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ECONOMY – ITS MEANING AND TYPES

The purpose of every economy is to satisfy human wants by using limited or scarce resources available and known to a society. These wants can be satisfied by production and consumption of goods and services. For production, the factors of production are engaged in some economic activities. These economic activities bring income to the economic agents that can either be consumed or saved and invested. On account of these gainful economic activities and accumulated earnings, some countries grow fast while others cannot attain such high growth rate. As a result some economies attain the status of developed economies while others remain underdeveloped or developing economies. They are also known as rich and poor economies. We can look at economies on the basis of ownership of resources. The resources available may be in private ownership or the collective ownership. Thus there are different ways to look at the economy and its level of development. In this lesson we will explain all these terms in simple way so that you may understand and differentiate the meaning and nature of an economy and understand its various types.



OBJECTIVES

After completing this lesson, you will be able to:

- *explain the meaning of an economy;*
- *differentiate between various types of economic organizations on the basis of ownership and control of resources as well as on the basis of level of development;*
- *understand the meaning of economic development and economic growth;*
- *distinguish between economic development and economic growth;*
- *understand the important determinants of economic development.*



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4.1 MEANING OF AN ECONOMY

An economy is a man-made organization for the satisfaction of human wants. According to A.J. Brown, “An economy is a system by which people get living”. The way man attempts to get a living differs in major respects from time to time and from place to place. In primitive times ‘get a living’ was simple but with growth of civilization it has become much more complex. Here it is important to note that the way person earns his/her living must be legal and fair. Unfair and illegal means such as robbery, smuggling may earn income for oneself but should not be taken into consideration as gainful economic activity or a system of ‘get a living’. **It will therefore be appropriate to call that economy is a framework where all economic activities are carried out.**

Some of the salient features of an economy are as follows:

1. Economic institutions are man made. Thus an economy is what we make it.
2. Economic institutions can be created, destroyed, replaced or changed. For example the capitalism was replaced by communism in 1917 in USSR and the communism was destroyed in 1989 through a series of economic reforms by former USSR. In India after independence in 1947 through economic and social reforms we abolished Zamindari system and introduced many land reform.
3. Levels of economic activities keep on changing.
4. Producers and consumers are the same persons. Thus they have a dual role. As producers they work and produce certain goods and services and consume the same as consumers.
5. Production, consumption and investment are the vital processes of an economy.
6. In modern complex economies we use money as a medium, of exchange.
7. Now-a-days the government intervention in the economy is considered undesirable and the preference for free functioning of prices and market forces is increasing in all types of economic system.

4.2 TYPES OF ECONOMIES

As you know that economy is a man-made organization, which is created, destroyed or changed as per the requirement of the society. We can differentiate in various types of economic systems on the basis of following criteria.

4.2.1 On the Basis of Ownership and Control over Means of Production or Resources

Resources or means of production remain either in private ownership with full individual freedom to use them for the profit motive or they can be in collective ownership

(government control) and can be used for the collective welfare of the society as a whole. Based on the criterion of degree of individual freedom and profit motive, economies are labelled as:

- (A) Capitalist or free enterprise economy
- (B) Socialist or centrally planned economy
- (C) Mixed economy

Now we shall discuss about the main characteristics of these economics in brief.

(A) Capitalist Economy

The capitalist or free enterprise economy is the oldest form of economy. Earlier economists supported the policy of 'laissez fair' meaning leave free. They advocated minimum government intervention in the economic activities. The following are the main features of a capitalist economy;

(i) Private property

In a capitalism system all the individuals have the right to own property. An individual can acquire property and use it for the benefit of his own family. There is no restriction on the ownership of land, machines, mines, factories and to earn profit and accumulate wealth. After the death of a person the property or wealth is transferred to the legal heirs. Thus the institution of private property is sustained over time by the right of inheritance.

(ii) Freedom of enterprise

In a capitalist economy the government does not coordinate production decisions of the citizens. Individuals are free to choose any occupation. Freedom of enterprise implies that business firms are free to acquire resources and use them in the production of any good or service. The firms are also free to sell their product in the markets of their choice. A worker is free to choose his/her employer. In small business units owner himself takes the risk of production and earns profit or loss for himself. But in modern corporations the shareholders take risks whereas paid directors manage business. Thus the individual supervision of one's own capital is now no longer required to earn profit. Government or any other agency does not impose restrictions/obstacles in the way of workers to enter or leave a particular industry. A worker chooses that occupation where his income is maximum.

(iii) Consumer's Sovereignty

In a capitalist economy consumers are like a king. They have the full freedom to spend their income on goods and services that give them maximum satisfaction. In capitalist system production is guided by consumer's choices. This freedom of consumers is called consumer's sovereignty.

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(iv) Profit Motive

Self-interest is the guiding principle in capitalism. Entrepreneurs know that they will own the profit or loss after the payment to all other factors of production. Therefore they are always motivated to maximize their residual profit by minimizing cost and maximizing revenue. This makes the capitalist economy an efficient and self-regulated economy.

(v) Competition

There are no restrictions on the entry and exit of firms in a capitalism system. The large number of producers are available to supply a particular good or service and therefore no firm can earn more than normal profit. Competition is the fundamental feature of capitalist economy and essential to safeguard against consumer's exploitation. Although due to large-size and product distinction monopolistic tendencies have grown these days still the competition can be seen among a large number of firms.

(vi) Importance of markets and prices

The important features of capitalism like private property, freedom of choice, profit motive and competition make a room for free and efficient functioning of price mechanism. Capitalism is essentially a market economy where every commodity has a price. The forces of demand and supply in an industry determine this price. Firms which are able to adjust at a given price earn normal profit and those who fail to do so often quit the industry. A producer will produce those goods, which give him more profit.

(vii) Absence of government interference

In a free enterprise or capitalist economy the price system plays an important role of coordinating agent. Government intervention and support is not required. The role of government is to help in free and efficient functioning of the markets.

Capitalism in today's world

Pure capitalism is not seen in the world now-a-days. The economies of USA, UK, France, Netherland, Spain, Portugal, Australia ect. are known as capitalistic countries with active role of their respective government in economic development.

(B) Socialist Economy

In the socialist or centrally planned economies all the productive resources are owned and controlled by the government in the overall interest of the society. A central planning authority takes the decisions. The socialist economy has the following main features.

(i) Collective Ownership of means of Production

In a Socialist economy means of production are owned by the government on behalf of the people. The institution of private property is abolished and no individual is allowed to own any production unit and accumulate wealth and transfer it to their heirs. However, people may own some durable consumer goods for their personal use.



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(ii) Social Welfare Objective

The decisions are taken by the government at macro level with the objective of maximization of social welfare in mind rather than maximization of individual profit. The forces of demand and supply do not play any important role. Careful decisions are taken with the welfare objectives in mind.

(iii) Central Planning

Economic planning is an essential feature of a socialist economy. The Central Planning Authority keeping the national priorities and availability of resources in mind allocates resources. Government takes all economic decisions regarding production, consumption and investment keeping in mind the present and future needs. The planning authorities fix targets for various sectors and ensure efficient utilization of resources.

(iv) Reduction in Inequalities

The institutions of private property and inheritance are at the root of inequalities of income and wealth in a capitalist economy. By abolishing these twin institutions a socialist economic system is able to reduce the inequalities of incomes. It is important to note that perfect equality in income and wealth is neither desirable nor practicable.

(v) No class conflict

In capitalist economy the interests of the workers and management are different. Both of them want to maximize their own individual profit or earnings. This results in class conflict in capitalist economy. In socialism there is no competition among classes. Every person is a worker so there is no class conflict. All are co-workers.

Socialism in today's world

Countries such as Russia, China and many eastern European countries are said to be socialist countries. But they are changing now and encouraging liberalisation in their countries for their economic development.

(C) Mixed Economy

A mixed economy combines the best features of capitalism and socialism. Thus mixed economy has some elements of both free enterprise or capitalist economy as well as a government controlled socialist economy. The public and private sectors co-exist in mixed economies. The main characteristics of a mixed economy are as follows:

(i) Co-existence of public and private sectors.

The private sector consists of production units that are owned privately and work on the basis of profit motive. The public sector consists of production units owned by the government and works on the basis of social welfare. The areas of economic activities of each sector are generally demarcated. Government uses its various policies e.g. licensing policy, taxation policy, price policy, monetary policy and fiscal policy to control and regulate the private sector.



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(ii) Individual Freedom

Individuals take up economic activities to maximize their personal income. They are free to choose any occupation and consume as per their choice. But producers are not given the freedom to exploit consumers and labourers. Government puts some restrictions keeping in mind the welfare of the people. For instance, government may put restrictions on the production and consumption of harmful goods. But within rules, regulations and restrictions imposed by the government, for the welfare of the society the private sector enjoys complete freedom.

(iii) Economic Planning

The government prepares long-term plans and decides the roles to be played by the private and public sectors in the development of the economy. The public sector is under direct control of the government as such production targets and plans are formulated for them directly. The private sector is provided encouragement, incentives, support and subsidies to work as per national priorities.

(iv) Price Mechanism

Prices play a significant role in the allocation of resources. For some sectors the policy of administered prices is adopted. Government also provides price subsidies to help the target group. The aim of the government is to maximize the welfare of the masses. For those who can not afford to purchase the goods at market prices, government makes the goods available either free of cost or at below market (subsidized) prices.

Thus in a mixed economy people at large enjoy individual freedom and government support to protect the interests of weaker sections of the society.

Indian economy is considered a mixed economy as it has well defined areas for functioning of public and private sectors and economic planning. Even countries such as USA, UK, etc. which were known as capitalistic countries are also called mixed economies now because of active role of their government in economic development.



INTEXT QUESTIONS 4.1

1. Which of the following statements are True or False?
 - (i) On the basis of ownership of resources we can classify an economy as Rich economy and Poor economy.
 - (ii) Socialist economy aims at maximization of social welfare.
 - (iii) Freedom of choice, profit maximization and private property are the characteristics of a Socialist economy.
 - (iv) In a mixed economy public and private sectors co exist.
2. Fill in the blanks with appropriate words given in the bracket.
 - (i) Price mechanism plays role in capitalist or free market economy (the most important/a very limited)



- (ii) The freedom of choice is called in capitalist economy (consumers sovereignty/consumer surplus)
- (iii) The socialist economies are economies. (centrally planned decentralized)
- (iv) People can accumulate wealth and transfer it to their legal heirs in economy. (capitalist/socialist)
- (v) Public sector and private sector in a mixed economy (co-exist/does not exist)

3. Classify the following characteristics of different types of economies and put them in appropriate boxes.

Profit motive, central planning, consumer sovereignty, public and private sector, laws of inheritance, social welfare, government regulations, subsidy, competition, price mechanism, inequalities, no class conflict, economic planning and limited freedom of choice.

Capitalist Economy

Socialist Economy

Mixed Economy

4.2.2 Types of Economics on the Basis of Level of Development

On the basis of level of development economies can be classified in two categories:

- (i) Developed economy
- (ii) Developing economy

The countries are labeled developed or rich and developing or poor on the basis of real national and per capita income and standard of living of its population. Developed countries have higher national and per-capita income, high rate of capital formation i.e. high savings and investment. They have highly educated human resources, better civic facilities, health and sanitation facilities, low birth rate, low death rate, low infant mortality, developed industrial and social infrastructures and a strong financial and capital market. In short, developed countries have high standard of living.

Developing countries are low on the ladder of development. They are sometimes also called underdeveloped, backward or poor countries. But economists prefer to call them developing countries because it gives a sense of dynamism. The national and per capita income is low in these countries. They have backward agricultural and industrial sectors with low savings, investment and capital formation. Although these countries have export earnings but generally they export primary agricultural products. In short, they have low standard of living and poor health and sanitation, high infant mortality, high birth



Notes

and death rates and poor infrastructure. Thus economic development depends on many factors and has different meanings. Although you have already read, it will be useful to discuss again the meaning of economic development, its determinants and the difference between the terms economic development and economic growth in the context of present lesson.

4.3 MEANING OF ECONOMIC DEVELOPMENT

Economic growth, as distinguished from economic development, is a sustained increase in national income. Taking the differences in population into consideration, it is reflected in the growth of per-capita income (i.e. national income ÷ total population).

Although there may be year-to-year fluctuations or short-term variations in the growth of national income, there has to be a continuous growth in national income in the long-run for it to qualify as economic growth.

Economic development, on the other hand, includes not only economic growth but also various other economic changes that improve the quality of life or standard of living of people in a country. If with economic growth, a country experiences various economic changes such as reduction in poverty and unemployment, reduction in income and wealth inequality, increase in literacy rate, improvement in health and hygiene, decrease in population growth, improvement in environmental standards etc, that improve the quality of life then that is economic development. Such economic changes that are conducive to improvements in standards of living of people are necessary for economic development. Otherwise, peoples standard of living may not improve in spite of economic growth. It may happen that with economic growth, the rich get richer while the poor get poorer if the fruits of growth are snatched by the richer sections of the society. Clearly, economic development is a much broader concept than economic growth. It not only includes economic growth but also various other economic changes that bring about improvement in the standard of living of people or quality of life.

4.4 DETERMINANTS OF ECONOMIC DEVELOPMENT

The process of economic development is influenced by a number of economic as well as non-economic factors.

The important economic factors are as follows:

- (i) **Natural Resources:** The availability of natural resources facilitate and accelerate economic growth and economic development. It is believed that quality and quantity of natural resources affect the rate of growth.
- (ii) **Human Resources:** Another important determinant of economic development is the quantity and quality of human resources or the population. Other things being

equal, educated and technically qualified manpower helps in achieving higher growth rate. On the other hand illiterate and unskilled population retards economic growth.

- (iii) **Capital Formation:** Stock of capital goods is crucial for rapid economic growth. For increasing the stock of capital, rate of savings must be high. The savings must be invested. Given the rate of savings and investment the rate of growth will depend upon capital output ratio. If the domestic savings are not sufficient government can seek external assistance to increase capital formation and growth rate in developing countries.
- (iv) **Technology:** Technology can play an important role in the economic development. Technological progress depends upon continuous research and development. Through technological progress a nation may overcome other constraints such as scarcity of natural resources and low productivity. Developed economies invest in its human capital.

Besides these economic factors many other non-economic factors such as (i) caste system, (ii) family type, (iii) racial factors, and (iv) government policies also affect the rate of growth and economic development. It is very difficult to measure economic development and to give one index of economic development. The most commonly used index of economic development i.e. increase in per capita income suffers from a serious drawback. This index does not take into account the consumption of natural resources and environmental degradation such as the smoke from the industries or the pollution caused by various industrial waste and by-products in the air and water resources. The cutting of forest and selling of timber will earn income and will be considered an economic activity and the income added in the national income statistics but the harm caused by deforestation will not be shown as a negative entry in the national accounts statistics. The economist therefore are seriously working on preparation of some new index that may account for these environment costs to the society and can be used as a welfare index of the society.

4.5 DISTINCTION BETWEEN ECONOMIC DEVELOPMENT AND ECONOMIC GROWTH

Economic growth is a short-term measure and generally refers to year to year rise in national and per capita income in real terms. But the income index does not take into account the distributional aspects of national income. Another important thing is that income approach does not take into account the unproductive and dysfunction growth and productive and socially useful growth. Economic development on the other hand is a long term measure over a long period. The economic development refers to overall rise in standard of living and a better quality of life. Besides income index some non-income indices are also taken into account. These are high life expectancy at birth, low



Notes



Notes

infant mortality and high rate of literacy. An improvement in these non-income indices imply that the quality of life has also improved. Some important institutions like UNESCO and ILO include the basic needs approach such as availability of food, clothing and shelter, availability of drinking water, sanitation and public transport facilities good health and education as an index of economic development. The objective of development, therefore, is meeting the needs of the vast masses of population. The United Nations Development Programmes emphasizes on Human Development Index (HDI) that is based on per capita income, educational attainment and life expectancy. Thus it is a composite index of economic and social indicators. The economic development, therefore, is a much wider term to capture over all improvement in the quality of life of people.



INTEXT QUESTIONS 4.2

Answer the following questions.

1. What are the two categories of economy on the basis of level of development?
2. Give simple meaning of economic development.
3. Give economic factors of determinants of development.
4. What are the non-economic factors affecting development?
5. What is the serious drawback in income approach to development?
6. Distinguish between economic growth and economic development.
7. How is capital formation important for economic growth?



WHAT YOU HAVE LEARNT

- In this lesson we have learnt the meaning of an economy. It is a system of socially and legally acceptable ways by which people get a living. An economy is also looked at as a system of cooperation for the satisfaction of human wants.
- In a modern complex economy, the cooperation exists in the form ‘you do this for me and I will do that for you is not enough’. The cooperation can be seen across national boundaries. Thus economy can be seen as a system of mutual cooperation and exchanges.
- Economy can be classified into the following three categories on the basis of ownership and control over means of production.



- (i) Capitalist Economy
 - (ii) Socialist Economy
 - (iii) Mixed Economy
- Economy can be classified into the following two categories on the basis of level of development:
 - (i) Developed Economy
 - (ii) Developing Economy
 - Capitalist Economy gives much importance to individual freedom and competition. Consumers behave like a king and play a significant role in the allocation of resources through price system, profit motive and markets.
 - Socialist Economy gives too much importance to collective ownership, society's welfare and economic planning. The inequalities are reduced and class conflict is avoided.
 - Mixed economy gives importance to the merits of both the systems. Here public and private sectors coexist. Public sector works on the basis of socialist economy whereas the private sector works on the basis of capitalist economy.
 - Developed rich countries have higher per capita income and better standard of living and quality of life.
 - Underdeveloped or poor countries on the other hand have low income, savings and investment and therefore they have poor standard of living.
 - The process of economic development is determined by number of economic and non-economic factors.
 - There is a difference between development and economic growth. Generally economic growth refers to short-run improvements in a few selected sectors and variables. The economic development on the other hand refers to long run increase in national and per capita income along with many other non-economy factors that improve overall quality of life.



TERMINAL EXERCISE

1. What is meant by an economy? Give the major characteristics of a capitalist economy.
2. "Economy is a system of mutual cooperation and exchanges." Discuss.



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3. Explain the types of economy on the basis of ownership and control over means of production.
4. Distinguishes between economic development and economic growth.
5. What are the main determinants of economic development?



ANSWERS TO INTEXT QUESTIONS

Intext Questions 4.1

1. (i) False (ii) True (iii) False (iv) True
2. (i) the most important (ii) Consumer’s sovereignty (iii) centrally planned
(iv) Capitalist (v) Co-exist
3. Classify the following characteristics

Capitalist Economy	Socialist Economy	Mixed Economy
Profit motive	Central Planning	Public and Private Sector
Consumer Sovereignty	Social welfare	Government Regulations
Law of inheritance	No class Conflict	Economic planning
Competition		Subsidy, Economic planning
Price mechanism		Limited freedom of choice
Inequalities		

Intext Questions 4.2

1. Developed Economy and Developing Economy
2. Economic development is a process by which an economy’s real national income increases over a long period of time.
3. Natural Resources, Human Resources, Capital Formation, Technology.
4. Caste system , family type , racial
5. It does not take into account the environmental costs and resource depletion.
6. Economic growth is a short term improvement in real income whereas economic development is long run increase in real income plus improvement in overall standard of living and quality of life.
7. Capital formation determines the growth rate given the capital output ratio.