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ECONOMY AND ITS PROCESSES

1.1 INTRODUCTION

All of us are engaged in various types of activities. As student you are primarily engaged in your studies. Some of you may also be working to earn. And those of you who are not earning will ultimately try to do some work that will fetch you income. All of us earn or want to earn in order to spend and save. Thus all income earning, spending and saving activities are very important activities. These are called economic activities. Income is the source of spending and saving. On the other hand the need for spending and saving provides the motivation for earning an income. If there is no need of spending and saving there is no need of earning an income. So economic activities are interrelated and interdependent.

Income is generated in the production process. It is spent on goods and services produced in the production process. Spending for satisfaction of wants is consumption activity. Spending for producing more is investment activity. As such production, consumption and investment are the three basic economic activities or processes. The area in which these activities take place is called an'economy'. In this lesson you will learn about the meaning of an economy and its various economic processes viz. production, consumption and investment.

1.2 OBJECTIVES

After going through this lesson, you will be able to :

- explain the meaning of an economy;
- state the types of goods and services provided by an economy;
- explain the meaning of production, consumption and investment;
- distinguish between 'gross' and 'net' investment;
- explain the meaning of saving;
- explain the interrelationship between different economic processes.

1.3 MEANING OF AN ECONOMY

We find people working on farms, in offices, factories, shops, schools, colleges, hospitals, etc. We all have to work in order to earn. People work and get money income in exchange. With this money income they buy goods and services. We buy most of these goods and services to satisfy our and our family members' wants. We also buy goods and services for use in business. The work places where people work are called production units. These production units are the sources of livelihood to the people working there. Some get wages and salaries. Some get rent by renting out properties. Some get interest by lending money. The owner of these production units gets profit. All these production units together make an economy.

The term 'economy' is generally associated with a country. But it may need not always be so. It can also be associated with city, town and village. A city's economy includes factories, shops, offices, schools, colleges, banks and all other work places located in that city. Similarly a village economy includes farms, shops and all other establishments in that village where people work. We can even talk of a world economy which will include all production units existing in the world. Indian economy thus includes all the production units or work places existing in India.

1.4 WHAT DOES AN ECONOMY PROVIDE ?

What types of goods and services does an economy provide ? It has already been stated that the economy provides goods and services. These goods and services directly or indirectly satisfy the wants of the people. Goods and services provided to the consumers satisfy their wants directly. These are called consumer goods and services. Goods and services provided to the producers are used for producing more goods and services. These are called producer goods and services. Thus goods and services are broadly classified into (a) consumer goods and services and (b) producer goods and services.

(a) Consumer Goods and Consumer Services

(i) Consumer Goods :

Those goods which directly satisfy human wants are called **consumer goods**. It will include all purchases made for direct satisfaction of wants like the food items, clothes, shoes, books, furnitures, scooters, etc. We buy these goods for ourselves and for other family members.

Consumer goods can be classified into two categories : (a) single use consumer goods and (b) durable use consumer goods. As is clear from the term itself, a unit of single use consumer goods can be used only once. Food items like milk, sugar, vegetables, etc. and other goods like soap, oil, ink, paper etc. are all single use consumer goods. Durable use consumer goods, on the other hand, are those goods which can be used by the consumers again and again like furniture, clothes, shoes, refrigerator, television, radio etc.

(ii) Consumer Services :

As consumers we require not only goods but also services. For example, we need the services of a barber for hair-cut, the services of a tailor for stitching our clothes, the services of schools and colleges, services of doctors, services of banks and postal and transport services etc. All these services are called consumer services as they directly satisfy the wants of the consumers. However, unlike goods, all services can only be single use services. The production of a service and the consumption of it takes place at the same time. Thus a service produced and consumed cannot be used again. Hence all services are only single use.

(b) Producer Goods and Producer Services

(i) Producer Goods :

Those goods which are used to produce more goods and services are called **producer goods**. Machines, tools, buildings, raw material etc. are all producer goods. These goods are required by the producers for producing more goods.

Furthermore, producer goods are used not only to produce more goods but also to produce more services. For example, an X-ray machine in a hospital or a stethoscope with a doctor is a producer good as this helps in rendering medical services. Thus producer goods are those goods which are used to produce goods and services.

Producer goods are also classified into single use producer goods and durable use producer goods. Single use producer goods are those goods which are used up in production in a single act. For example, the raw material is single use producer goods. These goods lose their identity the moment they are used in production. Durable use producer goods are those goods which can be used in production again and again like machines, tools, vehicles, factory building etc.

(ii) Producer Services :

The production units not only require goods but also services. For example, services like that of banking, transport, insurance, advertising, etc. are needed by production units. All such services help in producing goods and services. However, producer services are also only single use services. In fact, as all services whether they are consumer services or producer services are produced and consumed simultaneously, these can only be single use.

(c) What makes a product a consumer or a producer good or service?

Whether a good is a consumer good or a producer good is determined by its use and not by its nature. Let us take a few examples. Vegetables when purchased by families are consumer goods but when purchased by a restaurant are producer goods. A refrigerator purchased by a restaurant is a producer good but when purchased by a family is a consumer good. A car purchased by a person for his personal use is a consumer good but when purchased for using it as a taxi is a producer good. Pens, papers, fans etc. purchased by banks are producer goods, but when these goods are purchased by people working in the banks for their household use they would be called consumer goods. A sewing machine with a tailor is a producer good but a sewing machine with a housewife is a consumer good. Similarly, whether a service is a consumer service or a producer service depends upon its use and not on its nature. For example, banking services, transport services, medical services, etc. can be both consumer as well as producer services. These would be called consumer services when used by consumers and producer services when used by producers.

POINTS TO REMEMBER

- An economy is a system by which people earn their living.
- An economy comprises production units like farms, factories, shops, banks, etc. in a particular area which may be a village, a town, a city, a country or the whole world.
- Economy provides goods and services to the consumers and producers.
- Goods and services which directly satisfy human wants are called consumer goods and services.
- Goods and services which are used for producing more goods and services are called producer goods and services.
- Single use goods are goods which can be used only once.
- Durable use goods are goods which can be used again and again.
- All services are only single use as they are produced and consumed simultaneously.
- The use of goods determines whether it is producer goods or consumer goods.

INTEXT QUESTIONS 1.1

1. Which of the following statements are correct and which are false?

i) Geographical area of a country is called an economy.

ii) An economy is a system by which people earn their living.

iii) An economy consists of the production units that exist in a particular area.

iv) An economy provides only consumer goods and services.

v) An economy provides only producer goods and consumer services.

vi) Goods and services satisfy the wants of the people directly or indirectly.

vii) All single use goods are consumer goods.

viii) All services are single use.

2. Categories the following into consumer goods and producer goods :

i) Fertilisers used in farming.
ii) Sewing machine with a tailor.
iii) Utensils in a household kitchen.
iv) Aeroplanes of Indian Airlines.
v) Vegetables in the kitchen of a restaurant.
vi) Blackboard in a school.
vii) Clothes in a shop.
viii) Sugar with a bakery.

3. Categorise the following into single use and durable use goods :

i)	Milk	ii)	Seeds
iii)	Ghee	iv)	Cooking Gas
v)	Shoes	vi)	Papers
vii)	Watch	viii)	Fan
ix)	Utensils	x)	Flower pot.

1.5 VITAL PROCESSES OF AN ECONOMY

By vital processes of an economy we mean processes without which an economy cannot exist. There are three vital processes of an economy : production, consumption and investment.

(i) Production :

Production is generally understood as making of goods in a factory such as machines, televisions, cloth, medicines etc. or growing of crops on farms. But in economics the word 'production' has a much wider meaning. It includes not only the making of various goods but also the services. For all of us services are also as essential as the goods. In fact some of the goods cannot be used by us if necessary services are not provided. For example, television or radio cannot be used unless the services of artists or technicians are provided. Similarly a train or a bus is a good which cannot be used without the services of a driver. Goods cannot reach actual users without the services of transporters, traders etc. Thus production includes the goods made and the services provided in an economy.

There are some services which are provided by family members to themselves or to one another like cooking and washing clothes, cleaning the house, ironing clothes, polishing shoes and so on. Such services are also a part of production. But when it comes to measurement of the value of these services, problems arise about getting the required data of the quantity and value of these services. As such, in practical estimates, these services are left out of production. Similarly all 'leisure-time' activities such as growing fruits, flowers and vegetables in kitchen garden are also excluded from production for the same reason.

(ii) Consumption :

Consumption is defined as an activity concerned with using up of goods and services for direct satisfaction of wants. In other words, consumption is an act of satisfying one's wants.

As in case of production, consumption also includes consumption of both goods and services. We consume food, clothes, furniture etc. We use services of tailors, barbers, washermen, repairers, tutors, etc. All these are examples of consumption activity. Consumption activity takes place as soon as we buy these goods and services. In other words, by consumption we mean acquiring of goods and services for consumption.

All purchases by households, with an exception of purchase of a house, are consumption purchases. The purchase of houses by households is treated as a purchase of producer good. However, the services of a house is a part of consumption activity. Thus using up of goods and services to satisfy human wants is defined as consumption.

iii) Investment :

Whatever is produced during a year is not generally acquired for consumption in that year. Why is it so that generally production exceeds consumption during a year ? This is due to the following reasons :

(a) Goods lying with production units

All goods before reaching the users as finished goods undergo a number of processes. For example, the clothes that we wear, have reached us after undergoing many processes such as converting cotton into thread, then weaving it into cloth, then dying it, then stitching it into clothes and then sending it to the shopkeeper for selling them to us, the users. All these processes are like pipelines and in each of these pipelines there are goods known as raw material and semi-finished goods. Unless there is a stock of raw material and semi-finished goods at each stage of production, the next stage of production will be held up.

In addition, the producers have to keep some stock of finished goods ready in anticipation of demand from the market. So a part of the production of the year is used up in building stock of finished and semi-finished goods and raw material with the production units. This represents one component of total production of the year which is not used for consumption.

(b) Durable use goods acquired by the production unit

Production units make investment in fixed capital goods like new machines, equipment. vehicles, buildings etc. during the year. These are durable use goods. This is another component of production of the year not used for consumption during the same year.

Production of a year exceeds the consumption of that year on account of the above two reasons. This excess of production over consumption equals investment. The two components responsible for the excess are (i) Investment in stock and (ii) Investment in fixed capital goods. This brings us to the distinction between stock investment and fixed investment.

Stock Investment vs. Fixed Investment

(a) Stock Investment

Additions to the stock of raw material, semi-finished goods and finished goods during a year is called stock investment or inventory investment. Such a stock at the beginning of the year is called **opening stock**. The stock that exists at the end of the year is called **closing stock**. Suppose the relevant year is from April 1, 1997 to March 31, 1998, the stock of raw material, semi-finished goods and finished goods that exists on April 1, 1997 is called opening stock. The stock of these goods on March 31, 1998 is called closing stock. The excess of closing stock over the opening stock is called inventory investment. However, it is possible that during a particular year the production may be less than consumption. It implies that the closing stock is less than the opening stock. This is called negative investment or disinvestment.

The following table 1.1 shows how stock investment is calculated.

Table 1.1

Calculation of Stock Investment

Particulars	Opening Stock (Rs.)	Closing Stock (Rs.)	Stock(Inventory) Investment (Rs.)
Raw materials	10,000	12,000	2000
Semi-finished goods	15,000	18,000	3000
Finished goods	20,000	18,000	(–)2000
Total	45,000	48,000	3000

The value of total opening stock was Rs.45,000/- and the value of total closing stock was Rs.48,000/-. So during the year the total investment in stock or inventory investment was Rs.3000/-.

(b) Fixed Investment

Acquiring up of durable use producer goods by production units is called **fixed investment**. It amounts to adding new machines, equipment etc.

Total investment equals the sum of inventory investment and fixed investment. The alternative name for investment is **capital formation**.

Gross Investment vs. Net Investment

Investment as defined above is called **gross investment**. It is distinguished from **net investment**. The difference is explained below :

A production unit possesses some fixed capital. This fixed capital is in the form of machines, tools, factory building etc. When this fixed capital is used in production, some wear and tear take place during the year. Some accidental damage may also take place. All these reduce the value of fixed capital. The value of fixed capital may also go down due to obsolescence. Obsolescence means loss of value of fixed capital due to change in technique of production or due to change in demand for goods that it produces. These changes make the fixed capital, like machine, obsolete. For example, steam engines became obsolete when diesel engines began to be used and diesel engines became obsolete when electric engines were introduced. Change in fashion is another example that makes the machines obsolete.

The loss of value of fixed capital due to wear and tear in use and due to expected obsolescence is called depreciation or consumption of fixed capital.

If we subtract this depreciation or consumption of fixed capital from gross investment, we get net investment. So,

Net Investment = Gross Investment - Depreciation

1.6 SAVING

Production activity is undertaken in production units. The owners of factors of production render services to these units. In return they receive incomes in the form of wages and salaries, rent, interest and profits.

There are two alternative uses of income for any person. A part of the income is spent on acquiring goods and services for satisfaction of wants. Such an expenditure is called consumption expenditure. The unspent part of income is called '**saving**'. Thus saving equals excess of income over expenditure.

Saving = Income - Consumption Expenditure

What do people do with savings? The savings are in the form of money. They may keep these savings at home or keep the same in banks. There may be several motives for savings. One motive of saving may be to meet any emergency expenses like expenses on illness, old age or any other unexpected expenditure. But generally the main motive is to earn interest income by lending these savings. It gives them an additional source of income in future years. Savings may be lent to the investors through banks or directly. The borrower pays interest.

Savings play a very important role in production process. In fact, saving is a major source of financing investment. Higher the saving more the possibility of investment. Investment means acquiring goods and services for production. Savings are used to acquire investment goods. So saving is the foundation of investment.

1.7 INTERRELATIONSHIP BETWEEN ECONOMIC PROCESSES

Production, consumption and investment processes are interrelated in the following manner:

First, production is the source of consumption and investment. If there is no production there would be no consumption and investment. Given production, if there is more consumption less would be available for investment.

Second, consumption provides motivation for production and investment. If there is no need for consumption, there is no need to invest and produce.

Third, investment determines the level of production. The more we invest, the more we can produce.

Fourth, saving is the major source of financing investment. More saving means more investment which in turn means more production leading to more consumption and investment.

POINTS TO REMEMBER

- The vital processes of an economy are : (i) production, (ii) consumption and (iii) investment.
- Production is the activity that creates goods and services.
- Production includes not only material goods but services also.
- Level of consumption is determined by the level of production in an economy.
- Production of goods and services affects not only the level of consumption but also the productive capacity in an economy.
- Consumption is the activity that uses the goods and services to satisfy wants.
- Addition of new capital goods to the existing stock of capital goods is called investment.
- Change in stock of raw material, semi-finished goods and finished goods is inventory or stock investment.
- Addition to fixed capital goods like machines, factory, building etc. is called fixed investment.
- The sum of inventory investment and fixed investment is called gross investment.
- Wear and tear of fixed capital by use or accidental damage and its expected obsolescence due to change in technique of production and change in demand of goods it produces is called consumption of fixed capital or depreciation.
- Net investment = Gross investment - Depreciation.
- Production, consumption and investment are interdependent.

INTEXT QUESTIONS 1.2

1. State whether the following statements are true or false :

i) Teaching in a school is production.
ii) Selling of goods by a shopkeeper is production.
iii) A student using stationery is production.
iv) Working in a Government office is taking part in production.
v) Buying of washing machine by a household is consumption.
vi) Buying of goods for resale is consumption.

2. Which of the following is a production activity?

i) Bathing in a river.
ii) Buying milk for the family.
iii) Getting a hair cut from a barber.
iv) Seeing a picture in a cinema hall.
v) Buying furniture for your personal use.

3. Tick (✓) the correct answer :

A. Consumption is the act of using -
i) the goods.
ii) the goods and services for satisfaction of wants.
iii) the goods over a long period.
iv) useful goods.

B. Investment is excess of production over :
i) unsold stock.
ii) consumption.
iii) depreciation.
iv) savings.

C. Production includes :
i) only goods
ii) only producer goods
iii) only producer goods and services
iv) goods and services.

D. Purchase of a cycle by a household is :
i) investment
ii) production
iii) consumption
iv) none of the above.

WHAT YOU HAVE LEARNT

- An economy is a system by which people get a living.
- An economy provides single use and durable use goods and services to the consumers and producers.
- The three vital economic processes of an economy are production, consumption and investment. These are inter-related.
- Production is a process of creation of goods and services. Consumption is the use of goods and services for the satisfaction of human wants. Investment is the difference between production and consumption during a given period.

TERMINAL EXERCISE

1. What do you mean by an economy?
2. Distinguish between consumer goods and producer goods with the help of an example.
3. Distinguish between consumer services and producer services with the help of an example.
4. Distinguish between single use producer goods and single use consumer goods.
5. Distinguish between durable use producer goods and durable use consumer goods.
6. Explain the relationship between production and consumption.
7. Distinguish between gross investment and net investment.
8. Distinguish between fixed investment and stock investment.

ANSWERS

Intext Questions 1.1

1. True : (ii), (iii), (vi), (viii)
   False : (i), (iv), (v), (vii)
2. Producer goods : (i), (ii), (iv), (v), (vi), (vii), (viii)
   Consumer goods : (iii)
3. Single use goods : (i), (ii), (iii), (iv), (vi)
   Durable use goods : (v), (vii), (viii), (ix), (x)

Intext Questions 1.2

1. True : (i), (ii), (iv), (v)
   False : (iii), (vi)
2. Production activity : (iii)
3. True : (A) (ii), (B) (ii), (C) (iii), (D) (iii)

Terminal Exercise

1. Read Section 1.3
2. Read Section 1.4 a(i) and b(i)
3. Read Section 1.4 a(ii) and b(ii)
4. Read Section 1.4 a(i) and b(i)
5. Read Section 1.4 a(i) and b(i)
6. Read Section 1.7
7. Read Section 1.5 (iii)
8. Read Section 1.5 (iii)