

# NATURE AND SCOPE OF BUSINESS ECONOMICS



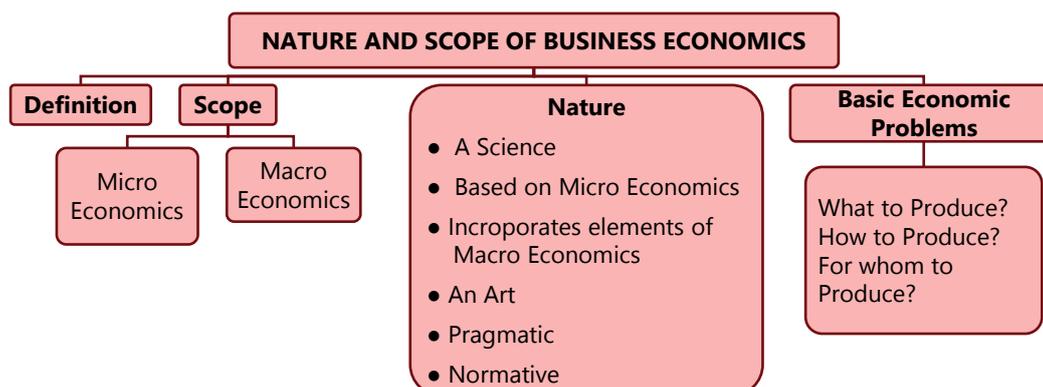
## UNIT – 1: INTRODUCTION

### LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Explain the Meaning of Economics.
- ◆ Describe the Meaning and Nature of Business Economics.
- ◆ Describe the Scope of Business Economics.

### CHAPTER OVERVIEW



## 1.0 INTRODUCTION

### 1.0.0 What is Business all about?

A business is an economic activity. There are various types of business like manufacturing, mining, construction, agriculture, poultry- farming, food processing, banking, insurance, health, education, transportation, communication, so on and so forth. Each one of these businesses represents activity transforming a set of inputs into a set of output which is the essence of economic activity. We can say, creation of net value added is the basic objective of all such activities. On the input side we refer to men, materials, machines, management etc., or as the economists classify as land, labour, capital and entrepreneurship. By output, we refer to different types of goods and services. Within 'goods' also, we have consumer goods, producer goods, capital goods, private goods, public goods, merit goods like essential goods, non-merit goods like cigarettes. Some of these goods are non durable or single use goods and some are durable in nature.

The purpose of any economic activity such as production, consumption, distribution, exchange and inventory accumulation, is to create surplus or profit. Some of Non-Profit Organisations (NPOs) may not aim at private profits but they aim at 'social benefits.' In context of all economic enterprises, several decisions have to be taken. For example, a production unit has to decide – What to produce? When to produce? For whom to produce? Why to produce? In the same way, a finance enterprise dealing with funds has to decide – When to raise funds? Where to direct the use of these funds? What should be the maturity and other terms? Each decision problem represents an area of choice. It is suggested that economics is a discipline which is helpful in analysing the rationality and optimality of a given choice.

At this stage one must know what economics is all about.

### 1.0.1 What is Economics about?

The term 'Economics' owes its origin to the Greek word 'Oikonomia' which means 'household'. Till 19th century, Economics was known as 'Political Economy.' The book named 'An Inquiry into the Nature and Causes of the Wealth of Nations' (1776) usually abbreviated as 'The Wealth of Nations', by Adam Smith is considered as the first modern work of Economics.

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 ₹ 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 ₹ 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 ₹1000 with you. Had your mother given you ₹ 2000, you might have satisfied more of your desires. But, she has not. Now, you find 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.

**The fundamental facts:**

- (i) **‘Human beings have unlimited wants’; and**
- (ii) **‘The means to satisfy these unlimited wants are relatively scarce’ form the subject matter of Economics.**

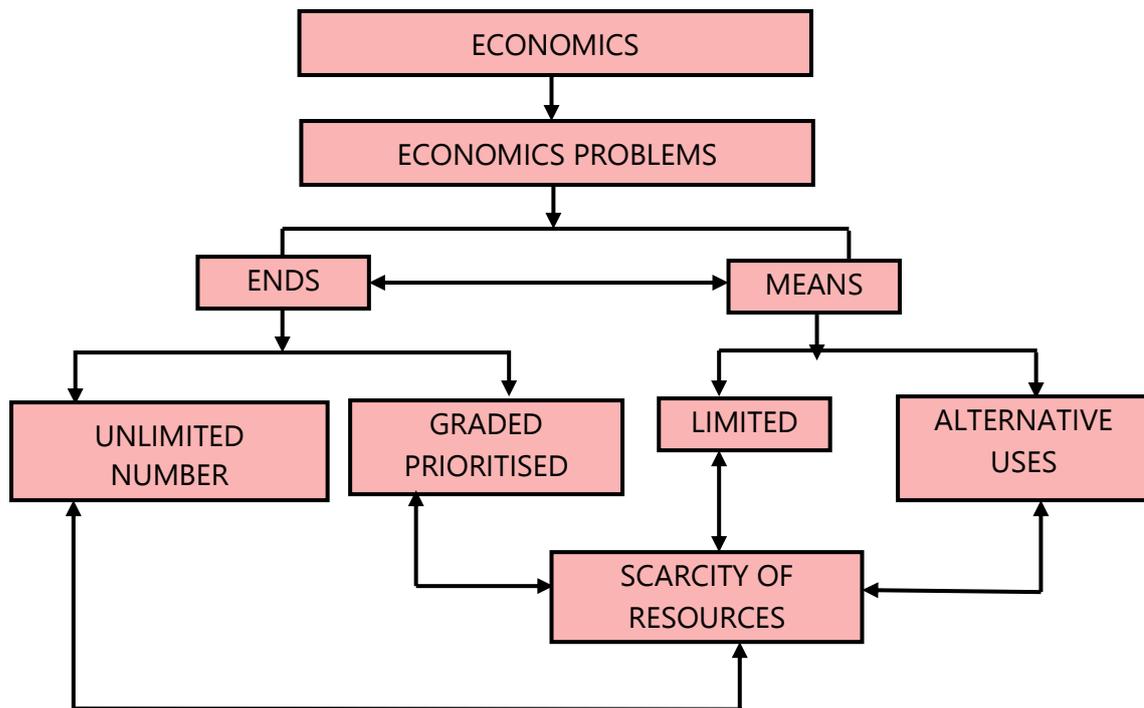
Let us now examine what Economics studies about. Economics is the study of the processes by which the relatively scarce resources are allocated to satisfy the competing unlimited wants of human beings in a society. Of course, the available resources will be efficiently used when they are allocated to their highest valued uses. 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 equipment 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 greener sources of energy such as solar and wind power. 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 (Global Financial Crisis 2007 and Corona Pandemic 2019). 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 matters fundamentally 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.



### 1.0.2 Meaning of Business Economics

Having understood the meaning of Economics, let us now understand what Business Economics is. For this, consider the following situation:

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 Aggrawal, 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 analysing 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 huge corpus of theory and techniques. Briefly put, Business Economics integrates economic theory with business practice.

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 analyse practical managerial problems. Business Economics is not only valuable to business decision makers, but also useful for managers of 'not-for-profit' organisations such as NGO, and voluntary organisations.



## 1.1 DEFINITIONS OF BUSINESS ECONOMICS

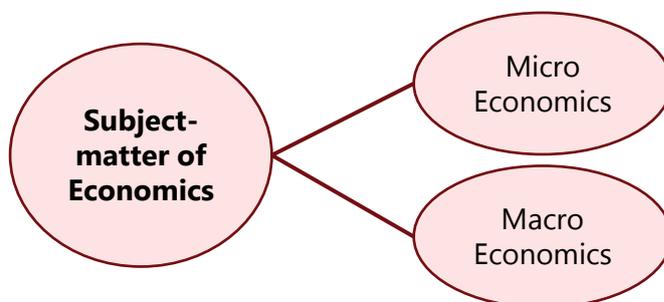
Business Economics may be defined as the use of economic analysis to make business decisions involving the best use of an organization's scarce resources. It is also known as Managerial Economics.

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.

**Our approach in this text is to focus on the heart of Business Economics i.e. the Micro Economic Theory of the behaviour of consumers and firms in competitive and not-competitive markets. This theory provides managers with a basic framework for making key business decisions about the allocation of their firm's scarce resources.**

## 1.2 NATURE OF BUSINESS ECONOMICS

Economics has been broadly divided into two major parts i.e. Micro Economics and Macro Economics. Before explaining the nature of Business Economics, it is pertinent to understand the distinction between these two.



**Micro Economics** is basically the study of the behaviour of different individuals and organizations 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 group of units rather than all the units combined, and therefore, it does not explain what is happening in the wider economic environment.

We 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**, in contrast, is the study of the overall economic phenomena or the economy as a whole, rather than its individual parts. Accordingly, in Macro-Economics, we study the behaviour of the large economic aggregates, such as, the overall levels of output and employment, total consumption, total saving and total investment, exports, imports and foreign investment and also how these aggregates shift over time. It analyzes the overall economic environment in which the firms, governments and households operate and 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.

A few areas that come under Macro Economics 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 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.

Having understood the meaning of Micro and Macro Economics, we shall examine the nature of Business Economics:

### ***Nature of Business Economics***

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. Business Economics enables application of economic logic and analytical tools to bridge the gap between theory and practice.

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/ her business environment.
- ♦ ***Business Economics is also 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.

### 1.3 SCOPE OF BUSINESS ECONOMICS

The scope of Business Economics is quite wide. It covers 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:

1. Internal issues or operational issues (this can be solved using Micro Economics)
2. External issues or environmental issues (this can be solved using Macro Economics)

Now we will see both of them one by one -

#### 1. Microeconomics applied to Internal or Operational Issues

Operational issues include all those issues that arise within the organization 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 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 provides 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 External or Environmental 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, and fiscal policy, foreign trade policy and globalization policies.
- ◆ Working of central banks and financial sector and capital market and their regulation.
- ◆ 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 fine-tune its policies to minimise their adverse effects.

## **1.4 DIFFERENCE BETWEEN ECONOMICS AND BUSINESS ECONOMICS**

<b>Basis of Difference</b>	<b>Economics</b>	<b>Business Economics</b>
<b>Meaning</b>	It involves the framing of economic principles to solve economic problems.	It involves the application of economic principles to solve economic problems.
<b>Character</b>	It is microeconomic as well as macroeconomic in character.	It is microeconomic in character.
<b>Main Task</b>	The fulfilment of needs of individuals as well as entities.	Proper decision making in a particular business entity.
<b>Nature</b>	It is positive as well as normative in nature.	It is only normative in nature.
<b>Scope</b>	It has a wider scope.	It has a comparatively narrow scope.
<b>Branches</b>	It has business economics as its applied branch.	It is an applied branch of economics.

<b>Concerned with</b>	All the theories from production to consumption including distribution.	It is concerned with only profit theory ignoring other theories.
<b>Analysis Involved</b>	It includes the analysis of macro level issues like growth, inflation and employment, etc.	It includes the analysis of micro level issues like demand, supply and profit etc.
<b>Concentration</b>	It concentrates only on the economic aspects of any business problem.	It concentrates on both economic as well as non-economic aspects of any business problem.
<b>Validity of Assumptions</b>	It is based on certain assumptions.	Some assumptions become invalid when applied.

## SUMMARY

- ◆ An economy exists because of two facts, i.e. human wants are unlimited and the resources are scarce.
- ◆ Economics is the study of processes by which the relatively scarce resources are allocated to satisfy the competing unlimited wants of human beings in a society.
- ◆ The subject matter of Economics is divided into two parts – Micro and Macro Economics
- ◆ Microeconomics examines how the individual units (consumers or firms) make decisions as to how to efficiently allocate their scarce resources.
- ◆ Macroeconomics study the behaviour of the large economic aggregates, such as, the overall levels of output and employment, total consumption, total saving and total investment exports and imports, and how these aggregates shift over time.
- ◆ Business Economics integrates economic theory with business practice and relies on economic analysis in the formulation of business policies.
- ◆ While Business Economics is basically concerned with Micro Economics, Macro economic analysis has got an important role to play. Macroeconomics analyzes the environment in which the business has to function.
- ◆ Business Economics is a normative science which is interdisciplinary and pragmatic in approach.

- ◆ There are two categories of business issues to which economic theories can be directly applied, namely: Microeconomics applied to operational or internal Issues and Macroeconomics applied to environmental or external issues.
- ◆ Business Economics makes use of microeconomic analysis such as, demand analysis and forecasting, production and cost Analysis, inventory management, market structure and pricing policies, resource allocation, theory of capital and investment decisions, profit analysis and risk and uncertainty analysis.
- ◆ Business Economics also considers Macroeconomics related to economic systems, business cycles, national income, employment, prices, saving and investment, Government's economic policies and working of financial sector and capital market.

**Study of Inventory Management, Product and Promotion Policy, Resource Allocation, Capital Budgeting, Risk and Uncertainty Analysis are outside the scope of this book. They will be taught in other subjects – Financial Management, Strategic Management etc. at higher levels of CA course.**

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

### LEARNING OUTCOMES

After studying this unit, you would be able to:

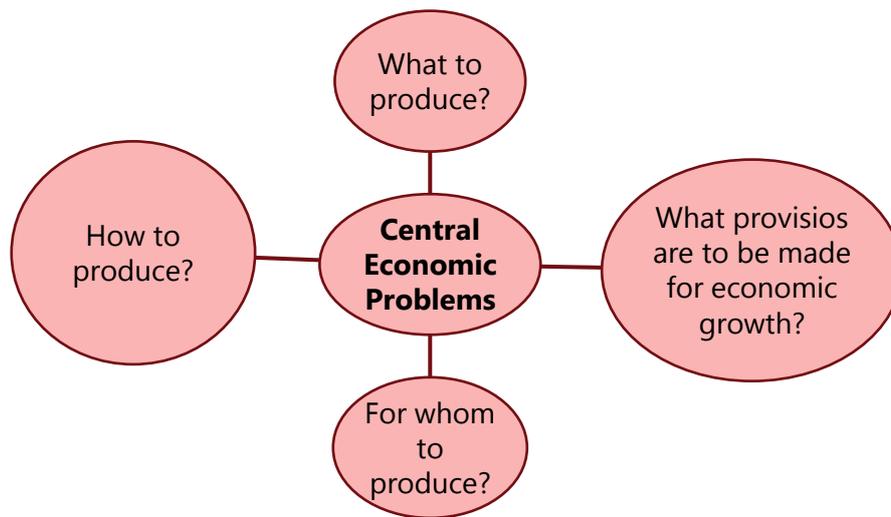
- ◆ Explain the Basic Problems faced by an Economy.
- ◆ Describe how Different Economies Solve their Basic Economic Problems.
- ◆ Explain the Role of Price Mechanism in Solving the Basic Problems of an Economy.

### 2.0 BASIC PROBLEMS OF AN ECONOMY

As mentioned in the last unit, all countries, without exceptions, face the problem of scarcity. Their resources (natural productive resources, man-made capital goods, consumer goods, money and time etc.) are limited and these resources have alternative uses. For example, coal can be used as a fuel for the production of industrial goods; it can be used for producing electricity, for domestic cooking purposes and for many other purposes. Similarly, financial resources can be used for many purposes. If the resources were unlimited, people would be able to satisfy all their wants and there would be no economic problem. Alternatively, if a resource has only a single use, then also the economic problem would not arise.

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:

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



- (i) **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. 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's, dams etc., will be produced or more consumer goods such as, cell phones will be produced. Not only the society has to decide about what goods are to be produced, it has also to decide in what quantities each of these goods would be produced. In a nutshell, a society must decide how much wheat, how many hospitals, how many schools, how many machines, how many meters of cloths etc. have to be produced.
- (ii) **How to produce?:** There are various alternative techniques of producing a commodity. For example, cotton cloth can be produced using handlooms, power looms or automatic looms. Production with handlooms involves use of more labour and production with automatic loom involves use of more machines and capital. A society has to decide whether it will produce cotton cloth using labour- intensive techniques or capital-intensive techniques. Likewise, for all goods and services, it has to decide whether to use labour- intensive techniques or capital - intensive techniques. Obviously, the choice would depend on the availability of different factors of production (i.e. labour and capital) and their relative prices. It is in the society's interest to use those techniques of production that make the best use of the available resources.
- (iii) **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.

- (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.

We shall now examine the term 'economic system'. 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.

You must be wondering how different economies of the world would be solving their central problems. In order to understand this, we divide all the economies into three broad classifications based on their mode of production, exchange, distribution and the role which their governments plays in economic activity. These are:



## 2.1 CAPITALIST ECONOMY

Capitalism, the predominant economic system in the modern global economy, is an economic system in which all means of production are owned and controlled by private individuals for profit. In short, private property is the mainstay of capitalism and profit motive is its driving force. Decisions of consumers and businesses 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 United States and United Kingdom, Hong Kong, South Korea 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:

- ◆ **Right to private property:** The right to private property means that productive factors such as land, factories, machinery, mines etc. can be under private ownership. The owners of these factors are free to use them in any manner in which they like and bequeath it as they desire. The government may, however, put some restrictions for the benefit of the society in general.
- ◆ **Freedom of enterprise:** Each individual, whether consumer, producer or resource owner, is free to engage in any type of economic activity. For example, a producer is free to set up any type of firm and produce goods and services of his choice.
- ◆ **Freedom of economic choice:** All individuals are free to make their economic choices regarding consumption, work, production, exchange etc.
- ◆ **Profit motive:** Profit motive is the driving force in a free enterprise economy and directs all economic activities. Desire for profits induces entrepreneurs to organize production so as to earn maximum profits.
- ◆ **Consumer Sovereignty:** Consumer is supposed to be the king under capitalism. Consumer sovereignty means that buyers ultimately determine which goods and services will be produced and in what quantities. Consumers have unbridled freedom to choose the goods and services which they would consume. Therefore, producers have to produce goods and services which are preferred by the consumers. In other words, based on the purchases they make, consumers decide how the economy's limited resources are allocated.
- ◆ **Competition:** Competition is the most important feature of the capitalist economy. Competition brings out the best among buyers and sellers and results in efficient use of resources.
- ◆ **Absence of Government Interference:** A purely capitalist economy is not centrally planned, controlled or regulated by the government. In this system, all economic decisions and activities are guided by self-interest and price mechanism which operates automatically without any direction and control by the governmental authorities.

### 2.1.0 How do capitalist economies solve their central problems?

A capitalist economy has no central planning authority to decide what, how and for whom to produce. In the absence of any central authority, it looks like a miracle as to how such an economy functions. If the consumers want cars and producers choose to make cloth and workers choose to work for the furniture industry, there will be total confusion and chaos in the country. However,

this does not happen in a capitalist economy. 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. Thus, if consumers want more cars, there will be an increase in the demand for cars and as a result their prices will increase. A rise in the price of cars, costs remaining the same, will lead to more profits. This will induce producers to produce more cars. On the other hand, if the consumers' demand for cloth decreases, its price would fall and profits would go down. Therefore, business firms have less incentive to produce cloth and less of cloth will be produced. Thus, more of cars and less cloth will be produced in such an economy. In a capitalist economy (like the USA, UK and Germany) the question regarding what to produce is ultimately decided by consumers who show their preferences by spending on the goods which they want.

**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 method and if labour is relatively costlier he will use capital-intensive method. Thus, the relative prices of factors of production help in deciding how to produce.

**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 level of income and 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.

Thus, we see above that what goods are produced, by which methods they are produced, for whom they are produced and what provisions should be made for economic growth are decided by price mechanism or market mechanism.

### 2.1.1 Merits of Capitalist Economy

- ◆ Capitalism is self-regulating and works automatically through price mechanism. There is no need of incurring costs for collecting and processing of information and for formulating, implementing and monitoring policies.
- ◆ The existence of private property and the driving force of profit motive result in greater efficiency and incentive to work.
- ◆ The process of economic growth is likely to be faster under capitalism. This is because the investors try to invest in only those projects which are economically feasible.
- ◆ Resources are used in activities in which they are most productive. This results in optimum allocation of the available productive resources of the economy.
- ◆ There is usually high degree of operative efficiency under the capitalist system.
- ◆ Cost of production is minimized as every producer tries to maximize his profit by employing methods of production which are cost-effective.
- ◆ Capitalist system offer incentives for efficient economic decisions and their implementation.
- ◆ Consumers are benefitted as competition forces producers to bring in a large variety of good quality products at reasonable prices. This, along with freedom of choice, ensures maximum satisfaction to consumers. This also results in higher standard of living.
- ◆ Capitalism offers incentives for innovation and technological progress. The country as a whole benefits through growth of business talents, development of research, etc.
- ◆ Capitalism preserves fundamental rights such as right to freedom and right to private property. Therefore, the participants enjoy maximum amount of autonomy and freedom.
- ◆ Capitalism rewards men of initiative and enterprise and punishes the imprudent and inefficient.
- ◆ Capitalism usually functions in a democratic framework.
- ◆ The capitalist set up encourages enterprise and risk taking and emergence of an entrepreneurial class willing to take risks.

### 2.1.2 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.

- ◆ Under capitalism, there is precedence of property rights over human rights.
- ◆ Economic inequalities lead to wide differences in economic opportunities and perpetuate unfairness in the society.
- ◆ The capitalist system ignores human welfare because, under a capitalist set up, the aim is profit and not the welfare of the people.
- ◆ Due to income inequality, the pattern of demand does not represent the real needs of the society.
- ◆ Exploitation of labour is common under capitalism. Very often this leads to strikes and lock outs. Moreover, there is no security of employment. This makes workers more vulnerable.
- ◆ Consumer sovereignty is a myth as consumers often become victims of exploitation. Excessive competition and profit motive work against consumer welfare.
- ◆ There is misallocation of resources as resources will move into the production of luxury goods. Less wage goods will be produced on account of their lower profitability.
- ◆ Less of merit goods like education and health care will be produced. On the other hand, a number of goods and services which are positively harmful to the society will be produced as they are more profitable.
- ◆ Due to unplanned production, economic instability in terms of over production, economic depression, unemployment etc., is very common under capitalism. These result in a lot of human misery.
- ◆ There is enormous waste of productive resources as firms spend huge amounts of money on advertisement and sales promotion activities.
- ◆ Capitalism leads to the formation of monopolies as large firms may be able to drive out small ones by fair or foul means.
- ◆ Excessive materialism as well as conspicuous and unethical consumption leads to environmental degradation.

## 2.2 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 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. Hence the central problems are solved through planning under socialist economy.

Some important characteristics of this economy are:

- ◆ **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.
- ◆ **Economic planning:** There is a Central Planning Authority to set and accomplish socio-economic goals; that is why it is called a centrally planned economy. The major economic decisions, such as what to produce, when and how much to produce, etc., are taken by the central planning authority.
- ◆ **Absence of Consumer Choice:** Freedom from hunger is guaranteed, but consumers' sovereignty gets restricted by selective production of goods. The range of choice is limited by planned production. However, within that range, an individual is free to choose what he likes most.

The right to work is guaranteed, but the choice of occupation gets restricted because these are determined by the central planning authority on the basis of certain socio-economic goals before the nation.

- ◆ **Relatively Equal Income Distribution:** A relative equality of income is an important feature of Socialism. Among other things, differences in income and wealth are narrowed down by lack of opportunities to accumulate private capital. Educational and other facilities are enjoyed more or less equally; thus the basic causes of inequalities are removed.
- ◆ **Minimum role of Price Mechanism or Market forces:** Price mechanism exists in a socialist economy; but it has only a secondary role, e.g., to secure the disposal of accumulated stocks. Since allocation of productive resources is done according to a predetermined plan, the price mechanism as such does not influence these decisions. In the absence of the profit motive, price mechanism loses its predominant role in economic decisions. The prices prevailing under socialism are 'administered prices'

which are set by the central planning authority on the basis of socio-economic objectives.

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

The erstwhile U.S.S.R. was an example of socialist economy from 1917 to 1990. In today's world there is no country which is purely socialist. Other examples include Vietnam, China and Cuba. North Korea, the world's most totalitarian state, is another example of a socialist economy.

### 2.2.0 Merits of Socialism

- ◆ Equitable distribution of wealth and income and provision of equal opportunities for all help to maintain economic and social justice.
- ◆ Rapid and balanced economic development is possible in a socialist economy as the central planning authority coordinates all resources in an efficient manner according to set priorities.
- ◆ Socialist economy is a planned economy. In a socialistic economy, there will be better utilization of resources and it ensures maximum production. Wastes of all kinds are avoided through strict economic planning. Since competition is absent, there is no wastage of resources on advertisement and sales promotion.
- ◆ In a planned economy, unemployment is minimised, business fluctuations are eliminated and stability is brought about and maintained.
- ◆ The absence of profit motive helps the community to develop a co-operative mentality and avoids class war. This, along with equality, ensures better welfare of the society.
- ◆ Socialism ensures right to work and minimum standard of living to all people.
- ◆ Under socialism, the labourers and consumers are protected from exploitation by the employers and monopolies respectively.
- ◆ There is provision of comprehensive social security under socialism and this makes citizens feel secure.

### 2.2.1 Demerits of Socialism

- ◆ Socialism involves the predominance of bureaucracy and the resulting inefficiency and delays. Moreover, there may also be corruption, red tapism, favouritism, etc.
- ◆ It restricts the freedom of individuals as there is state ownership of the material means of production and state direction and control of nearly all economic activity.
- ◆ Socialism takes away the basic rights such as the right of private property.

- ◆ It will not provide necessary incentives to hard work in the form of profit.
- ◆ Administered prices are not determined by the forces of 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.
- ◆ State monopolies created by socialism will sometimes become uncontrollable. This will become more difficult to regulate than the private monopolies under capitalism.
- ◆ Under socialism, the consumers have limited freedom of choice. Therefore, what the state produces has to be accepted by the consumers.
- ◆ No importance is given to personal efficiency and productivity. Labourers are not rewarded according to their efficiency. This acts as a disincentive to work.
- ◆ The extreme form of socialism is not at all practicable.

## 2.3 THE MIXED ECONOMY

The mixed economic system depends on both markets and governments for allocation of resources. In fact, every economy in the real world makes use of both **markets and governments** and therefore is mixed economy in its nature. In a mixed economy, the aim is to develop a system which tries to include the best features of both the controlled economy and the market economy while excluding the demerits of both. 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. At the same time, it is noticed that private property, profit motive and self-interest of the market economy may not promote the interests of the community as a whole and as such, the Government should remove these defects of private enterprise. For this purpose, the Government itself must run important and selected industries and eliminate the free play of profit motive and self-interest. Private enterprise which has its own significance is also allowed to play a positive role in a mixed economy. However, 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.

### 2.3.0 Features of Mixed Economy

**Co-existence of private and public sector:** The first important feature of a mixed economy is the co-existence of both private and public enterprise.

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

- (a) **Private sector:** Production and distribution in this sector are managed and controlled by private individuals and groups. Industries in this sector are based on self-interest and profit motive. The system of private property exists and personal initiative is given full scope. However, private enterprise may be regulated by the government directly and/or indirectly by a number of policy instruments.
- (b) **Public sector:** Industries in this sector are not primarily profit-oriented, but are set up by the State for the welfare of the community.
- (c) **Combined sector:** A sector in which both the government and the private enterprises have equal access, and join hands to produce commodities and services, leading to the establishment of joint sectors.

Mixed economy has the following **Merits** available to capitalist economies and socialist economies:

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

However, mixed economy is not always a 'golden path' between capitalism and socialism. It could also suffer from substantial uncertainties.

Mixed economy has the following **Demerits** available to capitalist economies and socialist economies:

- ◆ Mixed economy, sometimes, 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.

- ◆ 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**

- ◆ The basic problem of scarcity gives rise to many of the economic problems.
- ◆ Unlimited human wants and scarcity of resources lead to the central economic problems like what to produce, how to produce and for whom to produce.
- ◆ The basic economic problems of what, how and for whom to produce are solved by different economies in different ways.
- ◆ A capitalist economy uses the tool of price mechanism, a socialist economy uses the tool of central planning and a mixed economy uses a mix of both price mechanism and central planning to solve its basic economic problems.

## **TEST YOUR KNOWLEDGE**

### **Multiple Choice Questions**

1. *Economists regard decision making as important because:*
  - (a) *The resources required to satisfy our unlimited wants and needs are finite, or scarce.*
  - (b) *It is crucial to understand how we can best allocate our scarce resources to satisfy society's unlimited wants and needs.*
  - (c) *Resources have alternative uses.*
  - (d) *All the above.*
2. *Business Economics is -*
  - (a) *Abstract and applies the tools of Microeconomics.*
  - (b) *Involves practical application of economic theory in business decision making.*
  - (c) *Incorporates tools from multiple disciplines.*
  - (d) *(b) and (c) above.*

3. *In Economics, we use the term scarcity to mean -*
  - (a) *Absolute scarcity and lack of resources in less developed countries.*
  - (b) *Relative scarcity i.e. scarcity in relation to the wants of the society.*
  - (c) *Scarcity during times of business failure and natural calamities.*
  - (d) *Scarcity caused on account of excessive consumption by the rich.*
4. *What implication(s) does resource scarcity have for the satisfaction of wants?*
  - (a) *Not all wants can be satisfied.*
  - (b) *We will never be faced with the need to make choices.*
  - (c) *We must develop ways to decrease our individual wants.*
  - (d) *The discovery of new natural resources is necessary to increase our ability to satisfy wants.*
5. *Which of the following is a normative statement?*
  - (a) *Planned economies allocate resources via government departments.*
  - (b) *Most transitional economies have experienced problems of falling output and rising prices over the past decade.*
  - (c) *There is a greater degree of consumer sovereignty in market economies than planned economies.*
  - (d) *Reducing inequality should be a major priority for mixed economies.*
6. *In every economic system, scarcity imposes limitations on*
  - (a) *households, business firms, governments, and the nation as a whole.*
  - (b) *households and business firms, but not the governments.*
  - (c) *local and state governments, but not the federal government.*
  - (d) *households and governments, but not business firms.*
7. *Macroeconomics is also called——— economics.*
  - (a) *applied*
  - (b) *aggregate*
  - (c) *experimental*
  - (d) *none of the above*
8. *An example of 'positive' economic analysis would be:*
  - (a) *an analysis of the relationship between the price of food and the quantity purchased.*

- (b) *determining how much income each person should be guaranteed.*
- (c) *determining the 'fair' price for food.*
- (d) *deciding how to distribute the output of the economy.*
9. *A study of how increases in the corporate income tax rate will affect the national unemployment rate is an example of -*
- (a) *Macro-Economics.*
- (b) *Descriptive Economics.*
- (c) *Micro-economics.*
- (d) *Normative economics.*
10. *Which of the following does not suggest a macro approach for India?*
- (a) *Determining the GNP of India.*
- (b) *Finding the causes of failure of ABC Ltd.*
- (c) *Identifying the causes of inflation in India.*
- (d) *Analyse the causes of failure of industry in providing large scale employment*
11. *Ram: My corn harvest this year is poor.*  
*Krishan: Don't worry. Price increases will compensate for the fall in quantity supplied.*  
*Vinod: Climate affects crop yields. Some years are bad, others are good.*  
*Madhu: The Government ought to guarantee that our income will not fall.*  
*In this conversation, the normative statement is made by -*
- (a) *Ram*
- (b) *Krishan*
- (c) *Vinod*
- (d) *Madhu*
12. *Consider the following and decide which, if any, economy is without scarcity:*
- (a) *The pre-independent Indian economy, where most people were farmers.*
- (b) *A mythical economy where everybody is a billionaire.*
- (c) *Any economy where income is distributed equally among its people.*
- (d) *None of the above.*
13. *Which of the following is not a subject matter of Micro-economies?*
- (a) *The price of mangoes.*

- (b) *The cost of producing a fire truck for the fire department of Delhi, India.*
- (c) *The quantity of mangoes produced for the mangoes market.*
- (d) *The national economy's annual rate of growth.*
14. *The branch of economic theory that deals with the problem of allocation of resources is -*
- (a) *Micro-Economic theory.*
- (b) *Macro-economic theory.*
- (c) *Econometrics.*
- (d) *None of the above.*
15. *Which of the following is not the subject matter of Business Economics?*
- (a) *Should our firm be in this business?*
- (b) *How much should be produced and at price should be kept?*
- (c) *How will the product be placed in the market?*
- (d) *How should we decrease unemployment in the economy?*
16. *Which of the following is a normative economic statement?*
- (a) *Unemployment rate decreases with industrialization*
- (b) *Economics is a social science that studies human behaviour.*
- (c) *The minimum wage should be raised to ₹ 200/- per day*
- (d) *India spends a huge amount of money on national defence.*
17. *Which of the following would be considered a topic of study in Macroeconomics?*
- (a) *The effect of increase in wages on the profitability of cotton industry*
- (b) *The effect on steel prices when more steel is imported*
- (c) *The effect of an increasing inflation rate on living standards of people in India*
- (d) *The effect of an increase in the price of coffee on the quantity of tea consumed*
18. *The difference between positive and normative Economics is:*
- (a) *Positive Economics explains the performance of the economy while normative Economics finds out the reasons for poor performance.*
- (b) *Positive Economics describes the facts of the economy while normative Economics involves evaluating whether some of these are good or bad for the welfare of the people.*

- (c) *Normative Economics describes the facts of the economy while positive Economics involves evaluating whether some of these are good or bad for the welfare of the people.*
- (d) *Positive Economics prescribes while normative Economics describes.*
19. *Which of the following is not within the scope of Business Economics?*
- (a) *Capital Budgeting*
- (b) *Risk Analysis*
- (c) *Business Cycles*
- (d) *Accounting Standards*
20. *Which of the following statements is incorrect?*
- (a) *Business economics is normative in nature.*
- (b) *Business Economics has a close connection with statistics.*
- (c) *Business Economist need not worry about macro variables.*
- (d) *Business Economics is also called Managerial Economics.*
21. *Economic goods are considered scarce resources because they.*
- (a) *cannot be increased in quantity.*
- (b) *do not exist in adequate quantity to satisfy the requirements of the society.*
- (c) *are of primary importance in satisfying social requirements.*
- (d) *are limited to man made goods.*
22. *In a free market economy the allocation of resources is determined by*
- (a) *voting done by consumers.*
- (b) *a central planning authority.*
- (c) *consumer preferences.*
- (d) *the level of profits of firms.*
23. *A capitalist economy uses \_\_\_\_\_ as the principal means of allocating resources.*
- (a) *demand*
- (b) *supply*
- (c) *efficiency*
- (d) *prices*

24. Which of the following is considered as a disadvantage of allocating resources using the market system?
- (a) Income will tend to be unevenly distributed.
  - (b) People do not get goods of their choice.
  - (c) Men of Initiative and enterprise are not rewarded.
  - (d) Profits will tend to be low.
25. Which of the following statements does not apply to a market economy?
- (a) Firms decide whom to hire and what to produce.
  - (b) Firms aim at maximizing profits.
  - (c) Households decide which firms to work for and what to buy with their incomes.
  - (d) Government policies are the primary forces that guide the decisions of firms and households.
26. In a mixed economy -
- (a) all economic decisions are taken by the central authority.
  - (b) all economic decisions are taken by private entrepreneurs.
  - (c) economic decisions are partly taken by the state and partly by the private entrepreneurs.
  - (d) none of the above.
27. The central problem in economics is that of
- (a) comparing the success of command versus market economies.
  - (b) guaranteeing that production occurs in the most efficient manner.
  - (c) guaranteeing a minimum level of income for every citizen.
  - (d) allocating scarce resources in such a manner that society's unlimited needs or wants are satisfied in the best possible manner.
28. Capital intensive technique would get chosen in a
- (a) labour surplus economy where the relative price of capital is lower.
  - (b) capital surplus economy where the relative price of capital is lower.
  - (c) developed economy where technology is better.
  - (d) developing economy where technology is poor.

29. Which of the following is not one of the four central questions that the study of economics is supposed to answer?
- (a) Who produces what?
  - (b) When are goods produced?
  - (c) Who consumes what?
  - (d) How are goods produced?
30. Larger production of \_\_\_\_ goods would lead to higher production in future.
- (a) consumer goods
  - (b) capital goods
  - (c) agricultural goods
  - (d) public goods
31. The economic system in which all the means of production are owned and controlled by private individuals for profit.
- (a) Socialism
  - (b) Capitalism
  - (c) Mixed economy
  - (d) Communism
32. Macro Economics is the study of \_\_\_\_\_.
- (a) all aspects of scarcity.
  - (b) the national economy and the global economy as a whole.
  - (c) big businesses.
  - (d) the decisions of individual businesses and people.
33. Freedom of choice is the advantage of -
- (a) Socialism
  - (b) Capitalism
  - (c) Communism
  - (d) None of the above
34. Exploitation and inequality are minimal under:
- (a) Socialism
  - (b) Capitalism

- (c) *Mixed economy*  
(d) *None of the above*
35. *Administered prices refer to:*  
(a) *Prices determined by forces of demand and supply*  
(b) *Prices determined by sellers in the market*  
(c) *Prices determined by an external authority which is usually the government*  
(d) *None of the above*
36. *In Economics, the central economic problem means:*  
(a) *Output is restricted to the limited availability of resources*  
(b) *Consumer do not have as much money as they would wish*  
(c) *There will always be certain level of unemployment*  
(d) *Resources are not always allocated in an optimum way*
37. *Scarcity definition of Economics is given by-*  
(a) *Alfred Marshall*  
(b) *Samuelson*  
(c) *Robinson*  
(d) *Adam Smith*
38. *The definition "Science which deals with wealth of Nation" was given by:*  
(a) *Alfred Marshall*  
(b) *A C Pigou*  
(c) *Adam Smith*  
(d) *J B Say*
39. *Which of the following is not one of the features of capitalist economy?*  
(a) *Right of private property*  
(b) *Freedom of choice by the consumers*  
(c) *No profit, No Loss motive*  
(d) *Competition*
40. *There is need of economic study, because –*  
(a) *The resources are limited*  
(b) *The wants are unlimited*

- (c) *The resources are unlimited*
- (d) *Both a and b*
41. *The benefit of economic study is –*
- (a) *It ensure that all problems will be appropriately tackled*
- (b) *It helps in identifying problems*
- (c) *It enable to examine a problem in its right perspective*
- (d) *It gives exact solutions to every problem*
42. *The managerial economics –*
- (a) *Is Applied Economics that fills the gap between economic theory and business practice*
- (b) *Is just a theory concept*
- (c) *Trains managers how to behave in recession*
- (d) *Provides the tools which explain various concepts*
43. *Which of the following statements is correct?*
- (a) *Micro economics is important for study of a particular household and a particular firm*
- (b) *Macro economics is important for study of economic conditions of a country*
- (c) *None of the above*
- (d) *Both a and b*
44. *Mr. Satish hired a business consultant to guide him for growth of his business. The consultant visited his factory and suggested some changes with respect to staff appointment, loan availability and so on. Which approach is that consultant using?*
- (a) *Micro economics*
- (b) *Macro economics*
- (c) *None of the above*
- (d) *Both a and b*
45. *Profit motive is a merit of*
- (a) *Socialism*
- (b) *Capitalism*
- (c) *Mixed economy*
- (d) *None of the above*

46. \_\_\_\_\_ is also called as command economy
- Socialist
  - Capitalist
  - Mixed economy
  - None of the above
47. Which of the following statements is/are correct regarding business economics?
- Business economics attempts to indicate how business policies are firmly rooted in economic principles.
  - Business economics uses micro economic analysis of the business unit and macro economic analysis of business environment.
  - Business economics takes a pragmatic approach towards facilitating an integration between economic theory and business practices.
  - All the above.
48. Unlimited ends and limited means together present the problem of \_\_\_\_\_.
- Scarcity of resources
  - Choice
  - Distribution
  - None of the above

## ANSWERS

1.	(d)	2.	(d)	3.	(b)	4.	(a)	5.	(d)	6.	(a)
7.	(b)	8.	(a)	9.	(a)	10.	(b)	11.	(d)	12.	(d)
13.	(d)	14.	(a)	15.	(d)	16.	(c)	17.	(c)	18.	(b)
19.	(d)	20.	(c)	21.	(b)	22.	(c)	23.	(d)	24.	(a)
25.	(d)	26.	(c)	27.	(d)	28.	(b)	29.	(b)	30.	(b)
31.	(b)	32.	(b)	33.	(b)	34.	(a)	35.	(c)	36.	(a)
37.	(c)	38.	(c)	39.	(c)	40.	(d)	41.	(c)	42.	(a)
43.	(d)	44.	(a)	45.	(b)	46.	(a)	47.	(d)	48.	(b)