

Chapter 1 NATURE AND SCOPE OF BUSINESS ECONOMICS

UNIT 2: BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

2.0 BASIC PROBLEM OF AN ECONOMY

- All countries face the problem of scarcity as their resources are limited and resources have alternative uses.
- Every economy 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 :
 - What to produce?
 - How to produce?
 - For whom to produce?
 - What provisions (if any) are to be made for economic growth?

1. WHAT TO PRODUCE –

- Society has to decide whether to produce guns or butter, machines (capital goods) or cell phone (consumer goods).
- It also has to decide in what quantity each of the good would be produced.
- In nutshell, society must decide how much wheat, how many schools, how many meters of cloths etc. have to be produced.

2. HOW TO PRODUCE –

- Society has to decide whether the goods and services are to be produced using labour intensive techniques or capital intensive techniques.
- This choice would depend on the availability of different factors of production (i.e. labour and capital) and their relative prices.
- For eg. Cotton can be produced using handloom, power looms or automatic looms. Production with handlooms involves use of labour and production with automatic loom involves use of more machines and capital.
- It is in the society's interest to use those techniques of production that make the best use of available resources.

3. FOR WHOM TO PRODUCE –

- A society cannot satisfy wants of all and thus it has to take an important decision 'for whom' it should produce.
- It has to decide on who should get how much of the total output of goods and services i.e. How to distribute goods and services among members of society.

4. WHAT PROVISION SHOULD BE MADE FOR ECONOMIC GROWTH –

- A society has to decide how much saving and investment has to be made for future progress.
- A society would not like to use all its scarce resources for current consumption only, as if it uses all resources for current consumption and no provision is made for future production, the society's production capacity would not increase.

2.1 ECONOMIC SYSTEM:

An Economic System refers to the sum total of arrangements for the production and distribution of goods and services in a society. It includes various individuals and economic institutions.

2.2 CLASSIFICATION OF ECONOMIES:

A. CAPITALIST ECONOMY

B. SOCIALIST ECONOMY

C. MIXED ECONOMY

2.2.1 CAPITALIST ECONOMY (FREE MARKET ECONOMY /LAISSEZ FAIRE ECONOMY)

- It is an economic system in which all means of production are owned and controlled by private individuals for profit.
- Government has limited role in the management of the economic affairs under this system.
- Eg. United States, United Kingdom, Hong Kong, South Korea etc.
- The **characteristics** of such market form is as under :
 - (a) Right to Private Property :Factors of Production such as Land,factories.machines etc. can be under private ownership.The government may however put some restrictions for the benefit of the society in general.
 - (b) Freedom of Enterprise : Consumer,Producer or resource owner is free to engage in any type of economic activity.
 - (c) Freedom of Economic choice :All individuals are free to make their economic choices regarding consumption,work,production ,exchange ,etc.

- (d) Profit Motive: It is the driving force in a free enterprise economy and directs all economic activities.
- (e) Consumer Sovereignty: Under Capitalism, consumer is king and buyers ultimately determine which goods and services will be produced and in what quantities and thus producers produce mainly those goods and services.
- (f) Competition: It is most important feature of capitalist economy and brings out the best among buyers and sellers and results in efficient use of resources.
- (g) Absence of Government Interference: In this system all economic decisions and activities are guided by self-interest and price mechanism which operates without any control by the government authorities.

2.1.0 How do capitalist economies solve their central problems?

- 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. In capitalist economy this question is decided by consumers who show their preferences by spending on goods which they want.
- Deciding 'How to produce' – The price of factor of production help in deciding how to produce.
- Deciding 'For whom to produce' – Goods and Services in capitalist economy will be produced for those who have buying capacity .Higher the income, higher will be his buying capacity and higher will be his demand for goods in general.
- Deciding about saving, consumption and investment – Consumption and savings are done by consumers and investments are done by entrepreneurs. Consumer's savings among other factors are governed by the interest prevailing in market.

MERITS OF CAPITALIST ECONOMY:

1. It is self – regulating and works automatically through price mechanism.
2. Due to driving force of profit there is greater efficiency and incentive to work.
3. The process of economic growth is faster as investors try to invest in projects which are economically feasible.
4. Resources used are most productive as they result in optimum allocation of the available productive resources of the economy.
5. Results in high degree of operative efficiency.
6. Cost of Production is minimized as cost effective methods of production are employed.
7. Benefits of competition to consumer as it bring large variety of products that are qualitative in nature and at reasonable price.
8. Capitalism offers incentive for innovation and technological progress.
9. It encourages enterprise and risk taking and leads to entrepreneurial class willing to take risks.
10. It preserves fundamental right such as right to freedom and right to private property.

DEMERITS OF CAPITALIST ECONOMY:

1. It creates economic inequality and social injustice.
2. Under it there is precedence of property rights over human rights.
3. It ignores human welfare as under this system the aim is profit earning and not welfare of people.
4. It leads to wide differences in economic opportunities and perpetuates unfairness in society.
5. Due to income inequality, the demand pattern is not the real needs of society.
6. Exploitation of labour is common under capitalism leading to frequent strikes and lock outs.
7. Excessive competition and profit motive works against consumer welfare.
8. Misallocation of resources as resources will move into production of luxury goods (due to profit motive).
9. Less of merit goods (health care and education) and more of harmful goods will be produced due to profit motive.
10. It leads to formation of monopolies as large firms may drive out small firms by foul or fair means.

2.2.2 SOCIALIST ECONOMY (Command economy /Centrally Planned Economy) :

- This concept was propounded by Karl Marx and Frederic Engels in their work 'The Communist Manifesto'.
- In this economy the material means of production i.e. factories, mines, capital, etc. are owned by the whole community represented by the State.
- Resources are allocated according to commands of Centrally Planning authority and thus market has no role in allocation of resources.
- Under this, production and distribution of goods are aimed at maximizing the welfare of community as a whole.
- The **characteristics** of this economy are as under :
 - (a) Collective Ownership: Majority means of production will be in collective hands instead of private ownership thus helping in achieving socio-economic objective.
 - (b) Economic Planning: There is a Central Planning Authority to set and achieve socio-economic goals that is why called centrally planned economy.
 - (c) Absence of Consumer Choice :As there is planned production thus consumer's sovereignty gets restricted by selective production of goods. Also Right to work is guaranteed, however occupation gets restricted as they are determined by central planning authority.
 - (d) Relatively Equal Income Distribution :Differences in income and wealth are narrowed down by lack of opportunities to accumulate private capital.
 - (e) Minimum Role of Price Mechanism or Market Forces : Price Mechanism exists in a socialist economy but has a secondary role e.g. to secure the disposal of accumulated stocks.

The allocation of resources is done through predetermined plan .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 state is the sole entrepreneur ,there is absence of competition.

Eg. The Erstwhile USSR was an example of socialist from 1917 to 1990.No pure socialist country today .North Korea the world's most totalitarian state is an example of socialist country.

MERITS OF SOCIALISM :

- (1) Equitable distribution of wealth and income.
- (2) Rapid and Balanced Economic Development.
- (3) Better utilization of resources and ensures maximum production with no wastage of resources on advertisement and sales promotion.
- (4) Unemployment is minimized, business fluctuations are eliminated and stability is brought.
- (5) Ensures better welfare of the society by avoiding class war.
- (6) Ensures right to work and minimum standard of living to all people.
- (7) The exploitation by the employers and monopolies is not there.
- (8) Citizens feel secure as there is comprehensive social security.

DEMERITS OF SOCIALISM :

- (1) Due to predominance of bureaucracy there is corruption,favouritism , inefficiencies and delays.
- (2) Restricts freedom of individuals as there is State Control.
- (3) Takes away basic right such as Right of Private Property.
- (4) Will not provide incentive to hard work in form of profit.
- (5) As administered prices are not determined by market forces thus there is no cost calculation mechanism.Thus leading to make allocation of fresources impossible.
- (6) There is limited choice to consumers as whatever states produce has to be accepted by the consumer.
- (7) No importance is given to personal efficiency and productivity and thus labourers are not rewarded accordingly .This acts as disincentive to work.
- (8) The extreme form of socialism is not at all practicable.

2.2.3 MIXED ECONOMY :

- This system depends on both markets and government for allocation of resources.

- Its aim is to develop a system which tries to include the best features of both the controlled economy and market economy while excluding demerits of both.
- Under this system major economic development is due to private enterprise and private property and government runs important and selected industries to remove complete self-interest and profit motive as targeted by the Capitalist economy.
- The important features of Mixed economy are as follows :

FEATURES OF MIXED ECONOMY:

1. Co-existence of Private and Public Sector – There is co - existence of both private and public enterprise.
 - (a) **Private Sector** – Industries in this sector are managed and controlled by private individuals and groups with a motive of self-interest and profit.
 - (b) **Public Sector** - Industries in this sector are set up by state for the welfare of community and are not primarily for profit motive.
 - (c) **Combined Sector** – In such sector both government and private enterprises have equal access and join hands to produce commodities and services ,leading to establishment of joint sectors.

MERITS OF MIXED ECONOMY TO CAPITALIST AND SOCIALIST 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 decision making and better resource allocation.
3. Consumers are benefitted through consumer's sovereignty and freedom of choice.
4. Incentive for innovation and technological progress.
5. Encourages enterprise and risk taking.
6. Comparative greater economic and social equality and freedom from exploitation due to greater state participation and direction of economic activities.
7. Disadvantages of cut – throat competition avoided through government's laws like environment and labour regulations.

DEMERITS OF MIXED ECONOMY:

1. Excessive controls by the state resulting in reduced incentives and constrained growth of the private sector .
 2. Poor implementation of planning.
 3. High rates of taxation .
 4. Lack of efficiency and Corruption.
 5. Wastage of Resources.
 6. Undue delays in economic decisions and poor performance of the public sector.
 7. Difficult to maintain a balance between the public and private sectors.
- Example : India.

