CHAPTER I NATURE AND SCOPE OF BUSINESS ECONOMICS

OVERVIEW

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What is Economics about?

➢The word **'Economics'** is derived from the **Greek word 'Oikonomia'** which **means household management.**

➢Until the *19th century, economics* was known as ***'Political Economy'.***

➢In ***1776*, Adam Smith** published his book entitled ***"An Inquiry into the Nature and Causes of the Wealth of Nations"*** which is *considered as the first modern work of Economics.*

In words of

Alfred Marshall: *"Economics is the study of people in the ordinary business of life"*

Lionel Robbins: *"Economics is the science which studies human behaviour as a relationship between given ends and scarce means which have alternative uses"*

Paul A. Samuelson: *"Economics is the study of how societies use scarce resources to produce valuable commodities and distribute them among different people".*

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Fundamental Economic Problem

Every individual, every society and every country in this world faces the **problem of making CHOICE.** Because of ***two facts:***

- ➔ Human **wants are unlimited;** and
- ➔ The **means *i.e., resources*** to satisfy unlimited wants are **relatively scarce** and these scarce resources **have alternative uses.**

As a result we are confronted with the problem of making a choice of who wants to be satisfied or the choice among the uses of resources. Thus, *we are faced with the problem of allocation of resources to various uses.*

Economics is, thus, the *study of how we work together to transform 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.*

Definition of Economics

The **definition of Economics is narrow** because it *concentrates only at present* i.e. how to use relative scarce resources to satisfy unlimited human wants. So it gives the picture of a society with fixed resources, skills and productive capacity, deciding what type of goods and services to be produced and how to distribute among the members of society. *But the two important concerns of modern economies are not fully covered.*

Modern Aspects of Definition of Economics

Two of the most important concerns of modern economies. These are as follows:

→ **Economic Growth:** *The productive capacity of modern economies has grown tremendously. Not only has the quantity of available productive resources increased, their quality has also improved substantially.* **Example:** Population and labour force have increased, new sources of raw materials have been discovered, and new and better plant and equipment have been made available on farms

and in factories and mines. Better education and newly acquired skills have raised the productivity of the labour force, and has led to the discovery of completely new kinds of natural resources such as shale gas and new alternative sources of energy.

→**Economic Fluctuations:** *The resulting growth in production and income has not been smooth. There have been periods in which output not only failed to grow, but also actually declined sharply.*

Example: Factories workers and other productive resources have remained idle due to insufficient demand.

Modern Definition of Economics

Economics, therefore, concerns itself not just with the crucial concern of how a nation allocates its scarce productive resources to various uses; it also deals with the processes by which the productive capacity of these resources is increased and with the factors which, in the past, have led to sharp fluctuations in the rate of utilisation of these resources.

Meaning of Business Economics

- The *management of every company/ business/ organisation is faced with the problem of decision making.* 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 judgement 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.*
- The management of a business unit generally needs to make strategic, tactical and operational decisions. A few examples of issues requiring decision making in the context of businesses:

→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

→From where should the firm procure the necessary inputs and at what prices so as to have competitive edge in the market?

→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?

→How to combat the risks and uncertainties involved?

- *Decision making on the above as well as similar issues is not simple and straightforward as the economic environment in which the firm functions is highly complex and dynamic.* The problem gets aggravated because, most of the time, decisions are to be taken under conditions of imperfect knowledge and uncertainty. Decision making, therefore, *requires that the management be equipped with proper methodology and appropriate analytical tools and techniques.* Business Economics meets these needs of the management by providing a large corpus of theory and techniques. **Business Economics integrates economic theory with business practice.**

Business Economics all about

- Business Economics, also referred to as ***Managerial Economics,*** generally refers to the *integration of economic theory with business practice.*
- While the 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. Thus, *Business Economics comprises that part of economic knowledge, logic, theories and analytical tools that are used for rational business decision making.* referred to as ***Applied Economics*** *that fills the gap between economic theory and business practice.*

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➢ Business Economics is multidisciplinary

It has close connection with Economic theory (Micro as well as Macro-Economics), Operations Research, Statistics, Mathematics and the Theory of Decision-Making. A professional business economist has to integrate the concept and methods from all these disciplines in order to understand and analyse practical managerial problems.

Business Economics is not only valuable to business decision makers, but also useful for managers of 'not-for-profit' organisations.

DEFINITIONS OF BUSINESS ECONOMICS

↝ Business Economics may be defined as the use of economic analysis to make business decisions involving the best use of an organisation's scarce resources.

↝ **Joel Dean** defined Business Economics in terms of *the use of economic analysis in the formulation of business policies.*

Business Economics is *essentially a component of Applied Economics as it includes application of selected quantitative techniques* such as linear programming, regression analysis, capital budgeting, break even analysis and cost analysis.

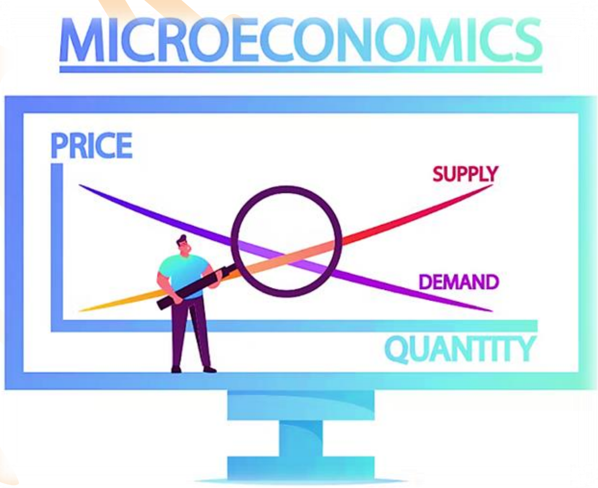
Nature of Business Economics

Economics has been broadly divided into two major parts i.e. Micro Economics and Macro Economics.

Subject matter of Economics
- MICRO ECONOMICS
- MACRO ECONOMICS

Micro Economics

Micro Economics is basically the study of the behaviour of different individuals and organisations within an economic system. In other words, *Microeconomics examines how the individual units (consumers or firms) make decisions as to how to efficiently allocate their scarce resources.* Here, the focus is on a small number of or a group of units rather than all the units combined, and therefore, it does not explain what is happening in the wider economic environment.



Mainly study the following in Micro-Economics:

- ➔ Product pricing;
- ➔ Consumer behaviour;
- ➔ Factor pricing;
- ➔ The economic conditions of a section of people;
- ➔ Behaviour of firms; and
- ➔ Location of industry.

Macro Economics

Macroeconomics is the study of the overall economic phenomena or the economy as a whole, rather than its individual parts. Accordingly, in Macroeconomics, we study the behaviour of the large economic aggregates, such as, the overall levels of output, total consumption, total saving and total investment and also how these aggregates shift over time. *It analyses the overall economic environment in which the firms, governments and households make decisions.* However, it should be kept in mind that this economic environment represents the overall effect of the innumerable decisions made by millions of different consumers and producers.

Few areas that come under Macroeconomics are:

- ➔ National Income and National Output;
- ➔ The general price level and interest rates;
- ➔ Balance of trade and balance of payments;
- ➔ External value of currency;
- ➔ The overall level of savings and investment; and
- ➔ The level of employment and rate of economic growth.

While Business Economics is basically concerned with Microeconomics, Macro economic analysis also has got an important role to play. Macroeconomics analyses the background of economic conditions in an economy which will immensely influence the individual firm's performance as well as its decisions. Business firms need a thorough understanding of the macroeconomic environment in which they have to function. **Example:** knowledge regarding conditions of inflation and interest rates will be useful for the business economist in framing suitable policies. Moreover, the long-run trends in the business world are determined by the prevailing macroeconomic factors.

Nature of Business Economics

The following points will describe the nature of Business Economics:

Business Economics is a Science	*Science is a systematised 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.
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 organisation. Since Business Economics is concerned more with the decision making problems of individual establishments, it relies heavily on the techniques of Microeconomics
Incorporates	A business unit does not operate in a vacuum. It is affected by the

elements of Macro Analysis	external environment of the economy in which it operates such as, 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 business environment.
Business Economics is an art	as it involves practical application of rules and principles for the attainment of set objectives.
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.
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.
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.
Positive Economics	*A positive or pure science analyses cause and effect relationship between variables in an objective and scientific manner, but it does not involve any value judgement. It states 'what is' of the state of affairs and not what 'ought to be'.* It is descriptive in nature in the sense that it describes the economic behaviour of individuals or society without prescriptions about the desirability or otherwise of such behaviour.
Normative Economics	*A normative science involves value judgements. It is prescriptive in nature and suggests 'what should be' a particular course of action under given circumstances.* Welfare considerations are embedded in normative science.

- *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.

Scope of Business Economics

The *scope of Business Economics is quite wide*. It c*overs 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:

Microeconomics applied to operational or internal Issues

Macroeconomics applied to environmental or external issues

Microeconomics applied to operational or internal Issues *Operational issues include all those issues that arise within the organisation and fall within the purview and control of the management. These issues are internal in nature.* 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 are a few examples of operational issues. The following Microeconomic theories deal with most of these issues:	
Demand analysis and forecasting	*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. *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.
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 a 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 maximise profits by producing the desired level of output at the minimum possible cost.
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.
Market Structure and Pricing Policies	*Analysis of the structure of the market 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.*
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.*
Theory of Capital and Investment Decisions	For maximising its profits, *the firm has to carefully evaluate its investment decisions and carry out a sensible policy of capital allocation.* Theories related to capital and investment *provide scientific criteria for choice of investment projects and in assessment of the efficiency of capital.* Business Economics supports decision making on allocation of scarce capital among competing uses of funds.
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.*
Risk and Uncertainty	Business firms generally operate under conditions of risk and uncertainty. Analysis of risks and uncertainties *helps the business firm in arriving at efficient*

Analysis	*decisions and in formulating plans on the basis of past data, current information and future prediction.*

Macroeconomics applied to environmental or external issues

Environmental factors have significant influence upon the functioning and performance of business. The major macro economic factors relate to:

- ➔ the type of economic system
- ➔ stage of business cycle
- ➔ the general trends in national income, employment, prices, saving and investment.
- ➔ Government's economic policies like industrial policy, competition policy, monetary and fiscal policy, price policy, foreign trade policy and globalisation policies.
- ➔ working of financial sector and capital market
- ➔ socio-economic organisations like trade unions, producer and consumer unions and cooperatives
- ➔ social and political environment

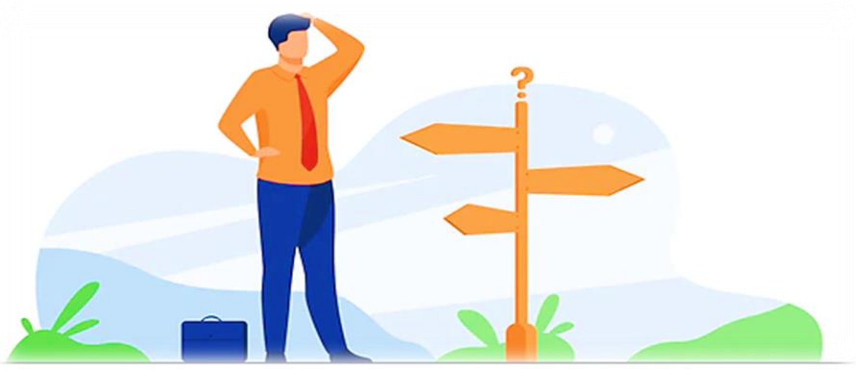
Business decisions cannot be taken without considering these present and future environmental factors. As the management of the firm has no control over these factors, it should in its policies to minimise their adverse effects.

BASIC PROBLEMS OF AN ECONOMY

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.**

These are:



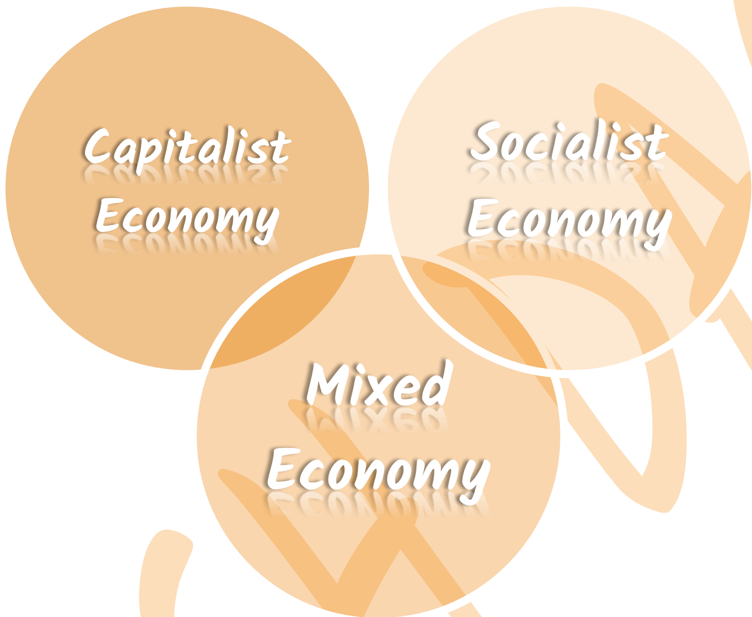
- How to produce?
- What to produce?
- What provisions (if any) are to be made for economic growth?
- For whom to produce?

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. ➢ **Example:** 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. ➢ The guiding principle is to allocate the resources in the production of goods in such a way that **maximises aggregate utility.** 
How to produce?	➔ There are many alternative techniques to produce a commodity. ➔ Choice has to be made between capital intensive technique or labour intensive technique of production. ➔ The choice of technique will depend upon availability of various factors of production, & the prices of factors of production. ➔ Such techniques of production have to be adopted that make best use of available resources. 
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. In other words, it has to decide about the shares of different people in the national cake of goods and services. 
What provision should be made for economic growth?	➔ A society cannot afford to use all its scarce resources for current consumption only. ➔ It has to provide for the future as well so that high economic growth can be achieved. Therefore, an economy has to make decisions about the rate of savings, investment, capital formation, etc. 

ECONOMIC SYSTEMS AND ITS TYPES

An economic system refers to the sum total of arrangements for the production and distribution of goods and services in a society. In short, it is defined as the sum of the total devices which give effect to economic choice. *It includes various individuals and economic institutions.*

Three types of economy:



Capitalist Economy

➢ *Capitalism 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 determine 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 U.S., U.K., Germany, Japan, Mexico, Singapore, etc.

➢ *A capitalist economy is also called a free market economy or laissez-faire economy.*

Features/ characteristics of Capitalist Economy

A. **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.*

B. **Freedom of enterprise:** *Each individual, whether consumer, producer or resource owner, is free to engage in any type of economic activity.* Example: a producer is free to set up any type of firm and produce goods and services of his choice.

C. **Freedom of economic choice:** *All individuals are free to make their economic choices* regarding consumption, work, production, exchange etc.

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

E. **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.*

F. **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.*

G. **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 mechanisms which operate automatically without any direction and control by the governmental authorities.*

How do Capitalist Economies solve their problems

A capitalist economy has no central planning authority to decide what, how and for whom to produce. Such an *economy uses the impersonal forces of market demand and supply or the price mechanism to solve its 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. *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.*
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 labour- intensive methods and if labour is relatively costlier he will use capital-intensive methods. Thus, *the relative prices of factors of production help in deciding how to produce.*
Deciding '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.*
Deciding about 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 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 a price mechanism*. There is no need of incurring costs for collecting and processing of information and for formulating, implementing and monitoring policies.

01. The existence of private property and the driving force of profit motive result in *greater efficiency and incentive to work.*
02. 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.
03. Resources are used in activities in which they are most productive. This results in *optimum allocation of the available productive resources of the economy.*
04. There is usually a *high degree of operative efficiency* under the capitalist system.
05. *Cost of production is minimised* as every producer tries to maximise his profit by employing methods of production which are cost-effective.
06. *Consumers are benefited 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 a higher standard of living.*
07. Capitalism *offers incentives for innovation and technological progress.* The country as a whole benefits through growth of business talents, development of research, etc.
08. *Capitalism preserves fundamental rights* such as the right to freedom and right to private property. Therefore, the participants enjoy maximum autonomy and freedom. *Capitalism usually functions in a democratic framework.*
09. Capitalism *rewards men of initiative and enterprise* and *punishes the imprudent and inefficient.*
10. The capitalist set up encourages enterprise and risk taking and emergence of an entrepreneurial class willing to take risks.

Demerits of Capitalism

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.*

02. Under capitalism, there is *precedence of property rights over human rights.*

03. Economic inequalities lead to *wide differences in economic opportunities and perpetuate unfairness in the society.*

04. The capitalist system *ignores human welfare* because, under a capitalist set up, the aim is profit and not the welfare of the people.

05. *Exploitation of labour* is common under capitalism. Very often this leads to strikes and lockouts. Moreover, there is *no security of employment.* This makes workers more vulnerable.

06. *Consumer sovereignty is a myth* as consumers often become victims of exploitation. Excessive competition and profit motive work against consumer welfare.

07. 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 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.

08. Due to *unplanned production*, economic instability in terms of overproduction, economic depression, unemployment etc., is very common under capitalism. These *result in a lot of human misery.*

09. There is *enormous waste of productive resources* as firms spend huge amounts of money on advertisement and sales promotion activities.

10. Capitalism leads to the *formation of monopolies* as large firms may be able to drive out small ones by fair or foul means.

11. Excessive materialism as well as conspicuous and unethical consumption lead to *environmental degradation.*

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* i.e. factories, capital, mines etc. are *owned by the whole community represented by the State*. All members are entitled to benefit from the fruits of such socialised 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 maximising the welfare of the community as a whole.*

➢ The erstwhile U.S.S.R. is an example of socialist economy. *In today's world there is no country which is purely socialist.* North Korea, the world's most totalitarian state, is another prominent example of a socialist economy. Other examples include China and Cuba.

Features/ characteristics of Socialist Economy

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, 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.

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*. 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.*

E. **Minimum role of Price Mechanism or Market forces:** *Price mechanism exists* in a socialist economy; *but it has only a secondary role,* Example: 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, the 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.*

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

Merits of Socialist Economy

01. *Equitable distribution of wealth and income* and provision of equal opportunities for all help to maintain economic and social justice.
02. *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.
03. *Socialist economy is a planned economy.* In a socialistic economy, there will be better utilisation 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.*
04. In a planned economy, unemployment is minimised, business fluctuations are eliminated and stability is brought about and maintained.

05. 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.

06. Socialism ensures the *right to work and minimum standard of living to all people.*

07. Under socialism, the *labourers and consumers are protected from exploitation* by the employers and monopolies respectively.

08. There is *provision of comprehensive social security* under socialism and this makes citizens feel secure.

Demerits of Socialism economy

01. Socialism involves the *predominance of bureaucracy and the resulting inefficiency and delays.* Moreover, there may also be corruption, red tapism, favouritism, etc.

02. 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.

03. Socialism *takes away basic rights* such as the right of private property.

04. It will *not provide necessary incentives* to hard work in the form of profit.

05. *Administered prices are not determined* by the forces of the market on the basis of negotiations between the buyers and the sellers. There is no proper basis for cost calculation. In the absence of such practice, the *most economic and scientific allocation of resources and the efficient functioning of the economic system are impossible.*

06. *State monopolies* created by socialism will *sometimes become uncontrollable*. This will be more dangerous than the private monopolies under capitalism.

07. Under socialism, the *consumers have no freedom of choice.* Therefore, what the state produces has to be accepted by the consumers.

08. *No importance is given to personal efficiency and productivity.* Labourers are not rewarded according to their efficiency. This acts as a disincentive to work.

09. The extreme form of socialism is not at all practicable.

MIXED ECONOMY

➢ 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.* It appreciates the advantages of private enterprise and private property with their emphasis on self-interest and profit motive. Vast economic development of England, the USA etc. is due to private enterprise.

➢ *Private enterprise which has its own significance* is also allowed to play a positive role in a mixed economy. However, <u>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.</u>

Different Sectors in Mixed Economy

In a mixed economy, there are ***three sectors of industries:***

➢ **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.*

➢ **Public sector** Industries in this sector are *not primarily profit-oriented,* but are set up by the State for the *welfare of the community.*

➢ **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

01. Economic freedom and existence of private property which ensures incentive to work and capital Formation.
02. Price mechanism and competition forces operating in the private sector promoting efficient decisions and better resource allocation.
03. Consumers are benefited through consumers' sovereignty and freedom of choice.
04. Appropriate incentives for innovation and technological progress.
05. Encourages enterprise and risk taking.
06. Advantages of economic planning and rapid economic development on the basis of plan priorities.
07. Comparatively greater economic and social equality and freedom from exploitation due to greater state participation and direction of economic activities.
08. 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.

01. It suffers from substantial uncertainties.
02. Mixed economy is characterised by 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 and
    - poor performance of the public sector.

03. 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. The system would then resemble capitalism with all its disadvantages.

SUMMARY NOTES

Adam Smith – 1776

- An inquiry into nature and causes of wealth of nations.
- Focus on macroeconomics.
- Wealth of nations.

Alfred Marshall-

- Study of man in ordinary business course.
- Focus on microeconomics.

Lionel Robbins –

- Relationship between scarce and its ends.
- studying about the unlimited wants and limited resources.

Ragnar Frisch – 1933 –

- Classification of Economics Macro and Micro Economic.

→ **Economics:** Greek Word: **Oikonomia** – Household Management.

Difference between Micro-Economics & Macro-Economics:

Micro-Economics	Macro- Economics
1. Study of Individual	1. Aggregate Demand
2. Individual Income.	2. National Income
3. Product Pricing.	3. National Output
4. Factor Pricing.	4. Inflation
5. Particular commodity	5. General Pricing
6. Price theory	6. Income Theory

7. Slicing Method	7. Lumping Method
8. Demand	8. Aggregate Demand.

Business Economics = Business practise + Economic models

Features: -

- Business Economics is science (cause and effect)
- Business Economics is Art (Optimum Utilization of resources)
- Business Economics uses Micro economic analysis (Individual unit)
- Business Economics rises Macroeconomics analysis (economy as a whole).

Difference between Positive Economics & Normative Economics:

Positive Economics	Normative Economics
1. What is, what was, what will.	1. what ought to be, what should be.
2. Facts, Statements.	2. Opinion, Value Judgment.
3. Descriptive	3. Prescriptive
4. Can be proved	4. Can't be proved.
5. Disposable income has declined by 15% during last year.	5. We must try to boost disposable income.
6. Higher Interest rates will Lampen house prices.	6. The Minimum wage should be raised by 20%.
7. Reliance Ltd. made profits of 5000 crore.	7. Reliance Ltd. should have profits of 10,000 crore with available resources.

→ Business Economics is pragmatic in nature (uncertainties), practical problems.

→ Interdisciplinary in nature.

Scope of Business Economics:

- Demand Analysis-Forecast.
- Production Scheduling.
- Profit Management.
- Pricing Strategy.
- Cost Analysis.
- Inventory management.

- Risk Management.

Central problems of Economy:

What to produce?	• Consumer goods, • Capital goods.
How to produce?	• Capital Intensive Technique (CIT), • Labor Intensive Technique (LIT) →Maximum Profit →Minimum Cost
For when to produce?	• Equal distribution, • Gap between rich & poor.
Who will solve this problem?	• Economic system.

Economic System
- Capitalist (USA)
- Socialist (China)
- Mixed (India)

Capitalist economy:

- Main objective- Profit.
- Free market economy.
- Freedom of enterprise.
- Freedom of choice.
- Personal Private ownership.
- Consumer sovereignty.
- High competition.
- Price Mechanism.
- Market forces the economy.
- Optimum utilization of resources.
- Laissez faire.
- Higher operating efficiency.
- No government intervention

Demerits:

- Social injustice.
- Consumer Exploitation
- Ignore human welfare
- economic inequalities
- Spend huge amount on advertising
- Formation of monopolies.

Socialist Economy:

- Centrally planned or State planned
- Socio-Economic system
- Command Economic System
- Government control
- Administered prices-controlled prices by government
- Collective ownership
- Equitable distribution of wealth and income
- Balanced economic development
- Economic stability
- Ensures welfare of Society.

Demerits:

- Predominance Bureaucracy – Red Tapism
- Consumer have no freedom of choice
- Restricts the freedom of individual
- Take away the freedom of ownership
- Labourers are not rewarded as per the work efficiency.

Karel Marx 1848 [Communist Manifesto] and Frederich Eagles:

Opposed capitalist economy and focused on socialist economic system

· First book of economics - Wealth of Nations.