CHAPTER 6

THE STRUCTURE AND WORKING OF AN ECONOMY

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INTRODUCTION

In order to understand the dynamics of business environment, it is essential to understand the nature, working and problems of an economy. This understanding enables us to know how the changes in the variables affecting the economy are caused and how do such variables interact. An understanding of these factors and their behaviour in an economic system further helps to make predictions about the state of the economy or business environment at least in the near future. There are basically three types of variables affecting an economy:

- **Exogenous (external) variables**, which affect the economy but are not affected by it. Some of these are wars, population growth, natural calamities, revolutions and the condition of foreign economies.
- **Policy variables**, including monetary policy, taxes, subsidies, anti-inflationary policy, industrial policy and the like, which are determined by the government.
- **Endogenous variables**, such as national income, output, employment, exchange rate, rate of interest and the inflation rate which are greatly determined or affected by the exogenous and policy variables.

In addition, there are socio-economic and non-economic variables like health, sanitation, education, administration, social values, traditions, beliefs and the like which also have an important influence on the economy.

WHAT IS AN ECONOMY?

An economy is a system in which productive units use scarce resources to produce a variety of marketable products (goods and services) that satisfy human needs. The term 'scarcity' means that resources are limited, have a cost and are capable of being put to alternative uses. The economy is defined as a system because it spells organised or functional relationship between the various sections of producers, suppliers, consumers and the government. The goods and services produced must be marketable and capable of satisfying consumer needs otherwise they will not longer be useful or valuable and would signify waste of effort and resources. The distribution and exchange functions are implicit in the concept of marketable goods and services. The economy can exist at global, national or region levels. It can even exist at a sectoral level. For that reason we have global economy, national economies and regional or state level economies. At sectoral level, we have agricultural economy, industrial economy, labour economy and so on.

THE MARKET MECHANISM

The market mechanism lies at the centre of the functioning of an economy. Market can be defined as the interacting group of buyers and sellers and to a mechanism by which prices and qualities of goods and services are determined. Competition lies at the heart of the market mechanism and in the competitive environment no single individual controls or determines production, consumption or marketing. Thus, government interference and monopolistic tendencies inhibit the working of the market mechanism. In a market economy the role of the government is, by and large, regulatory. The individuals and households decide what, how much and when to buy and business firms decide production technology, employment and related issues. Prices are the key variables that guide decisions both on the producing and consuming side. A high price stimulates supply but discourages production. A low price works in the opposite direction.

In a market system, the price mechanism end to keep demand and supply in balance and for this property, is also called 'equilibrating mechanism'. As the degree of competition increases, the power of any individual buyer or seller to affect the price goes down. When prices mechanism operates freely, changes in demand, production or supply conditions, separately or simultaneously, reflect in price changes, which balance demand and supply at new levels. The market mechanism under facilitating conditions seems to solve the basic three problems of the economy, viz., what to produce, how to produce and for whom to produce.

ROLE OF THE GOVERNMENT

Under competitive conditions, various producing units tend to be efficient as resources are scarce and expensive and they must provide maximum utility at least possible cost. Under these conditions resources tend to be optimally utilized and there are no idle, unutilized or underutilized resources. Government always plays an important regulatory and developmental role. Government provides constitutional and legal framework for the conduct of business, facilitates productive activities by providing administrative and economic infrastructure promotes efficiency by encouraging competition and creates conditions for economic stability and growth. This is attempted through planning and various macroeconomic policies such as fiscal and monetary policies. Government also assumes a major welfare role. It takes care of the negative side effects of productive business activities like pollution and excessive urbanisation associated with increasing crime, public health problems and deforestation. It promotes equitable distribution of wealth and income through appropriate redistributive policies. All these measures complement direct welfare measures like unemployment allowance, old age pension, primary education and rural development. In fact, the very existence of an economy requires the presence of a government.

ROLE OF MONEY IN THE ECONOMIC SYSTEM

A modern economy requires money for the transactions to take place. The primary function of money is to facilitate exchange of goods and services. For that purpose, it acts as a medium of exchange. Money also function as a measure of value, a standard for deferred payments and as a store of value. As a measure of value, money acts as a unit of account in terms of which the values of goods and services are measured and recorded. Money as a store of value can be held as property over a period of time. Money is riskless as its face value remains constant. However, its purchasing power (called real value) may change as market prices change. In a narrow definition, money includes currency notes and coins in circulation and all demand deposits, which can be really withdrawn from banks to conduct transactions. This type of money is called 'transaction money'. In a broad definition other high-liquidity assets (called near-money) like saving deposits and money market funds are also included as they can be easily converted into money and used in transactions, called (broad money).

In an economy, money keeps on circulating like blood in the human body. As transactions continue, money keeps on changing hands. This leads us to the concept of velocity of circulation of money, which basically refers to the speed of movement of money in an economy. It may be defined as the number of times an average monetary unit changes hands in a given period of time, usually a year. The circulation velocity increases in boom times and get slow in periods of recession. Another related concept is income velocity, which is defined as the ratio of nominal GDP and total money supply.

Money is the lifeblood of an economy. It is created by the central bank of a country and its supply is determined by the banking system as a whole. The demand for money is due to the basic functions which money performs. There are, however, three basic motives for which money is demanded and these motives are closely related to the functions or attributes of money. First, there is transaction motive (related to the medium of exchange function) by which individuals and business firms need money to conduct day-to-day transactions. Secondly, the precautionary motive creates demand for money to meet unforeseen contingencies. These funds are kept in cash or in such highly liquid short-term assets that can be immediately turned into cash. Finally, money is demanded out of speculative motive by which individuals and business firms keep money in cash (or in near-money asset forms) so that it can be readily invested in assets whenever a profitable opportunity comes in the way. Transaction demand for money depends largely on the size of transactions and income level of the economic unit. The level of precautionary demand depends upon the income level, the attitude and perception of the economic units towards future risk. Rate of interest is a weak factor in the transaction and precautionary demand but a strong determinant of the asset demand for money.

Money is not a passive factor playing merely the role of medium of exchange in an economic system. It affects the rate of interest (cost of capital for business firms), consumption, investment, bank deposits, fiscal position of the government, national output, inflation and even balance of payments and the rate of exchange. The interaction of money with macroeconomics variables is included in the subject matter of macro-economic and there are various approaches and schools of thought explaining these interrelationships. The scope of the book does not permit any rigorous treatment of these areas but the essential parts of the discussion are included in the subsequent chapters.

CIRCULAR FLOW OF MONEY, OUTPUT AND EXPENDITURE

A proper understanding of the working of an economy requires an insight into the circular nature of transactions between its various functional segments including the government. The case exhibited is that of an open economy which is in transaction with the outside world. The economy is analytically divided into the four segments:

1. ***The Household Sector.*** It consists of all the consuming units (individuals, families, cooperatives etc), which also provide factors of production like land, labour, capital entrepreneurship and other services to the business sector.

2. ***The Business Sector.*** It consists of all the producing units, which obtain productive factors from the household sector and produce a wide range of finished goods and services for consumption. A number of products are produced and consumed within the business sector itself. Such products are raw materials, capital goods, intermediate goods, finished

goods and business services, which together are called industrial (or business-to-business) products. The producing units are agricultural farms, various types of small and large industries in the public and private sectors, infrastructure units, public utilities and service organisations.

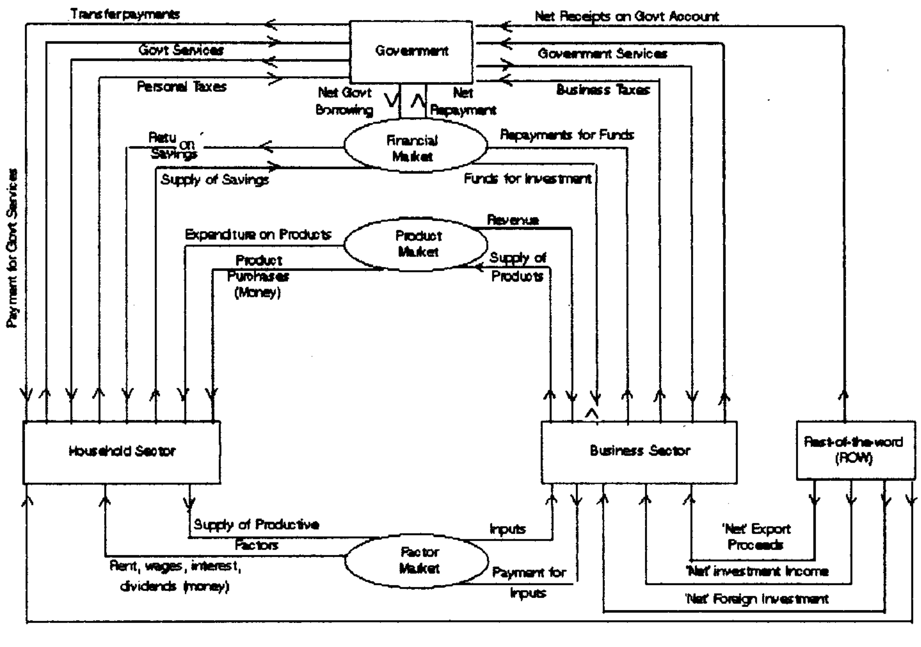
3. *Financial Sector.* It consists of a wide variety of banks and non-bank financial intermediaries who intermediate between the household and business sectors to provide a wide range of financial instruments and services (products) of short-term and long-term nature. Such institutions, apart from commercial banks, include mutual funds, development banks, investment banks, discount and finance houses, housing finance companies and investment finance companies with central bank and other regulatory institutions at the apex.

4. *Government.* Government viewed as a sector is a producer of various legislative, administrative and judicial services which are consumed by household and business and financial sectors and are indispensable for the economy to function. Government itself is a producer and consumer of a large range of other products drawing resources from the household sector. A number of government products (e.g. administration and national security) and not directly paid for. Different sectors of the economy have tax obligations towards the government, which are used to finance government expenditure of various types.

All of these sectors have regular transactions with the rest of the world, which includes foreign consumers, producers, governments and multilateral organisations like International Monetary Fund, World Bank, and World Trade Organisation.

BOX 6.1

Circular flow of money, output and expenditure in various sectors of an open economy



For the purpose of analytical convenience and better comprehension, the circular nature of transactions between the various components of the economy may be anatomized into the following relationship segments.

BUSINESS-HOUSEHOLD (B-HH) TRANSACTIONS

As described above, the household sector provides factors of production like land, labour, capital and entrepreneurship to the business sector as inputs. These factors, acting on the raw materials in the production system of business, produce a wide range of goods and services. The household sector gets paid for the supply of factors of production (and other services) in the form of rent, wages, interest and dividend in accordance with prices of these factors determined in the factor market (including labour market, land market etc.). These payments are called 'factor rewards' and constitute the income of the household sector. The household sector spends a part of the income on the goods and services produced by the business sector at prices determined in the product market. This household expenditure becomes the revenue of the business sector out of which it meets its various costs and earns a profit (positive or negative depending upon the state of costs and prices).

The rest of the household income is disposed off as saving and taxes to the government.

BUSINESS-FINANCIAL MARKET-HOUSEHOLD (B-FM-HH) TRANSACTIONS

The savings of the household sector are lodged partly in cash or idle hoardings (for precautionary or other motives), where the holders earn no interest, and partly as bank deposits or investment in securities issued by non-bank financial institutions. The rate of return depends upon the various factors like the demand for and supply of funds, the risk factors and term to maturity. Through the various financial intermediaries, the savings of the household sector are channelised into the business sector. Business sector demands such funds for expansion, modernization or diversification as per their project planning. The process of converting household savings into productive investment is called capital formation and is an important determinant of economic growth. The cost of capital paid by the business sector in the form of interest appears as revenue of the financial institutions which is disposed off as return to the household savers or investors, the rest going to meet the expenses of the institutions and earn a profit (if total revenue exceeds total cost).

BUSINESS-REST OF THE WORLD (B-ROW) TRANSACTIONS

In an open economy, business sector receives from the rest of the world (ROW) factor services (e.g. management), raw materials, capital equipment, intermediate products and components by way of imports and foreign capital as foreign lending or shareholding. In the same way, it exports to foreign firms and customers and makes investment in other countries in various forms such as collaborations, foreign subsidiaries etc. The two-way flow of trade, capital and investment income (by way of dividend or interest) generates net values, which can be positive or negative for the business sector. For example, if the trade balance is positive (exports exceeding imports), then the direction of transaction will be from ROW to business sector (as shown in the **Box 6.1**), otherwise it will be from business sector to ROW. The net flow of transactions between the business sector and the ROW predominantly determines the direction of balance of payments. The part of the business sector, which has transactions with the outside world, is generally called the external sector of the economy. A predominant part of the external transactions is in foreign currencies due to which the issues concerning the demand for and supply of foreign exchange and the rate of exchange between the domestic and foreign currencies emerge.

BUSINESS-GOVERNMENT (B-G) TRANSACTIONS

Business, like household sector, is the recipient of a number of administrative services for which it makes no direct payment. But there are a few services and utilities like electricity, water supply, waste disposal etc. which it receives from the government and for which it makes direct payment. It also receives subsidies and rebates on certain eligible items and the raw materials used in their production. Such rebates are on excise duty, sales tax and custom duty. Against such benefits, the business sector pays direct taxes (e.g. corporation tax) and indirect (e.g. excise duty and custom duty) taxes which are used by the government to finance its various expenditures. There is, however, no quid pro quo relationship between government services and tax receipts. A number of companies receive government shareholding, mostly through financing by public sector development banks, on which these pay dividends. Business firms also subscribe to government securities and receive interest income and associated tax rebates. The volume and nature of government-business transactions depends upon the size and self-sufficiency of business and the regulatory role of the government. Sometimes business sector is required by the government to perform such function like collection or deduction of taxes at source.

HOUSEHOLD-GOVERNMENT (HH-G) TRANSACTIONS

Household sector has a number of circular (as well as one way) transactions with the government. Household sector, like business sector, receives a number of administrative, public utility and infrastructure services some of which are directly paid for while others are not. The sector lends to the government by subscribing to its various securities and debt instruments and receives interest income, which is saved, invested or spent on products of the business sector. The sector makes a number of direct taxes e.g. income tax, wealth tax, and estate duty) payments and bears the incidence of commodity taxes. The sector also receives a number of transfer payments like unemployment allowance and pension, which are again used up in consumption savings and investment. Household sector is the largest consumer of government services. At the same time it is a supplier of manpower on the basis of which the government is able to function and produce various services. The transactions between the household sector and the government predominates the overall flow of funds in the economy.

GOVERNMENT-REST OF THE WORLD (G-ROW) TRANSACTIONS

Government, like the business sector, has a number of transactions with the outside world. Within the parameters of export-import policies, it conducts a substantial volume of canalized trade and receives payments for the services rendered. It also receives payments from foreigners for various types of administrative and economic services provided. It receives from and sends grants and relief to various foreign countries for various purposes. The government is a big borrower in the foreign financial markets. It borrows from foreign banks, other financial institutions in the market, governments and multinational institutions like International Monetary Fund and World Bank and makes repayments. Government also sometimes makes equity investment in joint ventures with foreign companies, and receives dividend income. Similarly, it has equity participation from MNCs in government companies on which it makes dividend payments. Government also spends substantial sums on the maintenance of embassies and consulates in foreign countries. All these transactions are summed up and balanced as 'net receipts on government account', which can be positive or negative.

HOUSEHOLD-REST OF THE WORLD (HH-ROW) TRANSACTIONS

In an open economy, just as household sector provides productive factors to the business sector. in the same way it can provide labour (e.g. consultancy services) capital and entrepreneurship or management to firms located abroad and receive factor payments in return. In the present computer age, the international movements of labour (e.g. consultancy and advisory services) and capital have become relatively easy. A number of countries like India have a large expatriate population from which the household sector receives substantial and regular sums of money as remittances. The household sector buys a number of consumer goods (directly imported) and services (like air travel) and makes payments in domestic or foreign currency depending upon the terms of transactions. The size and nature of transactions depend upon the export-import policy and foreign exchange regulation covering remittances.

These transactions depict the circular flow of money, output and expenditure in an economy. Some of the transactions are one-way while a few others fall out of the circular flow at some stage. For example, income of the household sector that goes into idle hoarding does not return to the system as investment or consumption. Then there are other leakages from the system. A part of the output or income could go unreported either because of lack of accounting or due to deliberate concealment to evade taxes or escape government attention. This generates black money and tends to establish a parallel economy, which remains, by and large, outside the control of the government. Further, in this circular system, two distinct flows can be identified - real flows and monetary flows. Both the flows are concomitant. Real flows are the physical product and investment flows. Monetary flows are in the form of nominal consumer expenditure and factor payments. The monetary value of these flows greatly depends upon the state of prices in the market. Similarly, physical flows of export and import of products (both consumer and industrial) are real flows and the payments arising from their transactions are monetary flows and are mostly in the form of foreign currencies (excluding barter cases). Remittances from the rest of the world to the various sectors of the economy are also monetary flows.

SECTORS OF AN ECONOMY: ALTERNATIVE CLASSIFICATIONS

In order to understand the structure of an economy, it is essential to understand its constituent sectors. Depending upon the nature of economic and business environment analysis, there exist a number of alternative classifications based on different criteria. The various sectors of an economy are identified or perceived on the basis of the nature of economic activity as well as various analytical and functional criteria. Some of the major sectoral classifications are as follows.

HOUSEHOLD, BUSINESS AND GOVERNMENT SECTORS

This is the most traditional but comprehensive sectoral classification of an economy. It consists of consuming private individuals or groups of individuals which provide various factor services like land, labour, capital and entrepreneurship or management to the business sector and receive factor incomes in the form of rent, wages, interest and profit. These incomes are partly spent on the goods and services produced by the business sector and partly disposed of as savings a part of which is converted into investment through the financial sector. Business sector includes both public and private sectors producing units which produce both goods and services drawing investible resources from the household sector directly as well as through the financial markets. Government produces a range of administrative, protective, supportive and regulatory services which are consumed both by the household and business sectors. Both the sectors provide funds to the government through taxes, lending and user charges for services provided to the by consumers. Government products are mostly public goods like national security, broadcasting services, flood control and social forestry, which are indivisible. The relationships between these sectors are described in the subsequent sections.

PRIMARY, SECONDARY AND TERTIARY SECTORS

This is a traditional but comprehensive classification of the business sector. Primary sector covers all economic activities relating to resources endowments of a country. According to the classification adopted by the Central Statistical Organisation in India, primary sector activities basically include agriculture, forestry and logging, fishing, mining and quarrying. Secondary sector covers manufacturing, construction, electricity, gas and water supply and tertiary sector encompasses trade, transport, storage, communication, financing, insurance, real estate, business services, public administration, defense and other services. In the primary sector, a number of activities allied to agriculture are also included. These activities cover land development, seed development, soil and water conservation, plant protection, conservation, upgradation and utilization of natural endowments, animal husbandry, dairying, irrigation, flood control and natural resources management. As the level of development of an economy improves, the range of economic activities in the various sectors diversifies which sometimes complicates the task of sectoral classification. In many cases some degree of arbitrariness is inescapable for classification of borderline activities between different sectors. Secondary sector is large and heterogeneous covering a wide range of manufacturing activities, infrastructure and public utilities.

DOMESTIC AND EXTERNAL SECTORS

Domestic sector consists of all the producing and consuming units which have no transactions with the rest of the world. If all the economic units in an economy had no transaction with the outside world, the economy would be called 'closed' or 'autarkic'. Such economies are rare in the present world. On the other hand, the units that have economic transactions with the rest of the world constitute the external sector. The external sector includes imports, exports, inward and outward foreign investments, servicing of foreign loans in investments in the form of interest, payments, amortization of foreign loans and repatriation of dividend income, unrequited receipts and payments in the form of cash and kind remittances, donations, gifts and grants. Multinational companies, foreign collaborations, foreign exchange markets, euro markets, multinational banks and financial institutions and exporters, importers and facilitating institutions in international business are major segments of the external sector. The sector also covers state trading and other international transactions on the government account.

REAL AND MONETARY SECTORS

This is an analytical classification often used in macroeconomic analysis. The distinction is drawn as the nominal or monetary values of variables could be misleading and the critical variables in an economy may depend upon 'real' (price-deflated) rather than monetary values of the causative factors. Further, the growth rate of an economy depends directly on the real factors and monetary factors play an indirect role through complex causative processes. Real sector of an economy encompasses output, employment, investment infrastructure, capital formation and all such real factors that have direct bearing on the behaviour and determination of these variables. In the determination of these variables, generally real (price-deflated) values of the causative factors are considered. Monetary sector covers the variables relating to money, credit and nominal rate of interest. The interaction between the real and monetary sector is one of the core concerns of macroeconomic analysis and a business manager must have at least a reasonably good understanding of the relations between the two sectors. The boundaries between these two sectors are only analytical and conceptual but the interaction is intricate with far reaching effects on the design of macroeconomic management. Professional business economists possess these skills and for that reason are generally in a better position to scan the present business environment and make predictions about the near future with a reasonable margin of accuracy.

Prudent macroeconomic management seeks to achieve a balance between the real and monetary sectors. If monetary sector grows faster than the real sector (due to declining rate of interest or fast expansion of money and credit supply), inflation may set in upsetting other macro-variables. On the other hand, if monetary sector growth is slower than that of the real sector, deflationary conditions may set in weakening the force of aggregate demand. Monetary authorities, under normal circumstances, tend to do monetary targeting in such a way that the growth rate of monetary sector is marginally higher than the real sector growth so that mild inflation is generated to maintain incentive for the real sector to grow.

PUBLIC, PRIVATE, JOINT AND COOPERATIVE SECTORS

The business sector is usually classified into public and private sectors. Co-existence of the two sectors characterizes a mixed economy. Almost all the economies of the world are in fact mixed economies; the different lies basically in the proportion of economic activities that fall between the two sectors. The relative size of the public sector vis-à-vis private sector depends upon the constitutional provisions and economic philosophy of the government, which are implemented through industrial policy. The public sector has the support of an enabling economic legislation. In a federal structure like India, public sector covers both central and state level units. Central public sector units in India, for example, have three broad organisation forms:

- *Departmental Undertakings* like railways, posts and telegraph and ordnance factories. These undertakings exist and function directly under a ministry. The enterprises are supported by annual appropriations from the treasury (through the concerned ministry) and its revenue is paid into it. The ministry controls the budgeting, accounting and audit and its permanent staff belongs to civil servant cadres. Such enterprises are generally of national or strategic importance.

- ***Government Companies*** are the joint stock companies registered under the Companies Act in which they are wholly or majority owned (shareholding of 51 per cent or more) by the government. These are created by the executive decisions of the government and approval of the parliament is not required. A government company has a separate legal personality and depending upon the extent of government ownership, directors are appointed by the government. Government has dominant control over such companies.

- ***Public Corporations*** are state-owned enterprises created by a special legislation. Their objectives, functions, management and organisational relationship with the government are defined under the legislation. These are generally independently financed; obtaining funds from the sale of goods and services as well as borrowings from the public and government. Under certain circumstances, these may receive appropriations from the government for capitalization or to meet losses. The kind of budgeting, accounting and auditing applied to departmental undertakings is not applied to the corporations. In a number of developed countries, public corporations are the predominant form of the public sector.

- ***Private Sector*** consists of a very large number of enterprises the size of which varies from very small to very large. Contrastingly, public sector enterprises are generally large-sized. In the private sector, there are innumerable tiny household industries on the one hand and large public limited companies on the other. The role and extent of the private sector is provided and constrained by the industrial policy of the government. This sector is competitive, profit-driven and tends to be customer focussed. Private sector development reduces the need for public investment and governments with fiscal problems generally tend to encourage private enterprise. To protect the public interest and fair play of market forces, there are various regulatory agencies of the government for different private sector segments and operations. Most of the regulatory measures are designed to protect the interests of consumers, investors, employees government and the public at large.

Enterprises in the joint sector have both public and private sector investments. The joint investment partly relieves the pressure for public investment and the government is able to share the gains of professional private management and technology in the private sector. Nevertheless, government plays an active role in controlling and directing joint enterprises. In such enterprises apart, from the government and private sector collaborators, public also can hold shares. Technically speaking, a joint sector enterprise can come into existence in any one of the following ways:

- New investment by government and private entrepreneurs jointly; or
- New investment by government companies (or public corporations) and private companies jointly through equity participation; or
- Equity participation or conversion of debt capital provided by public sector development banks to private companies through equity; or
- Acquisition by government or a government company of equity capital in a private company; or
- Sale of equity of a public sector company to a private company or companies as well as public.

Cooperative sector includes a large number of cooperative organisations mostly in the field of production, credit and marketing. A cooperative organisation or society is a voluntary and organized association of a number of persons driven by a common need for the purpose of carrying out collectively an economic function the dividends of which are shared by all the members. Cooperative form of economic organisation helps to prevent concentration of economic power and secures more equitable distribution of wealth and income. The cooperative movement has already made substantial progress in a number of developed countries like the UK, Sweden, Denmark and Japan and a number of East European countries. The foundation of the cooperative movement was established in India as early as in 1904 with the passage of the Indian Cooperative Act. The role of the government is generally great in fostering the cooperative sector. Government participates in equity and provides various other kinds of support like preference in land allotment, provision of infrastructure facilities, grants, financial assistance and subsidies, tax concession and purchase preferences. There are about 50,000 industrial cooperatives in India with a membership of about three million. Industrial cooperatives are most active in the fields of agro-industries, cotton ginning and pressing, textiles, storage, distribution, marketing, handicrafts, fishing, dairying, housing, retailing, agricultural implements, banking and credit. Indian Farmers' Fertilizers Cooperative Ltd (IFFCO) and National Agricultural Cooperative Marketing Federation (NAFED) are among the giant cooperatives. There are number of national level cooperative federations which assist the development of cooperative units in diverse areas. Some of the major national level federations are: National Cooperative Union of India (apex institution), National Agricultural Cooperative Marketing Federation, All India State Cooperative Banks' Federation, National Federation of Cooperative Sugar Factories, National Federation of Industrial Cooperatives, National Cooperative Housing Federation and National Cooperative Dairy Federation of India.

FORMAL AND INFORMAL SECTORS

The development economists concerned with the problems of inequitable development and poverty prefer the classification of an economy into formal and informal sectors. Formal sector consists of business units which are formally registered or noticed. These units are recognizable and are under some type of regulatory mechanism of the state. They maintain regular accounts which are verifiable and are generally aggregated and reported in some form or the other for monitoring. For that reason, the output of these units appears in the published national income statistics.

Informal sector consists of mostly petty or small businesses that are individually or family owned and uses labour intensive and simple technology. Workers in the sector are unskilled or semi-skilled and have little formal education. The benefits of minimum wages, bonus, proper working conditions or social security are not available to them like their counterparts in the formal sector. Most of the enterprises are merely for self-employment and have wide variety. The sector includes wayside tea-shops, dhabas, cobblers, hawkers, peddlers, street vendors, junk collection, snake charming, jugglery, petty mechanics and cleaners, barbers, small artisans, coolies, personal servants. Informal sector is generally large in poor and developing economies and is sometimes taken even as an indicator of economic development. Owners and workers in the informal sector are the marginalized classes of the society who struggle close to the subsistence level. Almost the entire income generated in the sector goes unreported as no proper accounts are maintained and as such escapes national income statistics. The sector breeds poverty, insanitation, urban concentration, slums and even crime. The sector grows fast under conditions of migration of rural population in urban areas and when employment opportunities in the formal sectors are limited or static. Haphazard growth of the informal sector is one of the core concerns of urban planners, municipal bodies as it builds pressure of demand on limited civic amenities.

Productive and Unproductive Sectors

Productive sector consists of all the activities which lead to increase in the production of goods and services. These activities are economic and cause value addition to the existing materials or services. Productive segments are responsible for economic growth of a country. These segments generate income on the one hand and increased output on the other. Productive activities can be direct as well as indirect. All manufacturing activities, for example, are directly productive whereas economic infrastructure like roads and communications and related services are not directly productive but provide indispensable support to production. Similarly social infrastructure like health, education and sanitation are not directly productive but support production in the long run through improvement in the quality of human capital.

Unproductive sectors are those where activities may generate money income but don't add the economy's output. Transfer payments (like pensions, unemployment allowance etc.), speculative activities including lotteries and horse races and subsidies are unproductive. Similarly, work of the people who are seemingly employed but don't cause any increase in production is unproductive. Such people are called disguisedly unemployed and can be withdrawn from work without loss of output. Incidence of disguised unemployment is commonly seen in family agriculture and government departments. Similarly, there are economic investments which can be unproductive. For example, unutilized investment or excess capacity in a firm is unproductive.

Endogenous and Exogenous Sectors

This is an analytical classification useful in macroeconomic analysis. Endogenous sectors constitute the economy in operation and are inextricably interwoven and interrelated. These sectors freely interact to determine various macro variables like income, output, employment, prices, rate of exchange and rate of interest, which are called endogenous variables. These are internal to and determined by the economic system. A predominant part of macroeconomic analysis is devoted to the study of endogenous segments.

Exogenous sector is considered external to the working system of the economy. The government and the central bank whose decisions with regard to the economy are autonomous generally compose the sector. The trends and conditions of the economy do have a bearing on these decisions but the decisions has no automatic relation with any of the endogenous variables. Decisions on money supply, deficit financing, external borrowing, taxes, public borrowings, public investment, defense spending and the like are exogenous in character. Decisions and actions in the exogenous sector greatly affect the endogenous sector.

Economic and Non-economic Sectors

This distinction closely follows that between productive and unproductive sectors. Economic sector consists of directly productive activities (like agriculture, mining and manufacturing) and infrastructure that directly or proximately supports economic activities. Such activities lead to value addition to a large number of product (including physical goods and services) lines, which satisfy human wants. Non-economic sectors, also sometimes called social sectors, include a wide range of activities which don't lead to consumable goods, and services but are an important part of human life. These include cultural, religious and other social activities like charity, literacy missions and social awareness campaigns (e.g. against smoking, exploitation of women and children, corruption and other social evils) that are undertaken not for financial or economic reasons but for social welfare and reforms. Activities like defense, administration and sanitation are also often included among the social sector. Economic sectors cause economic growth, social sectors add welfare or development dimension to growth. Improvement in the overall quality of life must be the end of all human activities. For this reason social sectors are all-pervasive and in resource-constrained developing countries a predominant responsibility of the state.

CONCLUSION

The different sectors of an economy do not fall in clearly demarcated categories. Functional or analytical sectoral divisions cut across a wide range of economic activities and in order to comprehend their fine boundaries, one must have a clear understanding of how an economy works? A business manager is interested in further sub-division of the sectors. A firm producing antibiotics, for example, is more interested in the developments that take place in the pharmaceutical industry, which is a part of chemical industry, which further belongs to the manufacturing sector. Finer divisions and sub-divisions permit a closer understanding of the sectoral environment that closely connect an individual firm belonging to it. At higher levels, the knowledge of the broad sectors, the interrelationship between them and of the macroeconomy as a whole is indispensable for the business manager. A number of variables like rate of interest, the rate of exchange and the rate of inflation are determined at the macro level but affect individual firms very closely. A business manager must watch these developments closely and integrate them into the practical decision-making and planning. The ability to do this re-requires a full understanding of the manner in which the economy functions.

Key Terms

Amortisation
Balance of payments
Broad money
Canalised trade
Cost of capital
Custom duty
Deficit financing
Development bank
Direct tax
Dividend
Economic growth
Euro market
Factor income
Factor market
Income velocity
Indirect tax
Intermediate product
Joint stock company
Joint venture
Monetary targeting
Money supply
Near-money
Public utility
Rate of exchange
Real estate
Rent
State trading
Subsidies
Transfer payment
Treasury
Unrequited receipts
User charger
Value addition
Velocity of circulation
Wealth tax

Supplementary Readings

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Long Questions

1. Describe the nature of major sectors of the economy. Explain inter-relationship between them. How does this inter-relation improve the understanding of a business manager about the economy?
2. Explain the role of the government in an economy. Is the intervention of the government in the economy desirable?
3. Discuss the role of money in an economic system. How does monetary changes affect the real sectors of an economy?
4. Explain the circular flow of money, outflow and expenditure in an economy. How is the flow affected by the transaction with the rest of the economy? What is the role of product, factor and finance markets in the working of the economy?
5. Differentiate between real and monetary flows in an economy. Explain the nature and working of the sectors that generate these flows.
6. Explain the nature and inter-relation between the following sectors.
   a. Domestic and external sectors
   b. Formal and informal sectors
   c. Public, private and cooperative sectors
   d. Exogenous and endogenous sectors.

Short Questions

1. Specify three transactions between each of the following sectoral pairs:
   a. Household sector and the government sector
   b. Business sector and the government sector

c. Household sector and the business sector
d. Business sector and the rest-of-the-world
e. Household sector and the rest-of-the-world.

2. Explain the working of the price mechanism in a free enterprise economy.
3. What is the nature of the monetary sector?
4. What are real economic flows? What is their relation with the monetary flows?
5. What is urban informal sector? List three challenges that it poses to the formal or organised sector.
6. Explain the importance of the cooperative and joint sectors.
7. List four major exogenous various variables that affect an economy.
8. How does market mechanism tends to maintain demand-supply balance in an economy?
9. Give five points highlighting the role of money in an economic system.

Practical Assignments

1. Study the latest Economic Survey published by the Government of India and find out the ways in which the government plays promotional and regulatory role in the economy. Circulate the report among a selected group of 8-10 students and hold a group discussion on the topic 'Is Indian Still Economy Over-regulated?'
2. Go through the latest RBI Annual Report on Currency and Finance and highlight the role of money in Indian economy.
3. Exhibit Box 6.1 before the class. Each student may be asked to give three examples of each relationship between various sectors of the economy. Hold a group discussion on how changes in one sector affect the development of other sectors.