

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

CENTRAL ECONOMIC PROBLEM

- What to produce & How much to produce
- How to produce, for whom to produce
- What provisions should be made for economic growth.

Problems of Allocation of resources:-

- What to produce

Human wants are unlimited and resources are limited to satisfy human wants. The question arises what goods are to be produced and in what quantity these goods to be produced.

- a) Durable / perishable goods
- b) single / Multiple use
- c) superior / inferior goods

It is also known as problem of choice making.

- How to produce

This problem is related to the problem of choice of treatment for producing a commodity. An economy has to choose between

- a) labour intensive technique &
- b) capital intensive technique

The economy has to decide about technique of production on the basis of cost of labour and capital. A labour surplus economy chooses labour intensive technique and a capital surplus economy chooses capital-intensive technique.

- for whom to produce

which determine the distribution of goods among the various individuals like,

a) class of society

b) targeted customers

c) their ability to purchase

to decide about the share of different people in the national goods and service.

- what provision should be made for economic growth

A society would not like to use all its scarce 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.

(Sustainable development).

◎ Capitalist economy

Capitalism is a political economic system based on private property and private profit. This type of system is also called laissez-faire or free market economy.

• Features

- Private ownership of property | Right to property
- Profit motive of production
- Freedom of enterprises (Government interference is 0)
- Existence of competition between producers
- In-equal distribution of Income

• Merits of capitalist economy

- Encourages economic activities
- Maximum efficiency
- Dynamic economy
- Rapid economic growth

• Demerits of Capitalist Economy

- Unequal distribution of income and wealth
- Business instability
- Consumer exploitation
- Misallocation of productive resources

◎ Socialist economy

Socialist economy is planned or command economy based on public ownership of property and social welfare motive. Prices are determined by central planning authority. Some of the socialist countries are Hungary, Poland, Yugoslavia.

• Features

Public ownership of property or factors of production

No freedom of enterprise i.e. complete role of govt.

Planning mechanism guides production

No competition

Social welfare motive

Equal distribution of income

• Merits of socialist economy

Optimum utilization of resources

Satisfaction of consumer needs

Equal distribution of income & wealth

• Demerits of socialist economy

Inaccurate calculation of cost

Bureaucratic set-up

Concentration of power in government hands.

⑥ Mixed economy

All economies are mixed economies with elements of both market and command. India is a mixed economy.

• features

- Planned economy
- Ownership of property is both by private and public sector.
- A dual system of pricing exists
- Balanced Regional Development
- Competition exists but is limited to the private sector.

► Merits of Mixed Economy

- Mixed economy secures the merits of both capitalism and socialism while avoiding the evils of both.
- Mixed economy protects individual freedom. Under the system, individuals have the freedom of consumption, choice of occupation, freedom of enterprise and freedom of expression.
- Price mechanism is allowed to operate under mixed economy.
- Reducing the inequalities of wealth and class struggle is one of the aims of mixed economy.
- Economic fluctuations can be avoided due to centrally planned economy.

> De-merits of Mixed Economy.

- Mixed economy is difficult to operate. Balancing and adjusting the public and private sector is often difficult.

- Excessive controls and heavy taxes are likely to prevail under mixed economy. This will discourage production in the private sector.

- Mixed economy is described by Schumpeter as capitalism in the oxygen tent. According to him it is only a trick of the capitalists to cheat the working class by offering them some temporary advantage like social security, uplift of the depressed class.