

CA Foundation – Business Economics

Chapter 1: Unit 2 – Basics Problem of an Economy & Role of Price Mechanism

Basic Problems of an Economy

- As discussed in the last unit, **all countries, without exception, face the problem of scarcity**. Their resources are limited and these resources have alternative uses.
- If the resources were unlimited, people would be able to satisfy all their wants and there would be no economic problem. Alternatively, if a resource has only a single use, then also the economic problem would not rise.
- Every economic system, be it capitalist, socialist or mixed, has to deal with the central problems of scarcity of resources relative to the wants for them. This is generally called **'the Central Problems of an Economy'**.

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?



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

Kya produce karna h?



Kitna produce karna h?

How to Produce?



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

Labour Intensive?



Capital Intensive?

For Whom to 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.
- In other words, it has to decide about the **shares of different people** in the national cake of goods and services.

*Kiske liye kitna
produce kare?*



What Provisions 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**.
- 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.



Multiple Choice Questions

- 1) 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?
- 2) 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 be certain level of unemployment
 - d) Resources are not always allocated in an optimum way

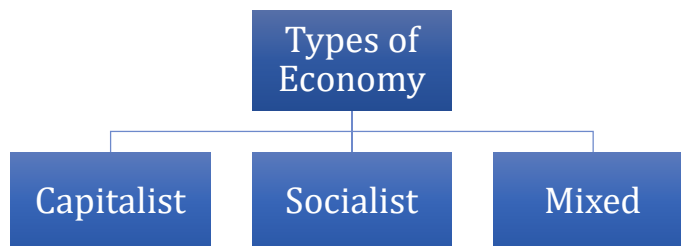
Multiple Choice Questions

- 3) 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

Economic System

- An economic system refers to the sum total of arrangements for the production and distribution of goods and services in a society.
- An economic system serves as a *framework for organizing and coordinating economic activities in a society, determining how resources are allocated, goods are produced, and services are distributed*

Let's understand, how different economies of the world solve their central problems.



Capitalist Economy



- Capitalism, the **predominant economic system** in the modern global economy, is an economic system in which all means of production are **owned and controlled by private individuals for profit**.
- In short, **private property is the mainstay of capitalism** and profit motive is its driving force. Decisions of consumers and businesses determines economic activity.
- Ideally, **the government has a limited role** in the management of the economic affairs under this system
- Some examples of a capitalist economy may include *United states and United Kingdom, Hong Kong, South Korea etc.*

Capitalist Economy = Free Market Economy = Laissez-Faire Economy

Characteristics of Capitalist Economy

- **Right to Private Property:** The right to private property means that **productive factors such as land, factories, machinery, mines etc. can be under private ownership**. The owners of these factors are free to use them in any manner in which they like and bequeath it as they desire. *The government may, however, put some restrictions for the benefit of the society in general.*
- **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.
- **Freedom of economic choice:** All individuals are free to make their economic choices regarding consumption, work, production, exchange etc.
- **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.

Characteristics of Capitalist Economy

- **Consumer Sovereignty:** **Consumer is 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 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**
- **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.
- **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.

How to Capitalist Economy solve their Central Problems ?

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

How to **Capitalist Economy** solve their Central Problems ?

Deciding '*What to Produce*'

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

How to **Capitalist Economy** solve their Central Problems ?

Deciding '*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 labor-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.

How to **Capitalist Economy** solve their Central Problems ?

Deciding '*For Whom to Produce*'

- Goods and services in 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.

How to **Capitalist Economy** solve their Central Problems ?

Deciding about '*Consumption, Savings & Investments*'

- 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 interest rates, higher will be the savings.**
- **Investment decisions depend upon the rate of return on capital.** The greater the profit expectation (i.e. the return on capital), the greater will be the investment in a capitalist economy. **The rate of interest on savings and the rate of return on capital are nothing but the prices of capital**

Merits of Capitalist Economy

- Capitalism is **self regulating** and works automatically through price mechanism. There is no need of incurring costs for collecting and processing of information and for formulating, implementing and monitoring policies.
- The existence of private property and the driving force of profit motive results in **greater efficiency and incentive to work**.
- The process of **economic growth is likely to be faster** under capitalism. This is because the investors try to invest in only those projects which are economically feasible
- Resources are used in activities in which they are most productive. This results in **optimum allocation of the available productive resources of the economy**
- There is usually **high degree of operative efficiency** under the capitalist system.

Merits of Capitalist Economy

- **Cost of production is minimized** as every producer tries to maximize his profit by employing methods of production which are cost-effective.
- Capitalist system offer **incentives for efficient economic decisions** and their implementation.
- Consumers are benefitted as competition forces producers to bring in a large variety of good quality products at reasonable prices. This, along with freedom of choice, ensures **maximum satisfaction to consumers**. This also results in **higher standard of living**
- Capitalism offers **incentives for innovation and technological progress**. The country as a whole benefits through growth of business talents, development of research, etc.
- Capitalism preserves fundamental rights such as right to freedom and right to private property. Therefore, the **participants enjoy maximum amount of autonomy and freedom**.

Merits of Capitalist Economy

- Capitalism **rewards men of initiative** and enterprise and **punishes the imprudent and inefficient**.
- Capitalism usually functions in a **democratic** framework
- The capitalist set up **encourages enterprise and risk taking** and emergence of an entrepreneurial class willing to take risks.

Demerits of Capitalist Economy

- There is vast **economic inequality** and **social injustice** under capitalism. Inequalities reduce the aggregate economic welfare of the society as a whole and split the society into two classes namely the haves' and the have-nots', sowing the seeds of social unrest and class conflict
- Under capitalism, there is **precedence of property rights over human rights**
- Economic inequalities lead to **wide differences in economic opportunities** and perpetuate unfairness in the society.
- The capitalist system **ignores human welfare** because, under a capitalist set up, the aim is profit and not the welfare of the people..
- Due to income inequality, the **pattern of demand does not represent the real needs of the society**.

Demerits of Capitalist Economy

- **Exploitation of labour** is common under capitalism. Very often this leads to strikes and lock outs. Moreover, there is no security of employment. This makes workers more vulnerable.
- **Consumer sovereignty is a myth** as consumers often become victims of exploitation. Excessive competition and profit motive work against consumer welfare.
- 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.
- **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.
- Due to unplanned production, **economic instability** in terms of over production, economic depression, unemployment etc., is very common under capitalism. These result in a lot of human misery.

Demerits of Capitalist Economy

- There is **enormous waste of productive resources** as firms spend huge amounts of money on advertisement and sales promotion activities.
- Capitalism leads to the **formation of monopolies** as large firms may be able to drive out small ones by fair or foul means.
- Excessive **materialism** as well as conspicuous and **unethical consumption** lead to environmental degradation

Multiple Choice Questions

- 4) Which of the following is a Normative Statement?
- a) **To check inflation RBI should restrict money supply.**
 - b) Govt. spend Rs. 500 crore annually on public health
 - c) Increase in crude prices will hit the industry hard
 - d) Export of vaccines has created shortage of onion in the country.
- 5) _____ guide a capitalist economy to decide what to produce
- a) Market survey
 - b) Economic models
 - c) **Intensity of consumer demand**
 - d) Cost of Production

Multiple Choice Questions

- 6) Business Economics in its approach is
- a) **Pragmatic**
 - b) Idealistic
 - c) Normative
 - d) None of these
- 7) Which of the following is not a characteristics of capitalist economy?
- a) Right to Private property
 - b) Freedom of Enterprise
 - c) Consumer sovereignty
 - d) **Planned Production**

Multiple Choice Questions

8) Which of the following is not correct about capitalistic system:

- a) Too much of waste due to cut-throat competition
- b) There is right to private property
- c) There is central planning authority**
- d) Unequal distribution of wealth

9) ____ economics explains cause and effect relationship between economic phenomena

- a) Positive**
- b) Normative
- c) Negative
- d) Applied

Socialist Economy



➤ The concept of socialist economy was propounded by **Karl Marx and Frederic Engels** in their work 'The Communist Manifesto' published in 1848.

➤ In this economy, the material means of production ie. factories, capital, mines etc. are **owned by the whole community** represented by the State.

➤ All members are entitled to get benefit from the fruits of such socialized planned production on the basis of equal rights.

➤ A socialist economy is also called as "**Command Economy**" or a "**Centrally Planned Economy**". Here, the resources are allocated according to the commands of a central planning authority and therefore, market forces have no role in the allocation of resources..

➤ Under a socialist economy, production and distribution of goods are aimed at maximizing the **welfare of the community** as a whole.

➤ **North Korea**, the world's most totalitarian state, is a prominent example of a socialist economy. Other examples include **China and Cuba**.

Characteristics of Socialist Economy

- **Absence of Consumer choice:** There is collective ownership of all means of production *except small farms, workshops and trading firms* which may remain in private hands. As a result of social ownership, **profit-motive and self-interest are not the driving forces** of economic activity as it is in the case of a market economy. The resources are used to achieve certain socio-economic objectives.
- **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.
- **Absence of Competition:** Since the state is the sole entrepreneur, there is absence of competition under socialism.

Characteristics of Socialist Economy

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

Characteristics of Socialist Economy

- **Minimum role of Price Mechanism or Market forces:** 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. In the absence of the profit motive, price mechanism loses its predominant role in economic decisions. **The prices prevailing under socialism are 'administered prices'** which are set by the central planning authority on the basis of socio-economic objectives.
- In today's world, there is **no country which is purely socialist**. The erstwhile **U.S.S.R** was an example of socialistic economy from 1917 to 1990.

Multiple Choice Questions

10) _____ refers to the sum total of arrangements for the production and distribution of goods and services in a society

- a) Business Economics
- b) Micro Economics
- c) Economic System**
- d) Economics

11) _____ is the mainstay in the capitalism

- a) Profit motive
- b) Private property**
- c) Consumers
- d) Competition

Multiple Choice Questions

12) In capitalist economy, what to produce is decided by _____

- a) Government
- b) Competition
- c) Entrepreneur
- d) Consumers demand**

13) Which of the following is not the merits of capitalist economy?

- a) No need to incur cost for formulating policies
- b) More efficiency
- c) Income equality**
- d) Incentives for innovation

Multiple Choice Questions

14) In socialist economy, resources are allocated according to:

- a) Market forces
- b) Consumer choice
- c) Commands of central planning authority**
- d) Entrepreneur decisions

15) Which of the following is not an example of Capitalist economy?

- a) USA
- b) Germany
- c) North Korea**
- d) South Korea

Merits of Socialist Economy

- **Equitable distribution of wealth and income** and provision of equal opportunities for all help to maintain economic and social justice
- **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.
- Socialist economy is a **planned economy**. In a socialistic economy, there will be **better utilization of resources** and it ensures maximum production. Wastes of all kinds are avoided through strict economic planning.
- Since competition is absent, there is **no wastage of resources** on advertisement and sales promotion
- In a planned economy, **unemployment is minimized**, business fluctuations are eliminated and stability is brought about and maintained.

Merits of Socialist Economy

- The absence of profit motive helps the community to develop a **co-operative mentality and avoids class war**. This, along with equality, ensures welfare of the society.
- Socialism ensures **right to work** and minimum standard of living to all people..
- Under socialism, the **laborers and consumers are protected** from exploitation by the employers and monopolies respectively.
- There is provision of **comprehensive social security** under socialism and this makes citizens feel secure.

Demerits of Socialist Economy

- Socialism involves the predominance of **bureaucracy** and the resulting **inefficiency** and delays. Moreover, there may also be **corruption, red tapism, favouritism**, etc.
- 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.
- Socialism **takes away the basic rights** such as the right of private property.
- It will **not provide necessary incentives to hard work** in the form of profit.
- **Administered prices** are not determined by the forces of market on the basis of negotiations between the buyers and sellers. There is **no proper basis for cost allocation**. In the absence of such practice, the most economic and scientific allocation of resources and the efficient functioning of the economic system are impossible.

Demerits of Socialist Economy

- **State monopolies** created by socialism will sometimes become uncontrollable. This will be **more dangerous** than the private monopolies under capitalism.
- Under socialism, the consumers have **no freedom of choice**. Therefore, what the state produces has to be accepted by the consumers.
- **No importance** is given to **personal efficiency and productivity**. Laborers are not rewarded according to their efficiency. This acts as a **disincentive to work**.
- The extreme form of socialism is not at all practicable.

Mixed Economy

➤ The Mixed Economy depends on both markets and governments for allocation of resources. In fact, **every economy in the real world makes use of both market and governments** and therefore is mixed in its nature.

➤ In a mixed economy, the aim is to develop a system which tries to include the best features of both the controlled economy and the market economy while excluding the demerits of both.

How the combination of controlled economy & Market economy works?

- It appreciates the advantage of private enterprise and private property with their emphasis on self-interest and profit motive.
- But it is noticed that profit motive and self-interest of the market economy may not promote the interest of the community as a whole so the Government should remove these defects of private enterprise.
- Government itself must run important and selected industries and eliminate the free play of profit motive and self-interest to ensure that they function in accordance with the welfare objectives of the nation.

Characteristics 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:** 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

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

Demerits of Mixed Economy

- **Excessive controls by the state** resulting in reduced incentives and constrained growth of the private sector.
- **Poor implementation** of planning
- Higher rates of **taxation**
- **Lack of efficiency**
- **Corruption**
- **Wastage of Resources**
- **Undue delays** in economic decisions
- **Poor performance** of the public sector.

Moreover, it is very difficult to maintain a proper balance between the public and private sectors. In the absence of strong governmental initiatives, the private sector is likely to grow disproportionately and system resemble capitalism with all its disadvantages.

Multiple Choice Questions

16) 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

17) Which of the following is not within the scope of Business Economics?

- a) Capital Budgeting
- b) Risk-Analysis
- c) Business Cycles
- d) **Accounting Standards**

Multiple Choice Questions

18) In a free market economy the allocation of resources is determined by

- a) Voting done by consumers
- b) A central planning authority
- c) **Consumer preferences**
- d) The level of profits of the firm

19) A capitalist economy uses _____ as the principal means of allocating resources

- a) Demand
- b) Supply
- c) Efficiency
- d) **Prices**

Multiple Choice Questions

20) Which of the following is considered as a disadvantage of allocating resources using the market system?

- a) Income will tend to be unevenly distributed**
- b) People do not get goods of their choices
- c) Men of initiative and enterprises are not rewarded
- d) Profit will tend to be low

21) Which of the following statements does not apply to a market economy?

- a) Firms decide whom to hire and what to produce
- b) Firms aims at maximizing profits
- c) Households decide which firm to work for and what to buy with their incomes.
- d) Government policies are the primary forces that guide the decisions of firms and households.**

Multiple Choice Questions

22) In a mixed economy?

- a) All economic decisions are taken by the central authority
- b) All economic decisions are taken by the private entrepreneurs
- c) Economic decisions are partly taken by the state and partly by the private entrepreneurs**
- d) None of the above

23) 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

Multiple Choice Questions

24) Freedom of choice is the advantage of

- a) Socialism
- b) Capitalism**
- c) Mixed Economy
- d) None of these

25) Exploitation and inequality are minimal under

- a) Socialism**
- b) Capitalism
- c) Mixed Economy
- d) None of these

Multiple Choice Questions

26) 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 these

27) 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

Multiple Choice Questions

28) 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

29) Profit motive is the merit of

- a) Socialism
- b) Capitalism**
- c) Mixed Economy
- d) None of the above

Multiple Choice Questions

30) _____ is also called command economy

- a) Socialism**
- b) Capitalism
- c) Mixed Economy
- d) None of the above