

## Unit - 2

### Basic Problem of an Economy. And Role of Price Mechanism

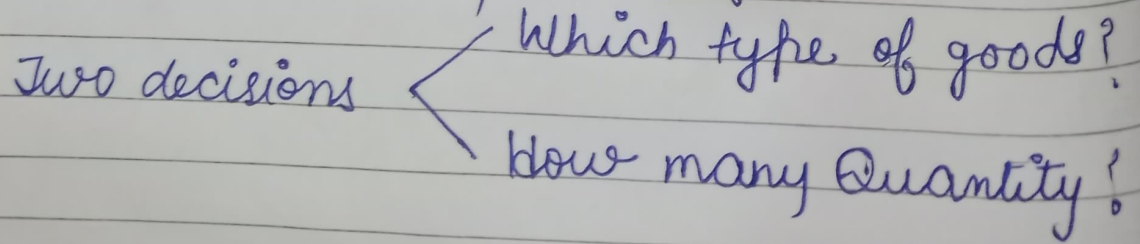
Every economic system, be it capitalist, socialist or mixed, has to deal with this central problem of scarcity of resources relative to the wants of them.

#### "Central Problems of an economy"

- What to produce?
- How to produce?
- For whom to produce?
- What provisions are to be made for economic growth?

#### \* What to produce?

- Resources are limited
- Society has to decide which goods and services should be produced and how many units of each goods should be produced.



### \* How to produce ?

Konsi technique use keni hi taki best use hoske resources ka

- Various alternative techniques of producing goods.
- Society has to decide between

- 1) Capital Intensive or
- 2) Labour Intensive Technique

- Choice depends on the availability of different factors of production, Relative prices, which technique makes the best use of available resources.

### \* For whom to produce ?

- For which section of society we have to produce goods.
  - \* Poor class section
  - \* Rich people
- How much of the total output of goods and services will be given to different sections.
- How the goods should be distributed among the members of society.

### \* What provision should be made for economic growth ?

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

- Make provision for future production
- Income or standard life of living of the people would remain stagnant and future level of income may actually decline. Therefore, society has to decide how much saving and investment should be made for future.

## " Types of Economies "

### 1) Capitalist Economy

- Predominant Economic System
- All means of production are owned and controlled by private individuals for profit
- Decisions of consumers and businesses determine economy activity.
- Govt has a limited role.
- Eg. United States  
United Kingdom  
Hong Kong  
South Korea

Free Market Economy  
laissez-faire Economy

→ Characteristics

① Right to private property

- Means productive factors such as land, factories, machinery, mines etc.
- Owners are free to use them in any manner in which they like and bequeath it as they desire.
- Govt. put some restrictions for the benefit of society in general.

② Freedom of enterprise

- Each individual (Consumer, producer or resource owner) is free to engage in any type of economic activity

③ Freedom of economic choice

- Free to make economic choice
- Consumption, work, production, exchange etc.

④ Profit motive

Induces entrepreneurs to organise production so as to earn maximum profits

- Main driving force in a free enterprise economy and directs all economic activities

## ⑤ Consumer Sovereignty

- Consumer is king
- Buyers will determine which goods and services will be produced and in what quantities.
- Consumers have unbridled freedom to choose, they will determine how limited resources are allocated.

## ⑥ Competition

- Brings out the best among buyers and sellers and results in efficient use of resources.

## ⑦ Absence of Govt. Interference

- All economic activities are guided by self-interest and price mechanism which operates automatically without any direction and control by the governmental authorities.

→ How do Capitalist Economy solve their central problem?

① 'What to produce'

- Aim of entrepreneur is to earn as much profit as possible.
- The question regarding what to produce is ultimately decided by consumers who show their preference by spending on the goods which they want.

② 'How to produce'

- Minimum cost of production technique should be used.
- Relative price of factors of production help in deciding how to produce.

③ 'For whom to produce'

- Production would be for those who have (buying capacity)  
↓  
(depends upon income)
- Higher the income → higher will be buying capacity and higher will be his demand for goods in general.

④

## Consumption, Saving and Investment

- Consumption and Saving are done by consumers and Investment are done by entrepreneurs.

- Consumer saving are governed by rate of interest prevailing in the market.

- Higher level of Income and Interest, Higher will be saving

- Investment depends upon the rate of return on capital.

- Greater the profit expectation → Greater will be investment

\* Rate of saving and Return on Capital are nothing but the prices of capital

## → Merits of Capitalist Economy

- Self regulating and work automatically through price mechanism.

- Economic growth is higher (but same entrepreneurs, but jyada profit earning, growth will be higher)

What should be provision made, for economic growth are decided by price market mechanism.

- Optimum allocation of available resources
- Incentive for innovation and technological progress.
- Profit motive is the main aim
- Functions in Democratic framework
- Cost of production is minimised.

### → Demerits of Capitalist Economy

- Socio Economic Inequality and social injustice
- Misallocation of resources (only luxury goods production)
- Unfairness in society and unequal economic opportunities.
- Less of Merit goods will be provided
- Unplanned production, economic instability.
- Environmental Degradation
- Formation of Monopolies

### Socialist Economy

Means of production are fully owned by the state.

- Socialised planned production on the basis of equal rights.
- Resources are allocated acc to

Propounded by Karl Marx and Frederick Engels in their work 'The Communist Manifesto' published in 1848. It is also known as Command / Centrally Planned Economy



## Central Planning Authority

- Market forces have no role
- Aimed at maximizing the welfare of community as whole.

### → Characteristics

#### ① Collective Ownership

Profit Motive and Self-Interest are not the driving forces of activity.

There is collective ownership of all means of production except small farms, workshops and trading firms which may remain in private hands.

- Resources are used to achieve socio-economic objectives

#### ② Economic Planning

Central Planning authority is set up to accomplish socio-economic goals

#### ③ Absence of Consumer Choice

- Consumer Sovereignty gets restricted by selective production of goods
- Range of choice is limited by planned production
- Right to work is guaranteed, but the choice of occupation get restricted

### ④ Relatively Equal Income Distribution

- Relative Equality of Income is an Important feature
- Diff. 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 Market Forces

Price Mechanism exist but it has only secondary role.

Price Mechanism exist only to secure disposal of accumulated stock.

Allocation of resources are done acc to predetermined plans.

Prevailing prices under socialism are 'administered prices' which are set by central planning.

East while 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 eg. Vietnam, China and Cuba

### ⑥ Absence of Competition

- State is the sole enterprise
- absence of competition

North Korea, the world's most Totalitarian State is eg. of Socialist Economy.

Totalitarian :- Autocratic

## → Merits of Socialism

- Equa Equitable distribution of wealth and income
- provision of equal opportunities to maintain economic and social justice
- Co-operative Mentality
- Social Security and No exploitation
- Absence of profit Motive
- Balanced Economic Development
- Unemployment is minimised
- Better utilisation of Resources.
- Business Fluctuation are eliminated
- Competition is absent, no wastage of resources on advertisement and sales promotion.

## → Demerits of Socialism

- Corruption, Red Tapism, Favouritism
- Restricts freedom of Individual
- No private ownership
- Takes away basic right i.e right of private property
- Does not provide necessary incentives to hard work in the form of profit
- limited freedom of choice to consumer
- Uncontrollable monopolies of govt.

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- No importance is given to personal efficiency and productivity

## The Mixed Economy

- Depends on both markets and govt. for allocation of resources.
- Every economy in the real world make use of Mixed economy
- It appreciates the advantages of private enterprises and private property with their emphasis on self-interest and profit motive.
- Government itself run important and selected industries and eliminate the free play of profit motive and Self interest

Private Enterprise which has its own significance is also allowed to play a positive role in mixed economy. The state imposes necessary measures to control and to regulate the private enterprises to ensure that they function for welfare objectives of nations.

## → Features

- ① Co-existence of public and private sector

In mixed economy there are three important sectors of industries :-

- 1) Private Sector
- 2) Public Sector
- 3) Combined Sector

### ① Private Sector

Production & distribution are managed by private individuals and groups.

- Self-Interest, profit motive and personal initiative
- Directly or indirectly regulated by govt. policy.

### ② Public Sector

Industries in this sector are not privately profit oriented but are set up by state for the welfare of the community.

### ③ Combined Sector

Both govt. & public enterprises have equal access, and join hands to produce goods, establishment of joint sectors

## → Merits

- Economic Freedom
- Better allocation of resources
- Freedom of choice & benefit to consumers
- Encourage enterprises & Risk taking
- Greater economic and social equality
- Disadvantage of cut throat competition averted through Govt. legislative measures.

Mixed Economy is not always Golden path b/w capitalism & socialism.

## → Demerits

- Excessive Control by Govt. may lead to problems i.e. reduced incentives, high rate of tax, lack of efficiency, corruption, wastage of resource
- Difficulting in developing maintaining balance b/w both Govt. & Market
- Without strong govt. initiatives, priv. sector is likely to grow unproportionately