

CA FOUNDATION

BUSINESS ECONOMICS



SAHARA

**2nd Floor, Service Road, Behind Maruthi Mandir,
Vijayanagar, Bangalore - 560040
Mobile: 8123482818**



SAHARA

CA FOUNDATION

BUSINESS ECONOMICS

**2nd Floor, Service Road, Behind Maruthi Mandir,
Vijayanagar, Bangalore - 560040**

Mobile: 8123482818

Web: www.saharaias.com

E-mail: info.saharaias@gmail.com

CONTENTS

| | |
|---|----------|
| Chapter 1 : NATURE AND SCOPE OF BUSINESS ECONOMICS----- | Page 1 |
| Chapter 2 THEORY OF DEMAND AND SUPPLY | |
| UNIT 1: LAW OF DEMAND AND ELASTICITY OF DEMAND ----- | Page 17 |
| UNIT 2: THEORY OF CONSUMER BEHAVIOUR | Page 38 |
| UNIT 3: SUPPLY..... | Page 47 |
| Chapter 3 THEORY OF PRODUCTION AND COST | |
| UNIT 1: THEORY OF PRODUCTION..... | Page 56 |
| UNIT 2: THEORY OF COST----- | Page 73 |
| Chapter 4 MEANING AND TYPES OF MARKETS | |
| UNIT 1: MEANING & TYPES OF MARKET | Page 82 |
| UNIT 2: DETERMINATION OF PRICES | Page 87 |
| UNIT 3: PRICE-OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS ----- | Page 90 |
| Chapter 5 BUSINESS CYCLES ----- | Page 109 |
| CHAPTER 6 DETERMINATION OF NATIONAL INCOME | |
| UNIT 1 - National Income Accounting..... | Page 117 |
| Unit 2 – THE KEYNESIAN THEORY ON NATIONAL INCOME ----- | Page 142 |
| CHAPTER 7 PUBLIC FINANCE | |
| UNIT – 1: FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE----- | Page 170 |
| UNIT – 2: MARKET FAILURE/ GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE ----- | Page 180 |
| UNIT – 3: THE PROCESS OF BUDGETMAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT----- | Page 193 |
| UNIT – 4: FISCAL POLICY----- | Page 205 |
| CHAPTER 8 MONEY MARKET | |
| UNIT - 1: THE CONCEPT OF MONEY DEMAND: IMPORTANT THEORIES ----- | Page 213 |
| Unit 2: THE CONCEPT OF MONEY SUPPLY | Page 223 |
| Unit 3: MONETARY POLICY..... | Page 237 |
| CHAPTER 9 INTERNATIONAL TRADE | |
| Unit 1: THEORIES OF INTERNATIONAL TRADE..... | Page 241 |
| Unit 2: THE INSTRUMENTS OF TRADE POLICY | Page 248 |
| Unit 3: TRADE NEGOTIATIONS..... | Page 256 |
| Unit 4: EXCHANGE RATE AND ITS ECONOMIC EFFECTS ----- | Page 262 |
| Unit 5: INTERNATIONAL CAPITAL MOVEMENTS..... | Page 270 |
| CHAPTER 10 INDIAN ECONOMY | Page 280 |
| PRACTICE QUESTIONS..... | Page 291 |

Chapter 1

NATURE AND SCOPE OF BUSINESS ECONOMICS

UNIT 1: INTRODUCTION

The term 'Economics' owes its origin to the Greek word 'Oikonomia' meaning 'household'. 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.

Before we start with the meaning of Business Economics, it is important for us to understand what Economics is about. For this, consider the following situation:

It is your birthday and your mother gives you Rs.1000 as birthday gift. You are free to spend the money as you like. What will you do? You have many options before you, such as:

Option 1 : You can give a party to your friends and spend the whole money on them.

Option 2 : You can buy yourself a dress for Rs.1000.

Option 3 : You can go for a movie and eat in a restaurant of your choice.

Option 4 : You can buy yourself a book and save the rest of the money.

What do you notice? You have many options before you. Given a choice, you would like to spend not only on your friends, but would also like to go for a movie, eat in a restaurant, buy a dress and a book and save some money. However, you cannot have all of them at the same time. Why? Because you have only Rs.1000 with you. Had your mother given you Rs.2000, you might have satisfied more of your desires. But, she has not. Now, you and yourself in a dilemma as to which of the above options to choose. You will have to go for one option or a combination of one or more options. What do you do? You evaluate the various alternatives and choose the one that gives you the greatest satisfaction. Similar dilemma is faced by every individual, every society and every country in this world. Life is like that. Since we cannot have everything we want with the resources we have, we are forever forced to make choices. Therefore, we choose to satisfy only some of our wants leaving many other wants unsatisfied.

Economics, therefore, concerns itself not just with how a nation allocates to various uses its scarce productive resources, important as that may be. It also deals with the process 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 resources. In the day-to-day events, we come across several economic problems like changes in price of individual commodities as well as general price level changes; economic prosperity and higher standards of living of some people despite general poverty of the masses; problems of unemployment of certain class of persons or in some areas. These are some of the matters connected with economic analysis. The study of Economics will help in analysing the possible causes contributing to these problems and might suggest a number of alternative courses, which could be adopted for tackling these problems. However, it is necessary to remember that most economic problems are of complex nature and are affected by several forces, some of which are rooted in Economics and some in political set up, social norms, etc. The study of Economics cannot ensure that all the problems will be tackled but, surely, it would enable a student to examine a problem in its right perspective and would help him in finding suitable measures to tackle the same.

Economics is, thus, the study of how we work together to transform the 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. This definition of Economics, with the narrow focus on using the relatively scarce resources to satisfy human wants, is the domain of modern neo classical micro economic analysis. Despite being correct, it is incomplete as it brings to our mind the picture of a society with fixed resources, skills and productive

capacity, deciding on what specific kinds of goods and services it ought to produce with the given resources and how they ought to be distributed among the members of the society. However, two of the most important concerns of modern economies are not fully covered by this concept.

On the one hand, we find that the productive capacity of modern economies has grown tremendously. Population and labour force have increased, new sources of raw materials have been discovered, and new and better plant and equipments have been made available on farms and in factories and mines. Not only has the quantity of available productive resources increased, their quality has also improved substantially. Better education and newly acquired skills have raised the productivity of 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. On the other hand, we know that 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. During such periods, factories, workers and other productive resources have remained idle due to insufficient demand.

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.

In the day-to-day events, we come across several economic issues such as changes in the price of individual commodities as well as in the general price level; economic prosperity and higher standards of living of some countries despite general poverty and poor standards of living in others; and some firms making extraordinary profits while others close down etc. These are fundamentally matters connected with economic analysis. The study of Economics will enable us to develop an analytical approach that helps us in understanding and analysing a wide range of economic issues. It would also provide us with a number of models and frameworks that can be applied in different situations. The tools of Economics assist in choosing the best course of action from among the different alternative courses of action available to the decision maker. However, it is necessary to remember that most economic problems are of complex nature and are affected by several forces, some of which are rooted in Economics and others in political set up, social norms, etc. The study of Economics cannot ensure that all problems will be appropriately tackled; but, without doubt, it would enable a student to examine a problem in its right perspective and would help him in discovering suitable measures to deal with the same.

Meaning of Business Economics

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 of that part of economic knowledge, logic, theories and analytical tools that are used for rational business decision making. In brief, it is Applied Economics that fills the gap between economic theory and business practice.

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

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.

Let's consider the following situations:

Mr. G. Ramamurthy, the CEO of Worldwide Food Limited, on completion of his presentation turned to his Board of Directors and raised the question "Well ladies and gentlemen, what you say? Shall we go into soft drink business?"

"Give us some time, Sir" remarked Swaminathan. "You are asking us to approve a major decision which will have long term impact on the direction of the company".

"I understand your concern for the company but now the time has come for us to expand our business. Soft drinks market is growing fast and it is closely related to our core business: food" answered Ramamurthy.

"But competition from White Soft Drinks Ltd. and Black Nectar Ltd. is tough. They are already into this business for years" remarked another board member.

"That is right. But we must not forget that the statistics show that there is still room for growth in this market. And also, food business is near maturity." Replied Ramamurthy.

"Don't forget that even Swati Foods tried entering the soft drink market and failed miserably", remarked Ashok Agrawal, another board member. "Moreover, the projections you are showing are based on last ten years' data. What is the guarantee that the trend will continue? He questioned. "Also, we should not forget that Indians have become health conscious and who knows tomorrow what will people prefer?" He continued.

"Well friends, all your concerns are logical, and believe me; I have given much thought to these 'ifs' and 'buts'. My people have spent many days analyzing all available data to arrive at a judgement. Our analysis indicates a strong possibility of earning above-average return on investment in this market, a return that will be more than what we are earning in food industry. We are already working on the details of production, cost, pricing, distribution, financing etc. I fear, if we wait for long, we will be missing an opportunity that may not come again for long. Let's go ahead and make the most of it" remarked Ramamurthy.

What do you notice in the hypothetical example given above?

The management of the company is faced with the problem of decision making.

As we are aware, the survival and success of any business depends on sound decisions. 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 judgment on the basis of information and choice of a particular alternative which the decision maker finds as the most suitable. As explained above, 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 are illustrated below:

- 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. Briefly put, Business Economics integrates economic theory with business practice.

NATURE OF BUSINESS ECONOMICS

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

The term Micro Economics is derived from the Greek word 'mikros', meaning "small". According to Prof. Boulding, "Microeconomics is the study of particular firms, particular households, individual price, wages, income, individual industries and particular commodities". In Micro-Economics we study the economic behaviour of an individual, firm or industry in the national economy. It is thus a study of a particular unit rather than all the units combined. It is basically concerned with the mechanism of allocation of given resources. Further, it is a partial equilibrium analysis as it seeks to determine price and output in an industry independent of those in other industries.

We mainly study the following in Micro-Economics:

- (i) Product pricing;
- (ii) Consumer behaviour;
- (iii) Factor pricing;
- (iv) The economic conditions of a section of people;
- (v) Behaviour of firms; and
- (vi) Location of industry.

Thus, when we are studying how a producer fixes the prices of his products, we are studying Micro-Economics. Similarly, when we are studying why an industry is located at a particular place, we are studying Micro-Economics.

Macro Economics

The term Macro Economics is derived from the Greek word 'makros', meaning "large". It is the study of overall economic phenomena or the economy as a whole, rather than its individual parts. According to Mc Connel, "Macroeconomics examines the forest and not the trees. Thus it analyses and establishes the functional relationship between large aggregates".

Thus, in Macro-Economics, we study the economic behaviour of the large aggregates such as the overall conditions of the economy such as total production, total consumption, total saving and total investment. It includes :

- (i) National Income and National Output;
- (ii) The general price level and interest rates;
- (iii) Balance of trade and balance of payments;
- (iv) External value of currency;
- (v) The overall level of savings and investment; and
- (vi) The level of employment and rate of economic growth.

| Micro economics | Macro economics |
|---|---|
| 1. It studies individual economic units | 1. It studies aggregate economic units |
| 2. Micro-economics is basically concerned with the mechanism of allocation of "given" resources. Further, microeconomics is a partial equilibrium analysis as it seeks to determine price and output in an industry independent of those in other industries. Moreover, micro-economics analysis looks into the determination of relative prices. | 2. Macro-economics is a general equilibrium analysis as it takes into account the disturbance in equilibrium price and quantity in one market which could lead to a disturbance in the equilibrium prices and quantities in all other markets. Macro-economics analyses the determination of absolute prices. |
| 3. Examples : a) individual demand b) price of a product | 3. Examples : a) aggregate demand b) general price level c) national income |

While Business Economics is basically concerned with Micro Economics, Macro economic analysis also has got an important role to play. Macroeconomics analyzes 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. For 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

Business Economics enables application of economic logic and analytical tools to bridge the gap between theory and practice. The economic world is extremely complex as there is a lot of interdependence among the decisions and activities of economic entities. Economic theories are hypothetical and simplistic in character as they are based on economic models built on simplifying assumptions. Therefore, usually, there is a gap between the propositions of economic theory and happenings in the real economic world in which the managers make decisions.

The following points will describe the nature of Business Economics:

- **Business Economics is a Science:** Science is a systematized 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 organization. Since Business Economics is concerned more with the decision making problems of individual establishments, it relies heavily on the techniques of Microeconomics.
- **Incorporates elements of Macro Analysis:** A business unit does not operate in a vacuum. It is affected by the 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.
- **Normative in Nature:** Economic theory has developed along two lines – positive and normative. 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. In other words, it states 'what is' of the state of affairs and not what 'ought to be'. In other words, 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. As against this, 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

here are two categories of business issues to which economic theories can be directly applied, namely:

1. Microeconomics applied to operational or internal Issues
2. Macroeconomics applied to environmental or external issues

Therefore, the scope of Business Economics may be discussed under the above two heads.

1. 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**: 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 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 maximize 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 maximizing 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 Analysis:** Business firms generally operate under conditions of risk and uncertainty. Analysis of risks and uncertainties helps the business firm in arriving at efficient decisions and in formulating plans on the basis of past data, current information and future prediction.

2. 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 globalization 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 ne-tune its policies to minimise their adverse effects.

Chapter 1

NATURE AND SCOPE OF BUSINESS ECONOMICS

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

Human wants are unlimited and productive resources such as land and other natural resources, raw materials, capital equipments etc. with which goods and services are produced to satisfy those wants are scarce. The problem of scarcity of resources is felt not only by individuals but also by the society as a whole. This gives rise to the problem of how to use the scarce resources to attain maximum satisfaction. This is generally called 'the economic problem'. Every economic system, be it capitalist, socialist or mixed, has to deal with this central problem of scarcity of resources relative to wants for them. The central economic problem is further divided into four basic economic problems.

These are :

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

(i) What to produce?: The first basic problem of an economy is to decide what type of goods it should produce. The requirements of every economy are unlimited while the resources to satisfy these requirements are limited. These resources are capable of being put into alternative uses. Once the nature of goods to be produced has been determined, then there arises the problem to determine the quantities of these goods i.e. how many quintals of wheat, how many million meters of cloth, how many refrigerators, how many T.V.s. etc. have to be produced.

Since the resources of the economy are scarce, so, the nature of goods and their quantities has to be decided on the basis of the preferences of the society. If the society gives priority to the production of more consumer goods now, it will have less in future. A higher priority on capital goods implies less consumer goods now and more in the future.

(ii) How to produce?: The other related problem of the economy is how to produce the goods. This problem is essentially concerned with the choice of technique of production i.e. either the labour intensive techniques or the capital intensive techniques are to be adopted. If, in an economy labour is available in abundance, it may use labour intensive techniques.

On the other hand, if labour is scarce, capital intensive techniques may be used. Moreover, technique to be used also depends on the type and quantities of goods to be produced. For instance, in order to produce capital goods, complicated and expensive machines and techniques are required. On the other hand, for simple consumer goods small and less expensive machines are required. But, while choosing between different methods of production, those methods should be adopted which bring about an efficient allocation of resources and, thereby, increase the overall productivity in the economy.

(iii) For whom to produce?: The third central problem of the economy is the allocation of goods among the members of the society. The problem "For Whom to Produce" is related to the manner in which the national product will be distributed among different individuals and classes of persons. The allocation of goods among the households takes place on the basis of exchange.

The choice in this case would be whether to produce for the benefit of a few rich persons or for providing for the needs of large number of poor and unprivileged persons. In a poor country like India, if a large proportion of the national product consists of T.V. sets, motor cars, refrigerators, superfine cloth etc., then the economy is said to be producing for the sake of rich.

On the other hand, any economy which wants to benefit the maximum number of persons would first try to provide for the necessities of the entire population and only after this job is accomplished will gradually shift to the production of comforts and luxuries.

(iv) What provision 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.

Different types of Economic systems

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.

Economies are divided into three broad classifications based on their mode of production, exchange, distribution and the role which their governments plays in economic activity. These are:

- Capitalist economy
- Socialist economy
- Mixed economy

Capitalist Economy:

Capitalism is an economic system and an ideology based on private ownership of the means of production and their operation for profit. It is one of the oldest economic systems and its origin is at the time of mid-eighteenth century in England in the wake of Industrial Revolution. It is that system, where means of production are owned by private individuals, profit is the main motive and there is no interference by the government in the economic activities of the economy. Hence, it is known as free market economy.

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. However many of them are not pure form of capitalism but show some features of being a capitalist economy.

An economy is called capitalist or a free market economy or laissez-faire economy if it has the following characteristics:

1) 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.

- 2) 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.
- 3) Freedom of economic choice:** All individuals are free to make their economic choices regarding consumption, work, production, exchange etc.
- 4) 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.
- 5) 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.
- 6) 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.
- 7) 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 do capitalist economies solve their central problems?

A capitalist economy has no central planning authority to decide as to what, how and for whom to produce and in the absence of any central authority; it looks like a miracle as to how such an economy functions. There can be confusion and chaos in the country when the producers choose to produce cloth and workers choose to work for the furniture industry, while the consumers are in need of cars.

In order to solve the central problems, such an economy uses the impersonal forces of the market demand and supply or the price mechanism. Such an economy uses the impersonal forces of the 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 prompts the businessmen to compete with one another in order to produce those goods which consumers are willing to buy. Thus, if consumers want more cars, there will be an increase in the demand for cars consequent upon which the prices of cars are bound to increase. A rise in the sale of cars; cost remaining the same, will increase the profits for the entrepreneur. This induces the producers to go in for more production. In other words, when the consumers' demand for any product decreases, the price would fall thereby reducing the profits for the entrepreneur and the production also goes down.

Deciding how to produce?

An entrepreneur produces his goods with that technique of production which renders his cost of production minimum. If labor is relatively cheap he will use labor intensive method and if labor is relatively costlier he will use capital intensive method. Thus, the relative prices of factors of production help in deciding as to how to produce.

Deciding for whom to produce?

Goods and services in a capitalist economy will be produced for those who have the capacity to buy. 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; however, also on how much property he owns. Higher the income, higher will be his buying capacity and higher generally will be his demand for goods in general.

Deciding about consumption, savings 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 rate of interest prevailing in the market. Higher the interest rates, higher are the savings. Investment decisions depend upon the rate of return on capital. The greater the profit expectation, the higher will be the investment in any capitalist economy. The prices of capital are – the rate of interest on savings and the rate of return on capital

Merits of Capitalist economy:

1. To attract the consumer, the producer will bring out newer and finer varieties of goods.
2. The existence of private property and the driving force of profit motive results in high standard of living.
3. Capitalism works automatically through price mechanism.
4. The freedom of enterprise results in maximum efficiency in production.
5. All activities under capitalism enjoy the maximum amount of liberty and freedom.
6. Under capitalism, freedom of choice brings maximum satisfaction to consumers
7. Capitalism preserves fundamental rights such as right to freedom and right to private property.
8. It rewards men of initiative and enterprise.
9. The country as a whole benefits through growth of business talents, development of research, etc.
10. Capitalism preserves fundamental rights such as right to freedom and right to private property. Therefore, the participants enjoy maximum amount of autonomy and freedom.
11. Capitalism rewards men of initiative and enterprise and punishes the imprudent and inefficient.
12. Capitalism usually functions in a democratic framework.
13. The capitalist set up encourages enterprise and risk taking and emergence of an entrepreneurial class willing to take risks.

Demerits of Capitalism

1. In capitalism, the enormous wealth produced is apportioned by a few. This causes rich to become richer and poor to become poorer.
2. Welfare is not protected under capitalism, because, here, the aim is profit and not welfare of the people.
3. Economic instability in terms of over production, economic depression, unemployment, etc., is very common under capitalism.
4. The producer spends huge amounts of money on advertisement and sales promotion activities like fair, exhibitions etc.

5. Class conflict arises between employer and employee. Workers will be paid low wages and this leads to strikes and lock-outs.
6. Productive resources are misused under capitalism. They are used for the production of luxuries as they will bring high profits.
7. Capitalism leads to the formation of monopolies.
8. There is no security of employment under capitalism.

SOCIALIST ECONOMY

Socialist means the system under which economic system is controlled and regulated by the government so as to ensure welfare and equal opportunity to the people in a society. The word socialism means 'all things to all men'. According to Samuelson, "Socialism refers to the government ownership of the means of production, planning by the government and income distribution".

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 get 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 maximizing the welfare of the community as a whole.

Some important characteristics of this economy are:

- (i) 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 force of economic activity as it is in the case of a market economy. The resources are used to achieve certain socio-economic objectives.
- (ii) Central Planning Authority : There is a central authority to set and accomplish socioeconomic goals; that is why it is called a centrally planned economy. Major economic decisions, such as what to produce, when and how much to produce, etc., are taken by the central authority.
- (iii) 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 some authority on the basis of certain socio-economic goals before the nation.

- (iv) Relatively Equal Income Distribution : A relative equality of income is an important feature of Socialism. Among other things, differences 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.

- (v) 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 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