

CHAPTER 1- Business ECONOMICS- AN OVERVIEW

Ques. What do you mean by Business economics?

Ans. MEANING: Business economics is the application of economic theory and analysis to practices of Business firms and other institutions.

Ques. Define Business economics.

Ans. "Business economics consists of the use of economic modes of thought to analyze Business situations".

By- Mc Nair and Merian

"Business economics is the integration of economic theory with Business practice for the purpose of facilitating decision making and forward planning by the management".

By- Prof. Spencer and Siegelman

"Business economics is the application of economic theory and methodology to Business administration practice".

By-Prof. Brigham and Pappas

Ques. What do you mean by Business economics? Explain the nature and scope of Business economics.

Ans. The nature and scope of Business economics are as follows:

A. The nature of Business economics can be studied under the following heads:

- 1) Micro-Economic Framework
- 2) Business Economics Is Normative in character
- 3) Other Aids

1). Microeconomic framework:

Business economics is basically micro in character, which deals with the behavior of individual economic units such as the consumers, the producers, individual firms, industry, etc. However, Business economics deals only with the problem of a firm. Thus, in Business economics we study the problems faced by the firms and how to solve them with the help of economic theory and tools and techniques of economic analysis.

➤ Some of the most popular micro economic concepts used in Business economics

are as follows:

1. Elasticity of demand,
2. Marginal cost and marginal revenue,
3. Opportunity cost,
4. Short and long run period of time,
5. Economies and diseconomies of scale,
6. Market structures and their significance in pricing policies.

➤ Besides, the above given economic concepts there are some of the well expected

models in price theory used in Business economics which are as follows:

1. Model for monopoly price,
2. Kinked demand curve model for oligopoly competition,
3. Model of price discrimination, etc.

➤ Again, Business economics also makes use of some aspects of macroeconomic analysis which are relevant in decision making and forward planning. For example, the sales and profits of a firm are affected by national income forecasting (N.I. is a macroeconomic concept); forward planning of a firm is affected by the growth and development of the national economy; some specific types of decision making process are solved with the help of theories of trade cycle, international trade, balance of payment, etc.

➤ In short, Business economics is basically micro in nature but it does make use of

some tools and macro economic analysis in decision making and forward planning of a firm,

2). Business economics is normative in character:

➤ There are two approaches to economic analysis:

1. Positive approach: It deals with actual happenings, i.e., the description and analysis of economic problems. It is concerned with what was? What is? Or what will be? In positive economics, we discuss how an economic unit or an economic system operates and functions under given conditions.

2. Normative approach: It is concerned with what ought to be. Here, we deal with two

questions:

- a. What should be done by a firm, that is, What should be its aims and objectives? and
- b. How to achieve these objectives?

3). Other aids: Business economics also requires the aid and assistance (help) of laws, practices and techniques of other disciplines like accounting, finance, marketing, production, personnel, etc. Besides, it also makes wide and extensive use of tools provided by mathematics, statistics and operation research.

B. The scope of Business economics

The scope of Business economics refers to its area of study and covers all those economic concepts, theories and tools of analysis which can be used to analyze the Business environment and to find solutions to practical Business problems.

1. The scope of Business economics covers two areas of decision making:

I. Operational (Internal) issues

II. Environmental (External) issues

1. Operational issues: Operational issues are those issues which arise within the Business organization and are under the control of the management.

➤ The operational issues can be categorized as follows:

1. **Resource allocation:** Business economics is concerned with the problem of optimum allocation of scarce resources. In determining the level of output to maximize profit, linear programming techniques (one of the concepts of Business economics) has been proved very useful.
2. **Demand analysis and Demand forecasting:** Demand analysis helps Business executives in taking production and pricing decisions. Similarly, the study of factors affecting demand for a product is essential for demand forecasting. The main topics (concepts of Business economics) covered in demand analysis are demand determinants, demand distinctions, various types of elasticity of demand, methods of demand forecasting, criteria for a good forecasting method, etc.
3. **Cost Analysis:** Cost analysis deals with monetary terms. Cost estimates are essential for Business decision making as it helps the firm to determine that output level which can be produced at least cost. The main topics covered in cost analysis are cost-output relationship, economies of scale, analysis of production function, cost control methods, cost-benefit analysis, etc.
4. **Pricing policies and Practices:** The success or failure of the firm largely depends on the correctness of its price and output decisions, that is, pricing policies. It is the pricing policy

which affects the revenue and hence profit of the firm. The main topics covered in pricing policies are determination of price in different market structures (such as, perfectly competitive, oligopoly market, etc.), pricing methods, product line pricing, price forecasting, etc.

5. **Profit planning and Break even analysis:** Profit making is the major goal of a firm. To achieve this goal certain difficulties are faced by the firm such as, changes in input prices, in technology, in government economic policies, etc. Business economics helps to solve these problems with the use of Profit theories, Break even analysis, Profit policies, etc.
6. **Capital budgeting and investment decision:** Efficient allocation and management of capital is one of the most important tasks of the managers as capital is a scarce factor and is obtained at a cost. Capital budgeting is helpful for efficient allocation of capital as it involves estimates of capital requirements for the project, profitability of capital, choice of capital investments, selecting a proper investment proposal, etc. main topics covered are, methods of capital budgeting, the concept of capital rationing, etc.
7. **Strategic planning:** The concept of strategic planning is newly included to the scope of Business economics with the emergence of multi-national corporations. Strategic planning provides management with a framework within which long term decisions can be made which have an impact on the behavior of the firm. Portfolio models and corporate simulation models come in the area of strategic planning.

2. Environmental (External) issues: Environmental issues in Business economics refer to the general Business environment in which the firm operates.

➤ The environmental issues can be categorized as follows:

I. General economic environment: (it involves the following)

- 1) Nature of the economic system in the country.
- 2) General trends in production, employment, income, saving, investment, etc.
- 3) Trends in the working of financial institutions like banks, insurance companies, financial corporations, etc.
- 4) Trends in the size, composition and duration of foreign trade.
- 5) Trends in labour and capital market.
- 6) Government's economic policies- namely industrial policy, monetary policy (by RBI) , fiscal policy (by Government), price policy, etc.

II. Social environment: (it involves the following)

- 1) Social factors like the value systems of the society, property rights, customs and habits.

- 2) Social organizations like trade unions, consumers' cooperatives and producers unions.
- 3) Social structure and class character of the various social groups.

III. Political atmosphere: (it involves the following)

- 1) Political stability.
- 2) Maintenance of law and order.
- 3) Security of life and property.
- 4) Nature of state activity.
- 5) Government attitude towards private Business.
- 6) Size and working of the public sector.

To sum up, external issues relate Business economics to macro economic theory, while operational issues relate it to microeconomic theory.

Ques. Write down the characteristics of Business economics.

Ans. The characteristics of Business economics are as follows:

1. Business economics is a branch and discipline of general economics.
2. Business economics is mainly micro in character because it concentrates only on the study of the firm.
3. The contents of Business economics are mainly based on the theory of the firm.
4. Business economics also studies macro economics to understand and adjust to the economic environment under which the firm operates.
5. Business economics is normative rather than positive in character.
6. Business economics is both conceptual and metrical. Conceptual in the sense, it makes use of the various concepts in order to understand and analyze the decision making problems. Metrical in the sense, it uses the various quantitative techniques to measure the impact of different factors and policies.
7. Business economics helps Business executives in making rational decisions, it helps in analyzing the various alternatives (scarce resources having alternative uses) and selecting the one which would give the optimal results.

Ques. Write down the importance / significance of Business/ Business economics.

Ans. The importance of Business economic are as follows:

1) It provides various tools and techniques to the firm to build up various models which help in the decision making process.

2) It provides various concepts such as, elasticity of demand, opportunity cost, break even analysis, short run and long run costs, etc., which helps in understanding and solving Business problems.

- **Basic Concepts of Business Economics: Opportunity Cost, Incremental Principle, Principle of time perspective, Discounting Principle, Equi-Marginal Principle.**

Ques. Write a note on opportunity cost principle.

Ans. Opportunity cost principle: The Austrian school of economists and their followers gave a new concept of real costs. According to them the real cost of production of a given commodity is the next best alternative sacrificed in order to obtain that commodity. It is called opportunity cost or displacement cost.

➤ Meaning: "The opportunity cost of anything (muffler) is the next best alternative that could be produced (mask) instead by the same factors or by an equivalent group of factors, costing the same amount of money". By- Prof. Benham

"The real ultimate cost of anything is the loss of that alternative which must be sacrificed when resources of any kind are devoted to a particular object".

By- Dr. Marshall

➤ Some examples of opportunity cost may be:

1. The opportunity cost of capital invested by the entrepreneur is the interest that could have earned if that capital had been employed in some other Business.
2. Opportunity cost of time is the amount of remuneration which an entrepreneur could have earned by working in some other occupation.
3. Opportunity cost of a machine is the loss of those products which could have been produced. It should be noted that the opportunity cost of a machine which cannot be used for any other purpose is zero.
4. If a machine can produce, say 10 units of product X or 20 units of product Y, then, the opportunity cost of producing 1 unit of X is 2 units of Y.
5. Suppose we have no information about quantities produced but have information about their prices. In such a case, the opportunity cost can be computed in terms of the ratio of their respective prices, say, P_x/P_y .

6. The opportunity cost of holding Rs. 500 as cash in hand for one year is the 10% rate of interest which would have been earned had the money been kept as fixed deposit in a bank.

Importance of the concept:

1. The concept is important in taking Business decisions,
2. It is helpful for the firm to decide the rewards of its factors as this concept helps the firm to pay as much amount to its factors which they can get or earn in other employment.
3. Determining factor prices
4. Determining economic rent
5. Consumption pattern decisions
6. Determining factor prices
7. Product plan decisions
8. Decisions about national priorities- For example, if a country is at war, then it will use its resources to produce more war-related goods as compared to civilian goods. This concept helps the country in making these decisions.

► Limitations of the concept:

1. In a large no. of cases, a specific factor has no opportunity cost. For example, a barren land has hardly any attractive alternatives.
2. Immobility of factors of production makes this concept a limited one.
3. Again the foregone alternatives may not be quantitatively measured. For instance a landlord may not know how much of rent he would be getting by cultivation of sugarcane instead of cotton.
4. The concept is based on the assumption of perfect competition which is hardly found in real life.

► Some points to remember:

1. Opportunity cost concept is directly applicable to manager's different decision areas such as, make or buy decision, break down or preventive maintenance of machines, replacement or new investment decision, direct recruitment from outside or departmental promotion.
2. The account never considers opportunity cost; it considers only the explicit costs.
3. In a macro sense, the opportunity cost of more guns in an economy is less butter.

Ques. Write a note on Incremental Principle / concept.

Ans. Incremental concept is closely related to the marginal costs and marginal revenues in economic theory. In actual Business situations, it often becomes difficult to apply the concept of marginalism which has to be replaced by incrementalism, for in real world Business, one is

concerned not with 'unit change' but with 'chunk change'. For instance, in a construction project the labor which a contractor may change is not by one but by tens.

➤ Incremental concept: In incremental concept we study the effect of changes in decision with regards to level of output, investment price, prices, products, procedures, on total cost and total revenue of a firm.

➤ There are two fundamental concepts in incremental analysis:

1. Incremental cost: It means change in total cost as a result of change in the level of output, investment, prices, etc.

Incremental cost may be computed by the given below formula:

$$\mathbf{IC = C_2 - C_1 = \Delta \text{ in } C}$$

where, C_2 is new total cost and C_1 is old total cost.

2. Incremental revenue: It means change in total revenue as a result of change in decisions taken by a firm with regards to output level, prices, investment, etc.

Incremental revenue may be computed by the given below formula:

$$\mathbf{IR = R_2 - R_1 = \Delta \text{ in } R}$$

Where, R_2 is new total revenue and R_1 is old total revenue.

➤ The incremental concept may be stated as under: "

A decision is obviously a profitable one if,

- a. It increases revenue more than cost, $IR > IC$.
- b. It decreases some cost to a greater extent than it increases others,
- c. It increases some revenue more than it decreases others, and
- d. It reduces costs more than revenues.

➤ Assumptions of the principle:

- i. The existence of idle capacity.
- ii. Absence of more profitable alternative avenues.

➤ Illustration of incremental principle:

Some Businesses take the view that to make an overall profit they must cover full cost (labor, materials and overhead) plus a provision for profit. But according to this concept, in order to make an overall profit it is not necessary to earn profit in each and every item, because by doing so the firm rejects the possibility of adding more to revenue than to cost. The relevant cost is not the full cost but the incremental cost. A simple problem will illustrate this point.

Illustration: Suppose a new order is estimated to bring in additional revenue of Rs. 5,000. The costs are estimated as under:

Sr. no.	Items	Cost (in Rs.)
1	Labor	1,500
2	Materials	2,000
3	Overhead (allocated at 120% of labor cost)	1,800
4	Selling and administrative expenses (allocated at 20% of labor and material cost)	700
5	Full cost	6,000

Table analysis: The order appears to be unprofitable. However, there is idle capacity which can be utilized to execute this order. If the order adds only Rs. 500 of overhead (not 1,800), Rs. 1,000 as labor cost (not 1,500), and no extra selling and administrative cost (not 700), the incremental cost of accepting the order will be as follows:

Sr. no.	Items	Cost (in Rs.)
1	Materials	2,000
2	Labor	1,000
3	Overhead	500
4	Total incremental	3,500

While it appeared in the first instance that the order will result in a loss of Rs. 1,000, it now appears that it will lead to an addition of Rs. 1,500 (Rs. 5,000 - Rs.3,500) to profit.

➤ Practical application of the principle:

1. Prof. James Early's study in America reveals that firms where the accounting system is more appropriate there use of this principle is more.

On the other hand, Prof. Haynes' study of small firms reveals that weak accounting systems are unable to make use of this concept as they do not have any specific data pertaining to incremental cost and incremental revenue.

Ques. Write a note on the principle of Time Perspective.

Ans. The economic concepts of the long run and the short run have become a part of everyday language. Business economists are also concerned with the short run and long run effects of decisions on revenue as well as costs. He has to make various decisions with regards to a definite time period. The definite time period may be in terms of short period or long period. If the firm wants to change output in the short run, it can do so only by changing the amount of variable factors and the decision to change output in the long run can be possible while having change in both variables as well as fixed factors.

➤ The really important problem in decision making is to maintain the right balance between the long run and the short run considerations. A decision may be made on the basis of short run considerations, but may as time elapses have long run repercussions which make it more or less profitable than it first appeared.

• An illustration will make this point clear:

Suppose there is a firm with temporary idle capacity. An order for 5,000 units comes to the management's attention. The customer is willing to pay Rs. 4 per unit or Rs. 20,000 for the whole lot but not more than that. The short run incremental cost (ignoring the fixed cost) is only Rs. 300. Therefore the contribution to overhead and profit is rupee 1 per unit. (i.e. Rs. 5,000 for the lot).

Analysis: However the following long run repercussions (indirect effects) of the order ought to be taken into account as well:

1. If the management commits itself with too much of Business at lower prices or with a small contribution, it may become impossible to have sufficient (idle) capacity to take up Business with higher contributions when the opportunity (increase in demand) arises thereafter. In such a case, the management may be compelled to make changes even in the fixed factors; hence, even the so-called fixed costs may become variable.
2. If other customers come to know about this low price, they may demand a similar low price, otherwise they may switch towards other manufacturers which are apart from such discriminations. The reduction of prices under conditions of excess capacity may

adversely affect the image of the company in the minds of its clientele ultimately affecting its sales. It is therefore important to give due consideration to the time perspective.

➤ Hence, the principle of time perspective may be stated as under; "A decision should take into account both the short run and long run effects on revenues and costs and maintain the right balance between the long run and short run perspectives".

Ques. Write a note on the discounting principle.

Ans. This concept is an extension of the concept of time perspective and has an important place in Business economics. It is particularly helpful in making investment decisions.

➤ Discounting principle is based on the rationale that individuals give more response to the present than the future.

A simple example would make this point clear: Suppose a person is offered a choice to make between a gift of Rs. 100 today or Rs. 100 next year. Naturally he would choose Rs. 100 today.

• This will true for two reasons:

1. First, the future is uncertain

ii. Second, Even if he is sure to receive the gift in future, today's Rs.100 can be invested so as to earn interest, whereas, if he does not accept Rs. 100 today, then even after one year he will get Rs. 100 only. If the rate of interest is 8% then after one year the value of Rs. 100 of today will become Rs. 108.

✓ Naturally, he would prefer the first alternative (choose a gift of Rs. 100 today) because he is likely to gain by Rs. 8 in future.

But then how much money today is equal to Rs. 100 one year later?

To find it out we shall have to find out the relevant rate of interest which one would earn if one decides to invest the money.

✓ Suppose the rate of interest is 8%. Then we shall have to discount Rs. 100 at 8% in order to ascertain how much money of today will become Rs. 100 one year after.

The formula is,

$$V = \frac{A}{1+r}$$

$$V = \frac{\text{₹.100}}{1+0.08} = \text{₹. 92.59}$$

where, V is present value, I is rate of interest.

The same reasoning applies to longer periods also.

➤ The discounting principle may be stated as under:

"If a decision affects costs and revenues at future dates, it is necessary to discount those costs and revenues to present values before a valid comparison of alternatives is possible".

Practical importance of the concept:

- 1) It is important for Business economics while taking investment decisions and forward planning.
- 2) It is also important for capital budgeting. As the gestation period of different capital projects is different; it is advisable to find out the present net worth of investment decisions (capital projection) which will yield a return over a period of time. Without doing so it is not possible to judge whether or not the cost of undertaking the investment today is worthwhile. Equal additional

Ques. Write a note on the concept of Equi marginal principle.

Ans. The equi marginal principle as a fundamental concept of Business economics is extensively used in the process of decision making and forward planning. This principle is useful in proper allocation of the available resources (having alternative uses) among the alternative activities.

➤ Suppose, a firm has 100 units of labour at its disposal. The firm is engaged in four activities which need labor services, viz., A, B, C and D. The firm can increase any one of these activities (A, B, C,D) by adding more labor but only by reducing it from the other activities.

Now, suppose the firm decides to add one additional worker in activity A, as a result of which there will be an increase in the 'net product value' of this activity which may be called as the 'marginal product value of labor'. Likewise, if one more worker is added to other productive activities B, C, D, then there would be an increase in the marginal product value of labor in these activities as well.

Now, it is obvious that the firm would allocate more workers in that activity, where the marginal product value is high. It would be in the interest of the firm to reduce the number of workers in those activities where marginal value is less and vice-a-versa.

➤ To take an example, if in activity A, the value of marginal product of labor is Rs.20 while that in activity B it is Rs. 30. It is profitable to shift labor from activity A to activity B thereby expanding activity B and reducing A. Such allocation and reallocation of the workers between the different activities or uses will continue **till the marginal product value of labor in each of the activity becomes equal. Symbolically, it can be expressed as follows:**

$$\text{VMPLA} = \text{VMPLB} = \text{VMPLC} = \text{VMPLD}$$

Where, VMP is value of marginal product, L stands for labor, A,B,C,D are the different activities.

At this level the shifting of workers between different activities and uses will stop, the output of the firm will be maximum and the firm would attain optimal position.

➤ Certain aspects of the equi marginal principle need clarification:

1) First, the value of marginal products is the net value of incremental costs. Suppose in activity B we add one unit of labor which adds 100 units of physical output and per unit cost is 50 paise means total value addition is 50 paise x 100 units = 50 Rs. But we must make one thing clear that with the addition of one labor there are certain other inputs such as raw materials, fuels and other inputs, which increases cost say up to Rs. 30 Hence the value of marginal product relevant for other purpose is - Net value addition = Incremental revenue - Incremental cost Rs. 50-Rs. 30 = Rs. 20 and not Rs. 50.

2) Secondly, if the revenues resulting from the addition of labor are to occur in future, these revenues ought to be discounted before comparisons in the alternative activities are possible. Activity A may produce revenue immediately but activities B, C and D may take 2, 3 or 5 respectively. Here, the discounting of these revenues will render them comparable.

3) Thirdly, the measurement of the value of the marginal product may have to be corrected if the expansion of an activity requires a reduction in the prices of the output. If activity B represents the production of radios and it is not possible to sell more radios without a reduction in price, it is necessary to make adjustments for the fall in price.

4) The phenomenon of diminishing returns must also be considered while applying the equi marginal principle. According to this law in any productive activity as more and more units of variable factors are added to a fixed factor then after a stage, the output increases at a diminishing rate. Inus, it is only after taking into account this tendency to diminishing returns that the allocation

of factors between different uses should be made in such a manner that the value of the marginal product in different uses is the same.

Introduction Basic Problem of on Economy

Que. What is an economic problem?

Ans. Economic problem consists in making decisions with regards to:

- a. Ends to be pursued,
- b. Goods to be produced,
- c. Means to be used for the achievements of certain ends.

Que. Define the term economic problem?

Ans. "The economic problem is essentially a problem arising from the necessity of choice; choice of the manner in which limited resources with the alternative uses are disposed off. It is the problem of husbandry of resources".

By- Prof. Eric Roll

Ques. Explain the fundamental problems faced by an economy?

Ans. Central problems of an economy can be classified into 3 ways:

- A) Allocation of resources
- B) Fuller utilization / employment of resources
- C) Growth of resources (Economic Development)

- A. In allocation of resources we study,
1. What to produce,
 2. How to produce,
 3. For whom to produce.

➤ What to produce (Types and amount of commodities to be produced): Human wants are unlimited and productive resources that are land, labour, capital, machines, tools, equipment and natural resources are limited. The question arises what goods are to be produced and in what quantity these goods to be produced so that maximum wants of the society can be fulfilled.

Obviously it is the basic problem of the economy. If we produce one commodity, it will mean that we are neglecting the production of the other commodity. We assume that all the factors of production in the economy are fully absorbed, so if we want to increase the production of one commodity, we will have to withdraw resources from the production of the other commodity.

➤ How to produce (Problem of the selection of the technique of production): This problem is related to the choice of technique for producing a commodity. An economy has to choose between-

a) Labour intensive technique

b) Capital intensive technique

The economy has to decide about the technique of production on the basis of cost of labour and capital. A labour surplus economy chooses labour intensive technique and a capital surplus economy chooses capital intensive technique. Besides, every method has its own advantages and disadvantages. Mechanization increases the quantity of production. The quality has also improved. As it requires a lesser number of workers, it results in unemployment. Handicrafts reduce unemployment but the quantity of production is lesser.

➤ For whom to produce (Problem of distribution of income): Goods and services produced in the economy are consumed by its citizens. The individuals may belong to economically weaker sections or rich class of people. Actually this is a problem of distribution of a nation's product i.e., national income among the factors of production that helps to produce it. It is the factor payments (rent, wages, interest and profits) which determines the distribution of goods among the various individuals in the society.

B) Fuller utilization/employment of resources (efficient use): Our means and resources are limited and scarce, so they should be properly used. There should not be the wastage of these resources. The problem with the economy is how to use its available resources, so that maximum production with minimum efforts and wastages can be made possible. Economic development will suffer, if certain resources remain idle. Since the 1930's after the great world depression we have started thinking of fuller utilization of limited resources.

C) Growth of resources (Economic Development): Increase in the population is the common feature of the economy. It becomes necessary that the rate of economic development must be faster than the rate of increase in the population, so that economic development may take place and the reasonable standard of living of the citizens can be maintained. In this connection, the economy has to decide about the rate of capital formation, investment and savings. Efforts are made for economic development of the society, so that it may be able to face the real challenges of time. Every capitalistic, socialistic and mixed economy has limited resources and unlimited wants. Thus it is required to make the best possible use of resources, so that economic development could be achieved at faster rates.

Working of Price Mechanism- Free Market Mechanism

Introduction -'Price Mechanism'

In most of the countries in the world basic economic problems are solved through the price system or price mechanism. Millions of producers and consumers engage in voluntary trade, intending to improve their own economic situations and their actions are invisibly co-ordinated by a system of prices.

Price system is a mechanism of prices and price changes. Everything has a price which is the value of a commodity expressed in terms of money. Prices represent the terms on which people and firms voluntarily exchange different commodities.

Definition: Price mechanism refers to the system where the forces of demand and supply determine the prices of commodities and the changes therein. It is the buyers and sellers who actually determine the price of a commodity.

Definition: Price mechanism is the outcome of the free play of market forces of demand and supply. However, sometimes the government controls the price mechanism to make commodities affordable for the poor people too.

For example, the Government of India recently passed an order to decontrol the prices of diesel and remove it from the jurisdiction of the government. Now the prices will be determined by the demand from consumers and supply from the oil companies.

- **Price mechanism in a free market economy-**

In a free market company, prices are freely determined by demand and supply. A price is in equilibrium when demand equals supply. Price goes up when there is an increase in demand, supply remaining constant. Price goes down when there is an increase in supply, demand remaining constant. Thus, prices serve as signals to producers and consumers. A rise in price informs the producers that more supply is needed, at the same time it instructs the consumers to substitute other goods. In other words, prices co-ordinate the decisions of the producers and consumers.

It should be noted that the price system as described above is an integral part of a free market economy (also called capitalism). Because in a free market economy, government intervention in the working of price mechanisms is as little as possible. Producers are free to produce any commodity, in any quantity and with any method they like. Consumers are free to spend their income on goods and services in any manner they like.

- **Working of Price System:**

Prices and price changes help balance demand and supply in an individual market. By matching demand and supply in each market, the price system simultaneously solves basic problems of the economy.

1. What to produce and how much is decided by the consumers through their purchase decisions. They express their preferences through their money expenditure. If consumers prefer commodity X more than commodity Y, demand for X will increase, while that of Y will decline. Consequently, the price of X will rise while that of Y will fall. Production of X will become more profitable than that of Y. Since producers are motivated by the desire to maximize profits, they will shift resources from Y industry to X industry so that output of Y will fall and that of X will expand till supply equals demand in both markets. This is how the pattern of total production in the economy gets adjusted to the pattern of total demand.
2. How to produce is determined by the competition among different producers. The best way for producers to meet price competition and maximise profits is to keep costs at a minimum by adopting the most efficient method of production.

If in the economy, labour is abundant and capital is short in supply, the price of labour will be low as compared to the price of capital. In this situation labour intensive methods of production will be less expensive as compared to capital intensive methods of production. Therefore producers will adopt labour intensive methods of production.

3. For whom goods are produced depends in large part on the demand and supply in the factor markets. Factor prices (wages, salaries, rent, interest, profits and dividends) are determined in the factor markets. And the distribution of national income among different groups of people in the society is determined both by the quantity of factor services and re prices of the factors of production. The persons who own costly factors of the production or larger quantities of factors of production will have a large share in national income and output. On the other hand, the persons who co own cheap factors of production or small quantities of factors of production will have a small share in national income and output. For example, the share of industrialists in national income is many times more than that of unskilled workers in our society.
4. Are available resources used efficiently or fully is also determined by the factor prices in the factor market. If, for an example, wage rate is freely determined by the market forces of demand and supply and if wage rate is flexible also, total demand for labour in the company will be equal to total supply of labour and there will be no unemployment among labourers. If unemployment arises for some reason, wages will fall, demand for labour will expand till it is again equal to supply of labour. Similarly, if the rate of interest is flexible, total investment in the economy will be equal to total savings. If investment is less than saving, the rate of interest will fall, investment will expand till it equals total saving.
5. As the economy continues to grow, this problem is also solved through the price system. The impetus for improvement, innovations and development comes through the price system. Higher prices and profits encourage industrial concerns to spend huge sums on research and experimentation to improve and develop techniques of production. The desire for profits motivates entrepreneurs to innovate and when an entrepreneur innovates, profits emerge. It follows that profits are both a cause and effect of innovations. And the economy grows continuously through inventions and innovations.

- **Evaluation of Price Mechanism :***

- A. Merits of Price System**

The main advantages of price system in a free market economy are as follows:

1. It is an automatic mechanism: No administrative apparatus is required to operate the price system and yet goods and services are produced according to demand, in the right quantity and at the right time. That is why Adam Smith, an 18th century economist, describes the price system as an 'invisible hand' which, acting through each persons' self interest and competition resulting therefrom, provides those goods that society wants, in the quantity that society desires, at the prices which society is prepared to pay.
2. It offers freedom to consumers: In a free market economy, consumers are allowed to freely express their preferences. They determine what is to be produced and how much. The producers who fail to respect their orders bear losses and are removed from the market.
3. It offers freedom to the producers The producers are free to produce any commodity in any quantity and with any method of production the forces of competition keep a check on their actions so that they cannot indulge in malpractices to exploit buyers or workers.
4. Prices convey information to the producers and consumers about the changes taking place in the economy. They make decisions on the basis of prices and price changes.
5. Prices co-ordinate the decisions of the producers and consumers in the market : Higher prices tend to encourage production and discourage consumption.
6. Adam Smith saw the harmony between private profit and public interest: He argued that "every individual, by pursuing his own interest, promotes that of the society more effectively than when he really intends to promote it."

- **Demerits of Price System**

The price system is open to criticism on a number of grounds:

1. Production of Wrong Goods : Producers do not recognise any sense of duty to the society. In pursuing profit motive, they produce even those goods which are harmful to the people, e.g. liquor and opium.
2. Neglect of Necessities: Price system based on profit motive caters to only those needs which find expression in terms of money. Luxuries are produced at the cost of essentials, because rich persons are prepared to pay high prices for luxuries, while ordinary persons do not have enough money to express their needs for such essentials as food and medicine.
3. Instability: Sometimes total demand in the economy is less than total output and sometimes it is the other way round. Hence frequent ups and downs in economic activities create insecurity in the economic life of the people.
4. Waste of Resources: Price system leads to waste of resources. The transfer of resources from declining industries to those which are expanding may take a long time. Labour and capital may remain idle and unemployed for a long time.

- **Limitations of Price System**

Advantages of the price system will be fully realised only when the checks and balances of perfect competition are present. In reality however, there are many ways that markets fall short of efficient perfect competition. These are known as limitations of the price system. These limitations are as follows:

1. **Imperfect Competition:** Whereas under perfect competition, no firm or buyer can influence market price individually, imperfect competition occurs when a seller or buyer is in a position to influence the market price to his advantage. When imperfect competition arises, society moves inside the production possibility curve. For example, when a monopolist raises price above cost to earn extra profits, production would be reduced below the efficient level. In reality, almost all industries contain some degree of imperfect competition.
2. **Externalities:** Inefficiency arises also when there are externalities which involve involuntary imposition of costs and benefits. For example, while airports produce a lot of noise, airlines do not compensate the people living around the airport for disturbing their peace.
3. **Public Goods:** These are goods which cannot be bought and sold in markets. Production of these goods in the private sector is impossible because the benefits are widely dispersed among the people and therefore, no individual can be forced to pay for it. The best example is national defence. When a nation protects its sovereignty and freedom, it does so for all its inhabitants whether they want the protection or not and whether they pay for it or not.
4. **Inequality:** Even if the economy functions most efficiently remaining always on the production possibility curve and never inside it, it may still-lead to an undesirable outcome. Because a free market economy may not produce a fair distribution of income. The reason is that incomes are determined by a wide variety of factors such as effort, education, inheritance, factor prices and luck etc. Since goods follow rupee votes in the market, unfair distribution of income will result in unfair allocation of resources in the economy.
5. **Constraints placed by the Government:** In reality, the price system is not allowed to function freely even in free market economies in the present day world. For instance;
 - a. When the government fixes prices of goods and services like sugar, edible oil and foodgrains and wages of workers, these act as constraints on the working of the free price system,
 - b. Such measures as taxes and subsidies, credit facilities and provision of social security also interfere with the working of the price system,
 - c. Nationalisation of banks and industries will also change the results of the working of the price system.