

the right of AB (such as through the point G) as a result of improvement in the technique of production or due to increase in the supply of factors of production, then it represents increase in economy's capacity to produce. This means that the production possibility curve explains whether the economy's capacity to produce is increasing or remaining constant.

Thus with the help of production possibility curve, it is possible to explain the basic problems of the economy.

## ■ 1.7. The Basic Competitive Model

There are two participants in the market. One is the producers and the other is the consumers. There exists large number of buyers and sellers in a competitive market and thus they compete among themselves. Producers compete with each other by producing the desired products to the consumers at a lowest possible price and the consumers compete with one another by paying the price for the products they are willing to buy, while others may not be able to afford the product. This is known as the **basic competitive model**.

The basic competitive model which assumes that the firms are interested to profit maximization, the consumers are rational or self interested and the markets are perfectly competitive.

A market where homogeneous product is exchanged between the many buyers and many sellers through mutual competition is called perfectly competitive market or market under perfect competition.

● **1.7.1. Price Determination in a Perfectly Competitive Market by Demand and Supply :** Many buyers and many sellers exist in a perfectly competitive market. For this individual buyer and individual seller are the price taker. As a result market price of the perfectly competitive market is determined by the interaction of market demand and market supply of that commodity.

The locus of the different amount of commodity a consumer purchases at different price is known from the individual demand curve. The sum of all the individual demand curve is the market demand curve. This market demand curve is downward sloping to the right like individual demand curve *i.e.*, total demand in the market

decreases as a result of increase in price and total demand in the market increases as a result of decrease in price.

On the other hand, the locus of the different amount of commodity a firm wants to supply at different price is known from the supply curve of that firm. The sum of all the firm's supply curve is the market supply curve. This market supply curve is upward rising to the right like firm's supply curve, *i.e.*, total supply in the market decreases as a result of decrease in price and total supply in the market increases as a result of increase in price.

Equilibrium price or market price under perfectly competitive market is determined by the interaction between market demand and market supply. The price at which market demand and market supply are equal is called **equilibrium price or market price**. Price determination under perfectly competitive market is now explained with the help of Fig. 1.20.

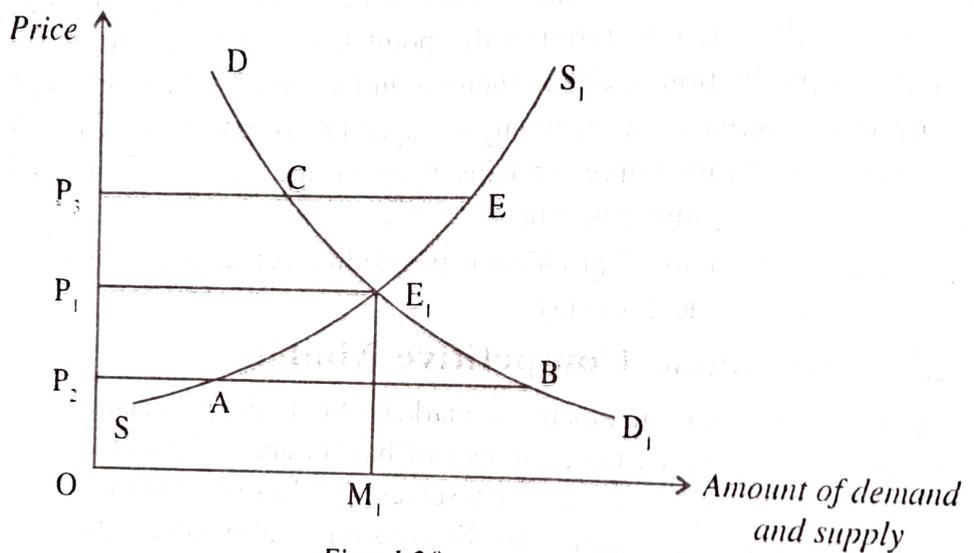


Fig : 1.20.

In Fig. 1.20., amount of demand and supply are plotted on the horizontal axis and price is plotted on the vertical axis. In the diagram,  $DD_1$  is the market demand curve and  $SS_1$  is the market supply curve. These two curves intersect each other at point  $E_1$ . The point  $E_1$  is called equilibrium point. Here the equilibrium price or market price is  $OP_1$ , because at this price, market demand and market supply are equal. Here  $OM_1$  is the amount of commodity at the equilibrium situation.

If the market price is  $OP_2$ , instead of equilibrium price  $OP_1$ , then the amount of total supply is  $P_2A$ . But at this market price the amount of total demand is  $P_2B$  *i.e.*,  $AB$  ( $P_2B - P_2A$ ) is the excess demand in the market. As a result price of the commodity will increase and ultimately price will be fixed at  $OP_1$ . On the other hand, if the market price is  $OP_3$ , instead of equilibrium price  $OP_1$ , then the amount of total supply is  $P_3E$ . But at this market price the amount of total demand is  $P_3C$  *i.e.*,  $CE$  ( $P_3E - P_3C$ ) is the excess supply in the market. As a result price of the commodity will decrease and ultimately price will be fixed at  $OP_1$ . In this way with the help of rise and fall in price levels, market demand and market supply become equal and market price is determined under perfectly competitive market.

## ■ 1.8. Price Control and Rationing

Price of commodity under perfectly competitive market is determined by the interaction of demand and supply. But the price which is determined by the interaction of demand and supply may not be accepted from social point of view. As a result government of the country may fix the maximum or minimum price of the commodity for the safeguard of the interest of buyers or sellers. **Determination of maximum or minimum price of any commodity by the government of the country is called price control.**

Now we discuss the situations in which government fix the maximum price of a commodity. Price of any commodity may increase too much due to too much decrease in supply of the commodity or due to too much increase in demand or due to these two causes at a time. As a result many buyers of the commodity specially poor buyers can face difficulties. In this situation government may fix the maximum price of the commodity to safeguard the interest of the buyer. So the government fix the maximum price to safeguard the interest of the buyer. The matter is explained with the help of Fig. 1.21.

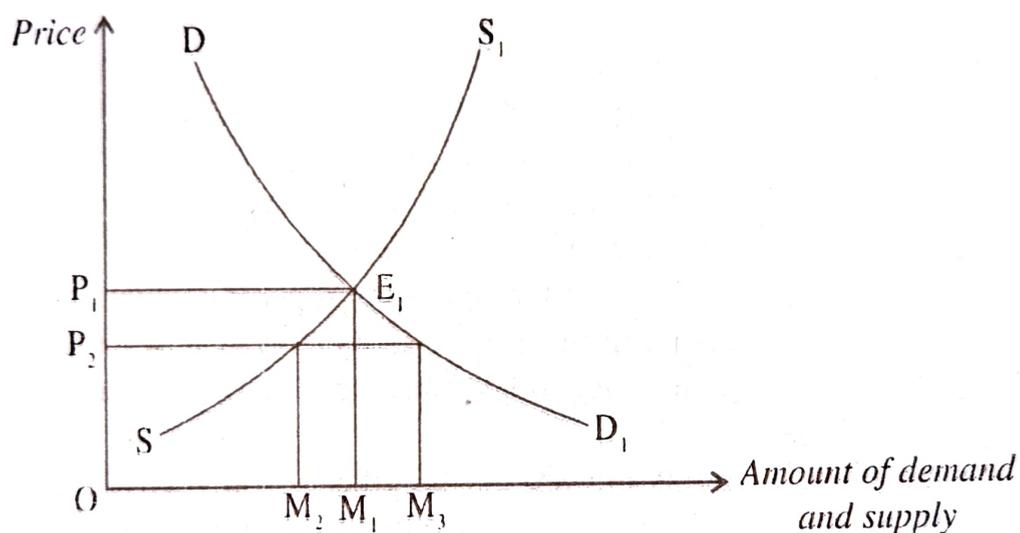


Fig : 1.21.

In Fig. 1.21., market demand curve  $DD_1$  intersects the market supply curve  $SS_1$  at point  $E_1$ . The point  $E_1$  is the equilibrium point. Here the equilibrium price or market price is  $OP_1$  and  $OM_1$  is the equilibrium amount of demand and supply *i.e.* the market price will be  $OP_1$  if there is not any control in the market. Suppose the market price  $OP_1$  is too large and the general public of the country face problem at this price. In this situation government may fix the maximum price lower than the price  $OP_1$  to save the consumer from the crisis. Let the government fix the maximum price at  $OP_2$ . From the diagram it is seen that at price  $OP_2$ , the demand for the commodity is  $OM_3$ , but the supply of the commodity is  $OM_2$ , *i.e.* excess demand in the market is  $M_2M_3$ , *i.e.* scarcity of the commodity will be  $M_2M_3$  in the market. In this situation if the government give up the distribution of the commodity to the seller then the seller can adopt different methods for selling the commodity. The seller can sale the commodity on the basis of first come first serve principle or the seller can sale the commodity to their known persons according to their preferences. But all the buyers cannot get the commodity as a result of give up the matter at the hands of the seller. As a result, problem of excess demand remain prevail and the tendency to increase prices also

exist. In this context black market for the commodity can be created and it may be very difficult to the government to control black market. **If any consumer gives more price greater than the price fixed by the government or any seller charges larger price compare to fixed price of the government then it is called black market or illegal market.**

It is desirable to remove the excess demand of the market to solve all these problems. In this respect most important process is the **ration system or rationing**.

Rationing means fixed amount of commodity officially allowed to each person during a time of shortage *i.e.* a system of limiting the amount of something that each person is allowed to have. Actually rationing refers to an artificial control on the distribution of scarce resources (food items, industrial production etc.). In economics rationing refers to artificial control of the supply and demand of commodity.

Rationing is done to ensure the proper distribution of resources without any unwanted waste. Controlling the prices, supply and demand through rationing leads to availability of goods and services for every section of the society.

### ■ 1.9. Price, Property Right and Profit

Property rights refer to the theoretical and legal ownership of specific property by individuals and the ability to determine how much property is used. In many countries individuals generally exercise private property rights—the rights of private persons to accumulate, hold, delegate, rent or sell their property. In economics property rights form the basis for all market exchange and the allocation of property rights in a society affects the efficiency of resource use.

In most developed countries the rights of property ownership can be extended by using patents and copyrights to protect scarce physical resources (*e.g.* houses, car etc.), non-human creatures (*e.g.* dogs, cats, etc.) and even some intellectual property, (*e.g.* inventions).

Private property rights are one of the pillars of capitalistic economies.

Every market price in a voluntary capitalist society originates through transfer of private property. Each transaction takes place between one property owner and another person interesting in acquiring the property. The value or price at which the property exchanges depends on how valuable it is to each party.

A cost is the expense that a business incurs in bringing a product or service to market. Price is the amount a customer pays for that product or service. The difference between the price that is paid and the cost that is incurred in the profit, the business make when the item sells.

There exist a relation among price, property rights and profit. The owner of a property who enjoys property right can get money by giving the property rights to other. This money is the price of the property. The difference between the price of the property and the cost of bringing that property in the market is the profit of that property. Here the amount of profit mainly depends on market demand and market supply of the property.

### ■ 1.10. Incentives and Information

An incentive is something that motivates an individual to perform an action. The study of incentive structures is central to the study of all economic activities (both in terms of individual decision-making and in terms of co-operation and competition

within a larger institutional structure). Therefore, economic analysis of the differences between societies (and between organizations within a society) amounts to characterizing the differences in incentive structures faced by individuals involved in these collective efforts. Incentives aim to provide value of money and contribute to organizational success. As such the design of incentive system is a key management activity.

Incentive can be classified according to different ways in which they motivate agents to take a particular course of action. Main classification are :

- (i) Remunerative incentive,
- (ii) Financial incentive,
- (iii) Moral incentive,
- (iv) Coercive incentive,
- (v) Natural incentive,
- (vi) Intrinsic motivation.

On the Other hand, information is any entity or form that resolve uncertainty or provides the answer to a question of some kind. It is thus related to data and knowledges as data represents values attributed to parameters and knowledge signifies understanding of real things or abstract concepts. As it regards data the information's existence is not necessarily coupled to an observer (it exists beyond an event horizon for example) while in the case of knowledge, the information requires a cognitive observer.

Information is conveyed either as the content of a message or through direct or indirect observation.

Information reduces uncertainty. The uncertainty of an event is measured by its probability of occurrence and is inversely proportional to that. The more uncertainty an event, the more information is required to resolve uncertainty of that unit.

The concept that the information is the message has different meaning in different context. Thus the concept of information becomes closely related to notions of constraint, communication, control, data form, education, knowledge, meaning, understanding etc.

Incentives are the core of economics. Without incentives have you ever thought why would some one take the risk of inventing a new product or save for future contingencies or work hard. In an economic system where government takes the decisions it makes central plan to decide what to produce, how to allocate the resources to produce these goods and whom to sell the goods. This economic system has a drawback that since nobody owns the resources that are used in the production of goods and services, the resources may not be fully utilized. So property rights should be enforced on the resources so that the private owner will have an incentive to produce goods and services, if the resources are fully utilized. Thus it is seen that the co-ordination among individual property right incentive and information is needed for proper use of property.

### ■ 1.11. Economic System

System which takes necessary arrangement for collection and distribution of resources to satisfy the basic problems of human world is called **economic system**.

Economic system is mainly divided into two groups. One is the Capitalistic Economic System and the other is the Socialistic Economic System.

Economic system in which private ownership of the factors of production exist and the functions of production and distribution are organised on the basis of private ownership is called **Capitalistic Economic System**. This type of economic system mainly organised by the price system.

On the other hand, economic system in which private ownership of the factors of production is absent and the functions of production and distribution are organised on the basis of social ownership is called **Socialistic Economic System**.

Economic system which emerges by the combination of capitalistic economic system and socialistic economic system is the **Mixed Economic System** or mixed economy. So, economic system in which private sector alongwith the government sector of planned economy co-exist is called **Mixed Economic System**.

● **1.11.1. Capitalistic Economic System—Features, Merits and Demerits :** The economic system in which private ownership of the factors of production exist and the functions of production and distribution are organised on the basis of private ownership is called capitalistic economic system. This type of economic system is mainly organised by the price system.

❖ **1.11.1.1. Features of Capitalistic Economic System :** There exist some features of capitalistic economic system. Among them main features of capitalistic economic system are :

1. Private ownership of property,
2. Free enterprise,
3. Profit maximisation objective,
4. Consumer's sovereignty,
5. Free or unregulated price system.

❖ **1.11.1.2. Merits and Demerits of Capitalistic Economic System :** There exists some merits and demerits of the capitalistic economic system. Merits and demerits of capitalistic economic system are discussed in this sections.

□ **1.11.1.2.1. Merits of Capitalistic Economic System :** There are some merits of capitalistic economic system. Among it most important merits are :

1. Creation of incentive to work,
2. Liberty of producer and consumer,
3. Efficient allocation of factors of production,
4. Automatic economic system,
5. Incentive for innovation of new production technique,
6. Rapid economic development.

□ **1.11.1.2.2. Demerits of Capitalistic Economic System :** There are some demerits of the capitalistic economic system inspite of its some merits. The main demerits of capitalistic economic system are :

1. Social welfare is neglected,
2. Inequality in income and wealth distribution,
3. Creates economic crisis,
4. Class struggle,
5. Absence of consumer's sovereignty in real sense.

● **1.11.2. Socialistic Economic System—Features, Merits and Demerits :** Economic system in which private ownership of the factors of production is absent and the functions of production and distribution are organised on the basis of social ownership is called socialistic economic system.

❖ **1.11.2.1. Characteristic or Features of Socialistic Economic System :** There exist some characteristic or features of socialistic economic system. The most important features are :

1. Government ownership of property,
2. Economic planning,
3. Equitable distribution of income and wealth,
4. Abolition of price system,
5. Equal opportunity for all.

❖ **1.11.2.2. Merits and Demerits of Socialistic Economic System :** Some merits and demerits are seen in socialistic economic system. In this part merits and demerits of socialistic economic system are discussed.

□ **1.11.2.2.1. Merits of Socialistic Economic System :** There are some merits in socialistic economic system. The main merits of socialistic economic system are :

1. Proper employment of the factors of production,
2. Maximum economic welfare,
3. Absence of economic exploitation,
4. Removal of inequality in income and wealth,
5. Regulated economy,
6. Stop wastage of economic resources.

□ **1.11.2.2.2. Demerits of Socialistic Economic System :** In spite of some moral merits in socialistic economic system, some economist mention the demerits of socialistic economic system. The main demerits are :

1. Inefficient production system,
2. Sovereignty of consumers is absent,
3. Absence of appropriate price,
4. Low level of production standard,
5. Managerial inefficiency.

In spite of the above demerits of socialistic economic system its importance cannot be denied at present.

● **1.11.3. Mixed Economic System or Mixed Economy—Features, Merits and Demerits :** Economic system which emerges by the combination of capitalistic economic system and socialistic economic system is the mixed economic system or mixed economy. So economic system in which private sector along with the government sector of planned economy co-exist is called mixed economic system.

❖ **1.11.3.1. Characteristics or Features of Mixed Economy or Mixed Economic System :** There exist some characteristics or features of mixed economy. The most important features are :

1. Presence of government sector and private sector,
2. Regulated private property,
3. Mixture of market system and government control,
4. Economic planning,
5. Social control.

❖ **1.11.3.2. Merits and Demerits of Mixed Economy or Mixed Economic System :** Some merits and demerits are seen in mixed economy or mixed economic system. In this part merits and demerits of mixed economy are discussed.

□ **1.11.3.2.1. Merits of Mixed Economy or Mixed Economic System :** There exist some merits in the mixed economy or mixed economic system. The main merits of the mixed economy are :

1. Mixture of the merits of capitalistic economic system and socialistic economic system,
2. Removal of unregulated economic system,
3. Encouragement of private investment through government investment,
4. Establishment of welfare state,
5. Establishment of socialism through democratic process,
6. Rapid economic development.

□ **1.11.3.2.2. Demerits of Mixed Economy or Mixed Economic System :** In spite of some merits in mixed economy, some economist mention the demerits of mixed economy. The main demerits are :

1. Mutually conflicting system of capitalism and socialism,
2. Undesirable competition among government sector and private sector,
3. Failure of planning,
4. Dominance of monopoly and capitalist class,
5. Last resort of capitalism.

**In conclusion,** it may be pointed out that pure capitalism or pure socialism is absent now-a-days. At present it is seen that government regulated private sector and government sector exist in almost all the countries which is nothing but in mixed economy.

## 1.10 Price Mechanism

Price mechanism is an important concept to solve the central economic problems in the capitalist economies and to some extent in the mixed economies also. It can be defined as a **system through which economic decisions like determination of price of the commodities, price of the factors used, employment of the factors of production, volume of production, etc. are taken by the free interaction between market forces of demand and supply without any restriction on them.** Due to this, the economies where price mechanism is fully operative are termed as the market economies. In the capitalist economic systems price mechanism plays the vital role in solving the central economic problems. In the mixed economies price mechanism has a partial role to play in solving economic problems. But in the socialist economies price mechanism is completely absent.

### 1.10.1 Defects of Price Mechanism

Price mechanism has various defects. The negative sides of price mechanism are not deniable. Following are the drawbacks of price mechanism—

- [i] Price mechanism fails to operate in case of determining price of the social goods like roads, bridges, parks, etc. which are consumed by the mass and not by a particular individual.
- [ii] Price mechanism almost damages the public distribution scheme (PDS) of the developing economies.
- [iii] Sovereignty of both the firms and individuals may lead to generation of negative externalities like environmental pollution due to establishment of industries as required by the market forces.
- [iv] Emergence of natural monopoly of the respective commodity cannot be denied that may lead to loss of consumers' sovereignty.
- [v] Most important defect of the price mechanism is the negligence of social welfare objective of the community.