
UNIT 2 :- BASIC PROBLEMS OF AN ECONOMICS & ROLE OF PRICE MECHANISM

- 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 Problems*".



- 1) What to produce ? :- Capital Goods Or Consumer Goods.
- 2) How to produce ? :- Labour-intensive techniques or Capital-intensive techniques.
- 3) For whom to produce ? :- Decide on who should get how much of the total output of goods and service.
- 4) What provision should be made for economic growth ? :- A society would not like to use all its scarce resources for current consumption only.

❖ CAPITALIST ECONOMY

- All means of production are owned and controlled by **Private individuals for profits**.
- Called as "**Free Market Economy**" or "**Laissez-faire Economy**".
- **Eg**, US, UK, Hong Kong and South Korea.

❖ CHARACTERISTICS

- 1) Right to private property
- 2) Freedom of enterprise
- 3) Freedom of economic choice
- 4) Profit motive
- 5) Consumer Sovereignty
- 6) Competition
- 7) Absence of government interference

❖ HOW DO CAPITALIST ECONOMICS SOLVE THEIR CENTRAL PROBLEMS ?

- 1) What to produce :- Produce those goods which consumers wish to buy.
- 2) How to produce :- Cost of production minimum.
- 3) For whom to produce :- Those who have buying capacity.
- 4) Deciding about consumption, saving and investment :- Consumption and saving are done by consumers and investments are done by entrepreneurs.

❖ MERITS OF CAPITALIST ECONOMY

1. Self-regulating and works automatically through price mechanism.
2. Existence of private property and driving force of profit motive result in greater efficiency and incentive to work.
3. Economic growth to be faster.
4. Resources are used in activities in which they are most productive.
5. High degree of operative efficiency.
6. Cost of production is minimized to maximize the profit.
7. Consumers are benefitted as competition.
8. Offers incentives for innovation and technological progress.
9. Democratic framework.
10. Encourages enterprise and risk taking.

❖ DEMERITS OF CAPITALIST ECONOMY

1. Vast economic inequality and social injustice.
2. Property rights over human rights.
3. System ignores human welfare and aim is profit.
4. Due to income inequality, the pattern of demand does not present the real needs of the society.
5. Exploitation of labour is common and no security of employment.
6. Consumer sovereignty is a myth.
7. Misallocation of resources.
8. Less of merit goods like education and health care are produced.
9. Due to unplanned production, economic instability in terms of over production, economic depression, unemployment etc., is very common.

10. Spend huge amounts of money on advertisement and sales promotion activities.
11. Formation of monopolies
12. Environmental degradation.

❖ SOCIALIST ECONOMY

- Here, the resources are allocated according to the commands of a central planning authority.
- Socialist economy was propounded by **karl marx** and **Frederic Engels** in their work "**The Communist Manifesto**" published in **1848**.
- Also called as "**Command Economy**" or a "**Centrally Planned Economy**"

❖ CHARACTERISTICS

- 1) Collective Ownership
- 2) Economic Planning
- 3) Absence of Consumer Choice
- 4) Relatively Equal Income Distribution
- 5) Minimum role of Price Mechanism or Market forces
- 6) Absence of Competition

❖ MERITS OF SOCIALISM

1. Equitable distribution of wealth and income.
2. Rapid and balanced economic development is possible.
3. Competition is absent, there is no waste of resources on advertisement and sales promotion.
4. Unemployment is minimized.
5. Absence of profit motive.
6. Develop a co-operative mentality and avoids class war.
7. Socialism ensures right to work and minimum standard of living to all people.
8. Labour and consumers are protected from exploitation.
9. There is provision of comprehensive social security under socialism and this makes citizens feel secure.

❖ DEMERITS OF SOCIALISM

1. Socialism involves the predominance of bureaucracy and resulting inefficiency and delays. There may also be corruption, red tapism, favouritism, etc.
2. Restricts the freedom of individual.
3. Socialism takes away the basic rights such as the right of private property.
4. No incentives for hard work in the form of profit.
5. Sometimes monopoly become uncontrollable.
6. Consumer have limited freedom of choice.
7. Labourers are not rewarded according to their efficiency.
8. The Extreme form of socialism is not at all practicable.

❖ MIXED ECONOMY

- The mixed economic system depends on both markets and government for allocation of resources.

❖ FEATURES OF MIXED ECONOMY

- Co-existence of private and public sector :- The first important feature of a mixed economy is the co-existence of both private and public enterprise. In fact, in a mixed economy, there are three sectors of industries:
 - a) Private Sector
 - b) Public Sector
 - c) Combined Sector

❖ MERITS OF MIXED ECONOMY

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 sovereignty and freedom of choice.
4. Appropriate incentives for innovation and technological progress.
5. Encourages enterprise and risk taking.
6. Advantage of economic planning and rapid economic development.

7. Social equality and freedom from exploitation.

- **NOTE:-** However, mixed economy is not always a 'golden path' between Capitalism and socialism.

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