



## 6

## BASIC ECONOMIC ACTIVITIES

Production, consumption and capital formation are called the basic economic activities of an economy. Scarce resources are used in the production of goods and services with the objective of satisfying our needs and wants. The process of production of goods and services is carried by combining the factors like land, labour, capital and entrepreneurship. Factors are paid rent, wages, interest and profits for their productive services. The consumption activity consists of the use of goods and services for the direct satisfaction of individual or collective human wants. A part of current production is saved for future to add to existing capital stock like, plant, machinery, building etc. every year in order to expand production potential in future. So whatever is produced is disposed of either for consumption or for capital formation or both.



### OBJECTIVES

After completing this lesson, you will be able to:

- *understand production and its goals;*
- *know the factors of production and factor incomes;*
- *know about consumption;*
- *be familiar with the goods produced for consumption;*
- *understand how production and consumption help in capital formation;*
- *explain circular flow of economic activities.*

### 6.1 PRODUCTION

In the last lesson you have read about scarcity of resources and making choice. These scarce resources are used in the production of goods and services. The goal of



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production is to satisfy our wants. These goods and services produced can be sold in markets or can be provided by the government to public at nominal charge. Therefore Production is defined as creation of utility.

Production activities involve making of goods and services. People who make and sell these goods and services are known as producers. The producers combine the factors like land, labour, capital and entrepreneurship along with raw materials in order to transform them into various goods and services. **Land, labour, capital and entrepreneurship are called the factors of production.** The producers try to produce maximum amount of goods and services by using various combination of factors of production. Let us know more about these factors of production.

### 6.1.1 Land

Land is a gift of nature. It includes plain region, mountains and plateau region. The plain region is useful for agriculture and industrial activities. Mountains ensure flow of rivers into the plain region and provide facilities for tourism. Plateau region possesses reserves of minerals, fossil fuels and forests. Production of food grains, vegetables, fruits etc require agricultural land in the plain region. Along with this people also carry out animal husbandry, fisheries and forestry which are called allied activities. In India rural area is known for carrying out agricultural and allied activities. Some amount of land in the plain region is specially developed to establish industries and urban areas such as towns and cities.

### 6.1.2 Labour

In general labour implies the human effort through physical and mental exertions in the production of goods and services. A person working on the agricultural field is said to provide his physical labour while a writer of a book is said to provide his mental labour. People who provide labour are known as human resources. Production activities require both skilled and unskilled labour. Purely physical labour such as loading and unloading, ploughing on the field etc do not require special skill. But to become an engineer, doctor, teacher, lawyer, mechanic, electrician or tailor etc one must acquire skill through education and training.

### 6.1.3 Capital

By **capital**, we mean all man made appliances and all types of wealth used in production. Capital consists of machinery, tools, buildings, materials etc. Whereas land is a natural resource, capital is a man made resource. Capital is used to increase the efficiency of other factors of production like land or labour. The efficiency of land can be increased by use of better irrigation facilities and machines. However, capital is a passive factor of production and cannot be used without employing labour to work. Capital has a limited span of life, and becomes obsolete after a certain period. Small tools like, screwdrivers, calculators to heavy machines like engines, tractors,

ships are all examples of **fixed capital**, as they can be used in production for many years. Fixed capital also includes the buildings and heavy machines. The **working capital** includes raw materials like cotton yarn, clay, seeds, fertilizers, which are used-up in the process of production.

### 6.1.4 Entrepreneurship

Somebody must take the initiative to start the process of production of goods or services by bringing land, labour and capital together in right proportion. He will be responsible for choosing the right type of land, labour and capital and take important decisions with respect to quantity to be produced, money to be spent to buy the factors and raw materials, marketing the output produced etc. **Entrepreneurship** is the art of organizing the production activity. The person who makes the decisions and controls the production process and bears the risks and uncertainties involved in production is called an **entrepreneur**. He/She should be knowledgeable, courageous and should possess leadership qualities. The objective of an entrepreneur is to get maximum production by using the given resources and make arrangements for the sale of the finished products. He/she is also responsible to make payments to other factors of production.

He/she pays wages to the labourers, rent to the landlords and interest to the owner of capital in return for their productive services. Similarly, they earn profit for their productive activity. **Since these payments, rent, wages, interest and profits are received by the factors for their productive services, they are termed as factor incomes.**



### INTEXT QUESTIONS 6.1

- Below is a list of some of the factors that are used to produce shirts. Group them into **natural resources**, **human resources**, **fixed capital** and **working capital**

*Yarn, machinery, tailors, land for factory, wooden doors, colour, dye, building, sewing machines, telephones, marketing managers, advertising managers, packaging machines, scissors, buttons, bank loans, cash money*

- Which one of the following is not a characteristic of land:
  - Mobile
  - Gift of nature
  - Limited in quantity
  - Indestructible



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## 6.2 FACTOR INCOMES

These factors of production are owned by people. Land is owned by the landlord, labour is owned by labourer, capital is owned by people who acquire capital goods, entrepreneurship is owned by the entrepreneur. The owners of factors of production are paid in return for their productive services. When you hire a piece of land, you pay rent to the landlord for using the services of land. Thus the tenant pays rent for the services of land. Labour refers to the services rendered by the workers. It refers to the all types of workers, manual labour, technical workers and so on. When an employer requires the services rendered by a worker, he/she is ready to pay for his services. By hiring a worker, actually his services are hired. When a loan is taken from a bank to buy a tractor, seeds, machinery etc. interest is paid to bank. Thus, rent is paid to the landlords, wages to the labourers, interest to the owners of capital resources and profit to the entrepreneurs. Since they are paid in return to their productive services, they are called factor payments and their incomes are called factor incomes.



### INTEXT QUESTIONS 6.2

Ram Singh is farmer in a village of Haryana, who owns 2 hectares of land. Both, he and his wife Rani, work in the field. Earlier, they only grew paddy on their land. Now they want to increase the productivity of their land by growing two crops and better variety of seeds and irrigation. They want to grow two crops, paddy and potatoes. For this they need money to buy good quality seeds and fertilizers. As they do not have enough money, both work in other's farms as labourer. They spend some money on the fertilizers, seeds, pump sets etc. After working very hard, they manage to have a good crop of both paddy and potato. They keep some paddy and potato grown in their farm for their personal use and sell the rest. They earn Rs. 12,000 by selling their crops.

- Identify the factors of production in this story?
- What are the capital goods used in this example?

## 6.3 CONSUMPTION

The objective of production is to produce goods and services for consumption. The consumption activity consists of the use of goods and services for the direct satisfaction of individual or collective human wants or needs. To satisfy their wants the households purchase a large variety of goods and services like cycles, furniture, television set, car, refrigerator, food grains, milk, oil, soap etc. and services like

barber, teacher, doctor, bank and insurance companies etc. There is no time gap between the production and consumption of services. In case of services production and consumption take place simultaneously. They are consumed as soon as they are produced, such as the services of doctors, lawyers, teachers etc. As you visit a doctor to take medical advice, you consume his service. This is not the case with regard to goods. There is a time gap between the production and consumption of goods. Goods are considered to be consumed when they are purchased. However, certain durable goods like furniture, cycles etc. continue to provide services for many years, still they are considered to be consumed as soon as they are purchased.



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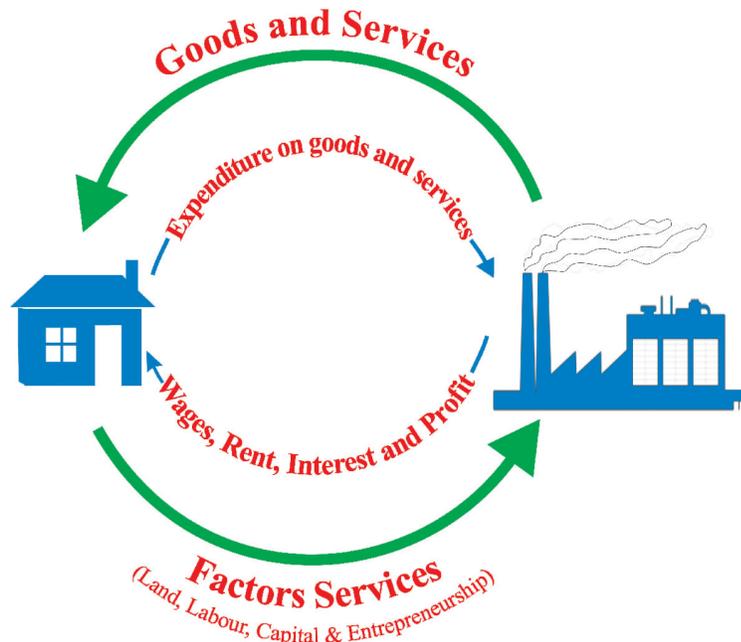
## 6.4 CAPITAL FORMATION

The third important activity of an economy is capital formation. As you have read, factor owners get factor incomes in return for their productive services. They spend a large part of their incomes on goods and services such as food articles, cloth, furniture, housing, bicycles, education, health care etc. However, they do not spend their entire income on these goods and services. They also save some income and deposit it in bank for future. For example, if an individual has an income of Rs. 500/ all of which she consumes, there is no saving. Instead if she restricts her consumption to Rs.300/, she saves Rs.200/ and may use this money to deposit in bank for future use. The bank, in turn, may use this money to lend an industrialist to invest in the expansion of his business. Capital formation is done by refraining from present consumption. It should be noted that saving, if kept idle, cannot constitute capital formation. If a person saves money and locks up in the house, no capital formation takes place. If only the saved money is invested in capital goods it leads to capital formation by facilitating production and consumption in future. Thus, current consumption is forgone and used towards adding to existing capital stock like, plant, machinery, building etc. every year in order to expand production potential in future. This increase in the stock of capital goods in a year is called capital formation or investment. Similarly, a part of nation's output is devoted not to immediate satisfaction of consumer wants but to the provision of plants and equipments by which production is maintained and expanded. To sum up, whatever is produced is disposed of either for consumption or for capital formation or both.

These three activities, production, consumption and capital formation are inter-related. An increase in the production of goods and services increases the level of consumption and capital formation. Increase in consumption is an indicator of rising standard of living of people and increase in capital formation is very important as the growth of the country depends on it. More consumption is possible if there is more production and more production is possible if there is more capital formation. Thus, the three economic activities have their impact on one-another to take the economy forward to the path of development.



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*Circular Flow Chart*



**INTEXT QUESTIONS: 6.3**

1. Give two examples of durable goods, non-durable goods and services.
2. There is an excess of production over consumption in a year. Where does it go?
3. How does production facilitate consumption and capital formation?



**WHAT HAVE YOU LEARNT**

- Production, consumption and capital formation are three basic economic activities.
- Production is defined as creation of utility.
- Land, labour, capital and entrepreneurship are four factors of production.
- Wages, interest, rent and profits are the factor payments made by the firm to the owners of factors of production. For the owners of the factor services the same are called factor incomes.
- Consumption means using up of goods and services for direct satisfaction of individual and collective wants.
- Capital formation is the surplus of production over consumption over a period of time.



### TERMINAL EXERCISE

1. An agricultural land is a fixed resource. How can its productivity be increased?
2. How can the productivity of labour be increased?
3. What are the main functions of an entrepreneur?
4. How does capital add to the productivity of labour?
5. If there is an excess of production over consumption in a year, where does it go? Also mention two goods which help in capital formation in an economy.
6. Mention the three important economic activities and show their inter-relationship diagrammatically.
7. Purchase of a cycle by a household is treated as:
  - (a) Capital formation
  - (b) Production by household
  - (c) Consumption
  - (d) Production for self consumption
8. Which of the following statements are true or false:
  - (a) Capital formation increases the capital of a country.
  - (b) Growing vegetables in the kitchen garden is not a part of production.
  - (c) A farmer producing wheat for self consumption is a part of production.
  - (d) A teacher teaching in school is production.
  - (e) A student using stationery is production.
  - (f) Digging a well by the members of a family in their own field is a part of capital formation.
  - (g) A truck transporting wheat from a village to the market in the nearby town is a part of production.
9. Fill in the blanks:
  - (a) Roads constructed by the government are ..... (production/ capital formation).
  - (b) Purchase of a tractor by a farmer is a part of ..... (production/ consumption).



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- (c) A new house purchased by an individual is .....(consumption/production).
- (d) A doctor seeing a patient is ..... (production/consumption).
- (e) A student studying in a school is ..... (production/consumption).

**ANSWERS TO INTEXT QUESTIONS****Intext Questions 6.1**

1. Natural resources – Land for factory

Human resources – Tailors, Marketing managers, Advertising managers.

Fixed capital – Machinery, wooden doors, buildings, sewing machines, telephones, packaging machines, and scissors.

Working capital- yarn, dye, buttons, bank loan, cash money.

2. a.

**Intext Questions 6.3**

1. Durable goods: Television, refrigerator, washing machine etc.

Non-durable goods: Bread, butter, milk, flour.

Services: Barber’s services, services of teacher, services of a doctor.

2. It goes to capital formation.
3. An increase in production of goods and services increases the level of consumption and capital formation. More consumption is possible only when there is more production and more capital formation is possible only when production is more than consumption.

## **MODULE-3**

### **PRODUCING GOODS AND SERVICES**

7. Production
8. Cost and Revenue

