Unit 1: Introduction

Name: ______________________

Date: _ _ / _ _ / _ _

Simple Economy

People in the society need many goods and services in their everyday life. In fact, the list of goods and services that any individual needs is so large that no individual in society, to begin with, has all the things needed.

Every individual has some amount of the goods and services that they would like to use. Any allocation of resources of the society would result in the production of a combination of different goods and services. The allocation of the limited resources and the distribution of the final mix of goods and services are two of the basic economic problems faced by the society.

Central Problems of an Economy

1. What to produce: when resources are scarce, an economy cannot produce everything in infinite quantity. If there are resources worth Rs. 10,000 we can use these to produce 10 tons of steel or 10 tons of wheat. Steel is needed for infrastructure while wheat is needed for food. Both steel and wheat is to be produced and how much to be produced depends on the economic system of that country.
2. How to produce: The problem of how to produce depends on the type of technology used. The two techniques of production are; labour intensive production and capital-intensive production. Choosing between the two is a problem because it leads to conflicting results. Labour intensive techniques can increase employment opportunities while capital intensive technique can increase efficiency. Society can choose the right technique among the two depending on the resources and requirement.
3. For whom to produce: Human wants vary from region to region. The individuals may belong to economically weak or rich sections. This raises the question 'For whom to produce?'. This leads to problem of distribution. Goods or services can be either distributed through the open market or fair price shops (ration shops). A market economy will decide based on purchasing power of the consumer while a socialist economy takes the decision based on requirements of the individuals.
4. Other Problems: They are as follows
   a) The problem of economic efficiency: Every economy must use its resources efficiently. Efficient use of resources will avoid creating scarcity.
   b) The problem of full employment: since resources are scarce, the available resources need to be fully utilized. Unemployment is case of under-utilization of resources and the economy does not get any benefit with these resources.
   c) The problem of economic growth: every economy must increase its ability to produce more goods and services with the available resources. The increase in the capacity to produce goods and services over time is called economic growth. It is measured in per capita income.

Economic Systems

Meaning

Choice is an important tool in the organization of economic activities. Because like and individual, a nation toto has limited resources. A nation tries to solve this problem by determining its type of economy or an economic system. An economic system is a system for resolving the basic economic problems of what, how and for whom to produce. It includes:

a) Centrally Planned Economy / Socialist Economy
b) Market Economy / Capitalist Economy
c) Mixed Economy

Centrally Planned Economy / Socialist Economy

A planned economy is an economic system in which inputs are based on direct allocation. Economic planning may be carried out in a decentralized, distributed or centralized manner depending on the specific organization of economic institutions.

An economy based on economic planning (either through the state, an association of worker cooperatives or another economic entity that has jurisdiction over the means of production) appropriates its resources as needed, so that allocation comes in the form of internal transfers involving the purchasing of assets by one government agency or firm by another. In a traditional model of planning, decision-making would be carried out by workers and consumers on the enterprise -level.

Less extensive forms of planned economies include those that use indicative planning as components of a market-based or mixed economy, in which the state employs "influence, subsidies, grants, and taxes, but does not compel." This latter is sometimes referred to as a "planned market economy". In some instances, the term planned economy has been used to refer to national economic development plans and state-directed investment in market economies.

Countries like China, Russia and North Korea are examples of centrally planned economies.

Capitalist Economy or Market Economy

Capitalism is an economic system based on private ownership of the means of production and the creation of goods and services for profit. Central characteristics of capitalism include private property, capital accumulation, wage labor and competitive markets.

In a capitalist market economy, investments are determined by private decision and the parties to a transaction typically determine the prices at which they exchange assets, goods, and services. The degree of competition in markets, the role of intervention and regulation, and the scope of state ownership vary across different models of capitalism.

Economists, political economists, and historians have adopted different perspectives in their analyses of capitalism and have recognized various forms of it in practice. These include laissez - faire or free market capitalism, welfare capitalism and state capitalism. Each model has employed varying degrees of dependency on free markets, public ownership, obstacles to free competition, and inclusion of state - sanctioned social policies.

Countries like America and Great Britain follow capitalism.

Mixed Economy

A mixed economy is variously defined as an economic system consisting of a mixture of either markets and economic planning, public ownership and private ownership, or free markets and economic interventionism. However, in most cases, "mixed economy" refers to market economies with strong regulatory oversight and governmental provision of public goods, although some mixed economies also feature several state-run enterprises.

In general, the mixed economy is characterized by the private ownership of the means of production, the dominance of markets for economic coordination, with profit-seeking enterprise and the accumulation of capital remaining the fundamental driving force behind economic activity.

But unlike a free-market economy, the government would wield indirect macroeconomic influence over the economy through fiscal and monetary policies designed to counteract economic downturns and capitalism's tendency toward financial crises and unemployment, along with playing a role in interventions that promote social welfare. Subsequently, some mixed economies have expanded in scope to include a role for indicative economic planning and/or large public enterprise sectors.

Countries like India, Germany and France follow mixed economy system.

Positive and Normative Economics

Different mechanisms in general are likely to give rise to different solutions to those problems, thereby resulting in different allocations of the resources and different distributions of the final mix of goods and services produced in the economy. Therefore, it is important to understand which of these alternative mechanisms is more desirable for the economy.

In economics, we try to analyze the different mechanisms and figure out the outcomes which are likely to result under each of these mechanisms. We also try to evaluate the mechanisms by studying how desirable the outcomes resulting from them are. Often a distinction is made between positive economic analysis and normative economic analysis depending on whether we are trying to figure out how a mechanism functions or we are trying to evaluate it. In positive economic analysis, we study how the different mechanisms function, and in normative economics, we try to understand whether these mechanisms are desirable or not.

The positive and the normative issues involved in the study of the central economic problems are very closely related to each other and a proper understanding of one is not possible in isolation to the other.

Micro and Macro Economics

Sl No	Parameter	Micro Economics	Macro Economics
1	Economic unit	It is the study of individual economic units of an economy	It is the study of economy and its aggregates.
2	Scope	It deals with individual income, individual prices and individual output, etc.	It deals with aggregates like national income, general price level and national output, etc.
3	Central Problem	Its Central problem is price determination and allocation of resources	Its central problem is determination of level of income and employment.
4	Main Tools	Its main tools are demand and supply of a commodity/factor.	Its main tools are aggregate demand and aggregate supply of economy.
5	Use	It helps to solve the central problem of what, how and for whom to produce in the economy	It helps to solve the central problem of full employment of resources in the economy. Equilibrium
6	Equilibrium Analysis	It discusses how equilibrium of a consumer, a producer or an industry is attained. It	It is concerned with the determination of equilibrium level of income and employment of the economy
7	Determinants	Price is the main determinant of microeconomic problems	Price is the main determinant of microeconomic problems
8	Limitation	It is based on unrealistic assumptions, i.e. In microeconomics it is assumed that there is a full employment in the society which is not at all possible	It has been analyzed that 'Fallacy of Composition' involves, which sometimes doesn't prove true because it is possible that what is true for aggregate may not be true for individuals too.
9	Approach	While analyzing any economy, microeconomics takes a bottom-up approach,	The macroeconomics takes a top-down approach into the consideration.
10	Example	Examples are: individual income, individual savings, price determination of a commodity, individual firm's output, consumer's equilibrium	Examples are: National income, national savings, general price level, aggregate demand, aggregate supply, poverty, unemployment etc