.
- (b) Excessive controls by the state resulting in reduced incentives and constrained growth of the private sector
- (c) 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.
- (d) In the absence of strong governmental initiatives, the private sector is likely to grow disproportionately.

TRY YOUR UNDERSTANDING 2.2

1. A mixed economy to solve its central problems relies on –
 - (a) Economic planning
 - (b) Price mechanism
 - (c) Price fixing
 - (d) Both 'a' and 'b'
2. In a socialist economy, the basic force of economic activity is profit. This statement is –
 - (a) Correct
 - (b) Incorrect
 - (c) Partially correct
 - (d) None of these
3. The interference of the government is very limited in –
 - (a) Socialist economy
 - (b) Capitalist economy
 - (c) Mixed economy
 - (d) All the above
4. In a competitive economy, the uncrowned king is –
 - (a) Government
 - (b) Producer
 - (c) Consumer
 - (d) Sell
5. Wastes of competition are found in –
 - (a) Capitalist economy
 - (b) Socialist economy
 - (c) Mixed economy
 - (d) None of these
6. A dual system of pricing exists in –
 - (a) Capitalist economy
 - (b) Socialist economy
 - (c) Mixed economy
 - (d) None of these
7. One of the important features of capitalist economy is –
 - (a) Economic planning
 - (b) Price mechanism
 - (c) Economic qualities
 - (d) Social welfare

ANSWER

1. (d) 2. (b) 3. (b) 4. (c) 5. (a) 6. (c) 7. (b)

