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ECONOMICS: BASES OF ECONOMIC THEORY

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This textbook acquaints readers with the way modern society's economic life is arranged, the way individuals, enterprises, and institutions act, and the forms of cooperation established among them.

This is the 5-th edition of the textbook and evidence of its wide popularity and readers' recognition. The textbook was published in foreign countries as well, but this is the first edition in English.

One of the important advantages of this textbook lies in authors' ability to combine such peculiarities as well-grounded, comprehensive, and detailed research of issues with simplicity, liveliness, and graphic description of information.

This textbook is intended for students of higher educational institutions studying such disciplines as "Bases of Economic Theory" and "Political Economy". This textbook will be helpful for all those interested in problems of modern economy.

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INTRODUCTION

Economy is an essential part of everyone's life. We have to face different economic problems such as job placement, gaining of income, purchasing of different goods and services, tax payment, opening and using of accounts in commercial banks, purchasing of the stocks and other securities, obtaining and returning of a credit, currency exchange, achievement of efficient activity of those enterprises and institutions we work at, creation and development of our own business, and many others. Almost every day we hear such words as inflation, employment and unemployment, entrepreneurship, private and government sectors, competition and monopoly, taxes, budgetary policy, monetary policy, privatization, exchange rate, social policy, salary, pensions, investments, leasing, gross domestic product, export, import, customs barriers, trade balance, market, exchange, joint-stock company, profit...

It is clear that it is difficult to expect serious personal economic achievement and effective management by organizations without understanding the ways economic system functions.

Our mission is to help you in comprehensive understanding the ways the economic system we live in functions, to raise your chances in making sound economic decisions due to your knowledge and competence. This edition is intended for beginners and those who would like to extend, put in order, systematize or renovate their knowledge in the field of economy. We would like to emphasize that the level of society's economic knowledge is one of the factors of its economic progress. Besides, effective establishment of the institutions of power under the democratic system requires the availability of electorate's high level of economic competence. People's low economic competence gives opportunities for populism, demagoguery, and irresponsible statements.

That's why, to obtain good economic knowledge means to help yourself, your family, your city, your region, and your country. That is not pathos, it is reality of life.

The textbook proposed to your attention is interpretation of the bases of modern economy, real situation established in the world economy, its peculiarities, and prospects are taken into consideration as well.

The textbook consists of three parts (three modules) – “General Economic Bases”, “System of Market”, “Government Regulation. International Economy”.

Basic features of the object of the study, purposes and methods, and types of economic systems are given in the first part (Units 1 – 5); such basic economic concepts as the needs, resources, production potentialities, labour division, exchange, money, and economic role of property are considered as well. System of market interactions of economic subjects, demand, supply, price, market balance, entrepreneurship, competition, income, and operation of enterprises are considered in the second part (Units 6 – 12). Necessity, methods, the main instruments of government regulation of economy as well as the main problems of international economic relations are considered in the third part of the textbook (Units 13 – 16).

We believe the textbook is intelligible to the reader in its style and interpretation. All that, however, doesn't mean that mastering the bases of economics will not require any efforts. That's not true: it, certainly, will require significant mental efforts. But, herein, we would like to assure the reader sincerely: your efforts will not prove to be vain, they will give you practical benefit, and you will improve your own economic knowledge. We believe that the readers will not be disappointed with the proposed textbook.

Part 1.

GENERAL ECONOMIC BASES

UNIT 1. ECONOMIC THEORY: SUBJECT, MEANING, METHODS

Everybody of us has a lot of problems in our life. It is not a secret, for example, that young people can have problems in their relationships with parents and friends, in love, cloths, money and so on. To solve their problems people have different approaches: spontaneously or reasonably, relying on their parents', their friends' advices or on their own experience and understanding. Often we use such characteristic as: "by experience". And usually when a person acts relying on his own experience the chances to solve the problem successfully rise enormously.

Many sciences are dedicated to give this experience and to help people to solve their problems better. Economic theory is one of such sciences. It is dedicated to give the knowledge of "economics" which plays a great role in our life. We will not prove that this is the main problem, but everybody will agree with the statement that it is in the list of the major problems.

In this unit we would like, first of all, to answer the three questions:

1. What does economic theory study?
2. Why does it study for?
3. What way does it study in?

Besides, we would like to present you the most outstanding economists, both of the past and of the present day and make a short excursion into the history of economic thought.

1.1. Subject and meaning of the economic theory

Subject of economic theory

Economic theory is among the sciences which study a man, his behavior and relationships with other people. A man's life is quite variable. The activities to which a man devotes his lifetime are variable, his lifetime is invaluable and it is impossible to reproduce. In figure 1.1 only some, randomly taken directions of man's activity are shown.

"The good things of life (goods)" shown in the figure present the set of things and services which are necessary for a man's life according to his understanding. They are as following: food staffs,

clothes and shoes, apartments, transport vehicles, furniture, TV set, telephone, computer, drugs and many other things. It is not difficult to be convinced that all these things do not exist in the nature (with some exceptions) readymade. All necessary goods must be produced and appropriate mental and physical efforts and some natural things must be spent. Nothing will come itself. It means that a man must devote part of his time – and rather significant one – to create these goods insuring himself and other people with all necessary for life.

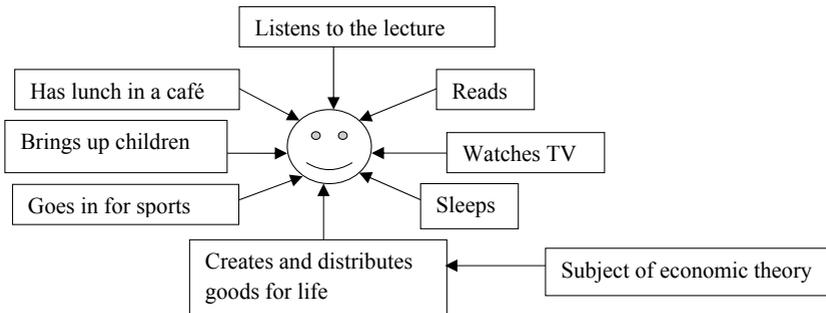


Fig. 1.1. Spheres of man's life activity

In what way does a man solve the problem of creation of necessary goods? Does he do it himself or in cooperation with other people? The answer is evident: there are no Robinsons in a contemporary society, and people must communicate and cooperate to solve their individual economic problems better. This can be defined as a necessary condition to rise economic protection of an individual.

While cooperating, people make decisions about the following: what to produce, how much to produce, how to produce, and who will own the created goods. The last issue is a problem of distribution of created goods among the members of society. All people can not get enough of everything they would like to have. People have to get and develop some definite order for distribution of the manufactured products.

It means that at first sight we can formulate the subject of the economic science as following: economic theory studies the people's activity connected with goods production and distribution.

Specialization of the subject

To develop the above mentioned statement we'll pay attention to some key issues of the people's economic activity.

Firstly, it is impossible to create goods without necessary original natural substances and some instruments for its processing, without labour costs and organizational efforts. All the components necessary to create goods such as natural raw materials, land, workforce, technical facilities, buildings, managerial abilities - are called economic resources and they are limited. The reserves are always limited. The production opportunities to manufacture the desirable goods are limited in total. Secondly, people are organized in such a way that it is difficult for them to struggle with their wishes to improve insurance with goods. The needs are continuously rising. You can blame or welcome it but the reality is such as it is, and you have to take it into consideration.

These are two critical characteristic features of people's economic activity. It is not difficult to notice the controversy: resources are limited, and needs are unlimited (figure 1.2).

What's the solution? To economize! People's economic activity is realization of choice and such organization of goods production which are oriented to satisfy the people's needs in real conditions in the best way.

Thus, you can define more precisely definition of the subject of economic science formulated earlier: economic theory studies people's activity connected with achievement of the effective use of the limited resources for the best satisfaction of the needs in goods.

How do people solve this problem of effectiveness? What principles of relationships are used for this purpose, what forms of cooperation are established, what role do different institutions play (enterprises, market, government)? Economic theory must explain all these and other questions.

Levels of economics learning

Economic phenomena can be examined at different levels. You can examine national economy as an object, that is, the economy of the country as a whole. Such approach is called Macroeconomic. *Macroeconomics*, therefore, is the branch of the economic science studying economics as a whole. Such problems as the volumes of the national production – indexes and dynamics, distribution of the national product, employment and unemployment, changes in the total level of prices (inflation and deflation), role of the state in economic life of society and some others are in the focus.

If you examine economic activity of some economic individuals – people, enterprises, organizations, - then such approach to economics learning is called Microeconomic.

Microeconomics is the branch of economic science studying behavior and relationships of different economic individuals at the

levels of local and private economic connections. One can include demand, supply, price, salary (wage), profit, entrepreneurship and so on in to the economic phenomena of microlevel.

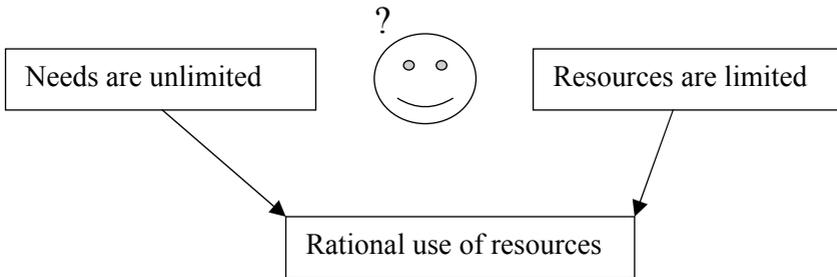


Fig. 1.2. Needs, resources, economy

There are no special separations between micro- and macroeconomic analysis in the basic course of economic theory. Some special “mixed” studying of economic phenomena and processes is used. At the same time there are special disciplines – “Microeconomics” and “Macroeconomics” where the appropriate approaches are kept to strictly enough. Usually these disciplines studying is carried out as development and deepening of the basic course in economics.

Purposes and meaning of the economic science

It is necessary to notice that the main purposes of economic science are the following:

- finding out and formulation of economic laws;
- transmission of the gained results for the use in the daily activity of the society’s members.

Knowledge becomes a science when the researchers are able to find out and formulate the laws. Economic science is dealt with economic laws learning (they are also called as economic principles, economic generalizations).

Economic law – is a stable, repeated, typical connection between economic phenomena. To learn economic law means to establish existence of the strong dependability between economic phenomena in some definite conditions.

There are many economic laws. Some of them are not difficult to find out while estimating the events taking place in our life attentively. For example, the workers pay out the definite part of their incomes into the budget of the state in the form of taxes. One can notice

that, in the greatest part of cases, people increase the consumer costs when the rate of the income tax is reducing, that is, they spend more money to buy goods and services. Such stable, typical connection exists between two economic phenomena: rate of income tax and value of consumer costs.

Here is one more simple example of economic law. The price reduction for the definite product, as a rule, results in the increasing of the quantity of the given product purchases. Parents, for example, give in easier to children's demand to buy a chocolate bar or a popular toy in such case. Here we can trace two phenomena and there is regular connection between them, - the price for the unit of the product and the quality of the purchased product.

However, not all economic laws can be discovered in such a simple way. There are many less evident economic laws. For example, it is more difficult "to see" the dependability between deficits of the state budget and the level of inflation of the country, balance of payment of the country and the rate of the national currency and many others. You can't understand this situation only with the help of life experience, you need special economic knowledge.

It is necessary to notice, that "white spots" in economic science always existed and will exist - economic science will never be able to present "the whole" and "the completed" picture of society's economic life. It is impossible because the economic relationships are not stagnated, once and forever given, they are movable, changeable, and it means that they are changing depending on the relationships of economic phenomena.

Economic science is devoted to give people knowledge of economic laws, to give the society gained results. Understanding of economic laws gives the opportunity to foresee what can happen in one or another situation, and what economic events are more probable in these or those conditions. The best fishermen are those studying the manner of the fish behavior and effectively using this knowledge. The knowledge of economic laws does not guarantee a rich "catch" for every one of us. A lot of other conditions influence the result of that. But one is evident - good economic education increases individual chances for the success in economic activity, for economic welfare of the family and a business.

1.2. Methods of economic life learning. Special features of economic laws

Induction and deduction

The achievement of the purposes of economic science is connected with the use of definite methods in learning of society's economic

life. The basic methods of economic science research, as any other science, are the methods of induction and deduction.

Induction is movement of the research from separate, definite facts to the general conclusions, and generalizations. Economist begins with the research of facts in this case. The facts are the statistic data, results of the questionnaires, visual observations and some other for the economist. Analyzing, systematizing, and generalizing facts, the economist comes to conclusions in which he fixes the existence of definite dependability between economic phenomena.

Deduction – is putting forward the hypotheses and their future examination with the help of facts. Hypothesis is the assumption of the definite dependability existing between economic phenomena. The hypothesis usually arises on the basis of some nonsystematic observations, practical experience, intuition and logical reasoning. **Hypothesis** is the advanced judgment demanding examination with the help of facts. Using the facts, economists either reject the judgment as not corresponding to the facts and that means mistaken one, or prove its correctness.

Abstracting

Researching some economic phenomena, economists can't learn all its details. They must refuse in attention to some characteristic features and properties of the examined phenomena.

Abstracting is intentional simplification of the researched object by excluding some of its details from the analysis. For example, we research such element of the economic life as money. We are interested, for example, in the reasons of money appearance in economic system, its influence on different economic processes, relationships of money and other economic elements. With that we do not pay attention to the colors, artistic design and system of protection from fake, resistance to wear and tear, and some other details of the paper money. The reader must not think that economists seek for the ways to ease their work; this is an unavoidable and absolutely necessary measure. Economists must “clear up” the phenomena from some details, simplify it to reach real results – to show mutual dependability of the economic phenomena. Only in such way they can create some ordered picture of the reality from the unbelievable majority of different economic events, a working model, which can be used in practice.

Assumption “under all other equal conditions”

Perhaps this is the largest stumbling-stone for the usual economic way of thinking in understanding of the possibilities, role and special

features of the economic theory. Misunderstanding results in unfair reproaches to the economists' address.

Thus, the economic science formulates the economic laws or principles where it is pointed out that coming of one event leads to the coming of another. It was mentioned earlier, that reduction of income tax results in increasing of consumer costs and reduction of the price of goods results in increasing of its purchases. But only “under all other equal conditions”, that is, with the influence of other factors (and they are necessarily existing) on the volumes of consumer costs or purchases, they stay *unchangeable!*

If, for example, the total reduction of people's money income is up to 10 percent, and the rate of the income tax is reduced up to 5 percent, then no increasing in consumer costs will be able – the total sum of money which people have will be reduced.

That is why, “all other equal conditions” will be unchangeable values of the received incomes, rates of interests on banks accounts for the given economic law (figure 1.3.) (if they, for example, increase, then people will be able to increase not their consumer costs, but investments in banks after reduction of the income rate) and other factors that have the influence.

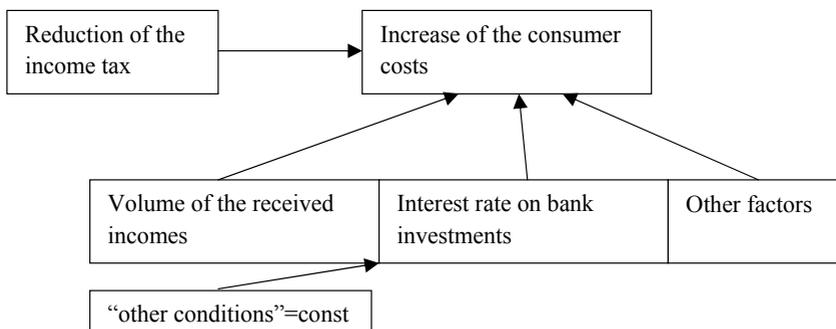


Fig. 1.3. Explanation of the assumption “under all other equal conditions”

Economic life is very complex. It is necessary to simplify it while researching to understand it. Work schemes and models, presenting economic reality “not in all its colors”, are necessary. Economic theory is not like the pictures of Clod Monet and other impressionists (a lot of color shades and unclear shapes) but is not like the pictures of the representatives of realism in art as well. Economic theory can be compared with the black-and-white sketches in art.

Economists offer the ground of the economic life like models. But you have to be able to “read” and use economic models in the right

way, and it presupposes realistic understanding of the opportunities and peculiarities of economic theory. It must help to understand the logic in behavior of economic individuals, their most probable solutions, their probable consequences and to create its own expectations and action plans on this basis.

Features of economic laws

The analysis of the *features of the economic laws* will serve for the exact understanding of the opportunities of the economic science and conditions of the use of its results.

Economic laws are *less strict* than the laws of the natural sciences. The majority of the last ones have an absolute character: under definite conditions some reason will result in some consequence, that is, in 100 cases from 100 those happened the connection “reason – consequence”, defined as the law, will work.

For example, under some temperatures the water always boils or turns into the ice. And there are no exceptions there. You can try to find such a rectangular triangle where the sum of squares of cathetues will not be equal to the square of hypotenuse. These searches are useless, aren't they? There are no such absolute laws in economics. Economic laws are softer. That's why, such expressions are used as “principle”, “generalization” to avoid such a strict word as “law”. It is not necessary for everyone of us to buy more matrix or to go to the dances more often when you see the reduction of the price for CD discs or for the disco club visiting. In economics the laws define the most probabilistic connection. This is indication that something must happen or will happen.

It is connected with the point that the economic theory is dealt with a man. His behavior is complex, it is defined by many circumstances. Economic theory is based on the fact that a man acts according to the principles of rationality, estimating benefits and costs. However, the people's actions have some irrational, unconscious, and uncontrollable emotions.

“Legal” or “Normal” economic actions are those which are expected from people in definite conditions.

Economic laws historically are *less lasting*. Natural laws are the “laws-long-livers”. Temporal space of life of natural laws is enormous if not endless. Economic laws, as a rule, have limited period of “life”. It is connected with the fact that personal relationships are more movable, personal activity in different spheres is changing constantly. Both conditions and forms of economy are changing, that is, the laws are changing.

The change of the day and night (natural law) is characteristic both for the period of living of the primitive-communal society and

for modern civilization. For example, the conditions of exchange operations, and formation of prices have changed greatly.

Economic policy

Understanding of the nature of economic phenomena, the relationships and peculiarities of economic laws must help people make effective decisions according to economic problems. *Economic policy* is considered as the measures directed to the decision of economic problems.

People cooperate in deciding economic questions. Economic policy regulates people's behavior and influences them. Economic policy is the subject of discussions in the society. For example, politics and managers argue actively.

People would like to listen to the economists' advices. However, the economist may express different judgments and recommend different measures. We often become witnesses of the discussions led by the economists themselves.

Economic points of view can be divided into positive and normative.

Positive economic points of view set up the really established economic ties without estimating whether they are good or bad. Positive economic theory accepts the reality as it is. For example, positive economics defines what inflation is and what its reasons are, which factors influence the currency rate, what instruments of the state regulation can help influence the export and import flows of goods and so on.

Normative economic judgments are the estimating judgments concerning the issue what economic ties must be, what economics must be, and what decisions should be made. Normative judgments may be connected with such issues as: what must be the role of the central bank of the country in definition of the currency rates, what must be the export or import duties. The following factors influence the normative judgments: economic world view, ethic values, party membership, level of culture and so on.

1.3. Historic process of economic science development

First economic theories

We gain the knowledge about the ancient people's economy life from the old ages. This knowledge is not full and cannot apply even for the role of the separate elements of economic theory. A special place is taken by the works of the great Greek philosophers such as

Xenophon (he introduced the notion of “economy”), *Aristotle* (thought about goods and money) and *Platon* (developed a theory of ideal society). The first theoretical thoughts of economic life appeared in the XVth – XVIIIth centuries. Mercantilism and Physiocracy are thought to be the first economic theories.

Mercantilism. Many European countries in the period from the XVth up to the middle of the XVIIIth century were influenced by economic theory of Mercantilism. The greatest representative of this direction of economic thought was Thomas Mun in England. One of the mercantilists – a Frenchman *Antoine Montchrestien* – gave a new name to the economic science – “*political economy*” (his work “*Treatise on political economy*”, 1615).

The term of “political economy” consists of three words: “politeya” (the organization of the society), “oikos” (a house, a household), “nomos” (law). Together it means: laws or rules of the economy.

Mercantilism can be considered as recommendations to the state related to the whole economy, and management of the state’s economy. The essence of mercantilism was in the following: the wealth is, first of all, the gold, with the help of which you can buy everything. The trade gives the gold. Those states become wealthy which are able to import a lot of gold without its export. So the state has to encourage manufactures producing goods for export, trade dealing with export of goods, prohibit the export of the gold itself, and to limit the import of goods from the other countries, for which it has to pay the gold.

Physiocracy. France was a centre of physiocratic ideas. They were the most popular in the middle of the XVIIIth century. The greatest representative of physiocrats was *François Quesnay*. The notion “physiocracy” consists of two words - “physis” (nature) and “cratos” (power). Together they mean power of nature.

The main hopes for the society’s economic development were connected by physiocrats with agriculture. In their opinion, the state has to give up the practice of supporting industry. The products of agriculture and other natural resources are the real source of wealth. The real wealth comes from the land.

The best for the state is, as physiocrats stated, to give the events to develop in their natural way without interference into the entrepreneurship. This idea was expressed as “let it be as it is”.

Classical political economy

One of the most significant books during the whole history of the mankind civilization appeared in 1776. It was named “*Research about the nature and reasons of peoples’ wealth*”, its author was *Adam*

Smith, professor of philosophy from Glasgow. Later he was named “father of economy”.

You can say that the basis of political economy as an independent science was laid by Adam Smith.

Adam Smith thought that the wealth of the nation is created in the process of production and not only agricultural production. The labour productivity is a decisive factor of the economic opportunities of the nation. The use of labour division, competition, and market increases production opportunities of the society.

A state in Adam Smith’s opinion must realize only the minimal interference into the economy. Here he used the idea of physiocrats – “*laissez faire*”. A market itself, as Adam Smith argued, will do all necessary for the effective distribution of resources, production organization, distribution of goods and profits. He compared a market with an “invisible hand” which effectively directs individual economic forces. Two outstanding theorists of the classical political economy are the two representatives of England: *David Ricardo* (“The basis of political economy and taxation”, 1817) and *John Stuart Mill* (“Basis of political economy”, 1848).

Development of classical traditions

In the second part of the XIXth century the classical political economy was significantly theoretically supported. The outstanding group of the greatest economists of the *neoclassic direction* appeared: *C. Menger*, *F. Viser*, *J.B. Clark*, *E. Bem-Bawerk* and other.

The most significant contribution to the economic science by the representatives of this generation of the economists was made by *Alfred Marshall*, as it is considered. His significant work is “Principles of economic science”, 1890.

Neoclassics modified significantly the theory of prices developed by the classics. They introduced such notions as demand, supply, price equation and so on. The purchaser was given a rather significant place in price formation by neoclassics. Classical school focused their attention on the role of producer as a main person in the process of the price formation.

Mathematical methods, schemes, and psychology were introduced into economic science actively in this period. Neoclassics changed the traditional economy significantly. In the end of the XIXth century and at the beginning of the XXth century the term “political economy” was used more seldom. More often economic theory was called “economics” as more general notion. Neoclassical ideas were introduced in the XXth century.

Marxist alternative

About the middle of the XIXth century one more direction was developed in the economic science as an alternative to the established economic traditions, – it is **Marxism**.

Karl Marx was born in Germany but when he was 24 he left his motherland forever because of political reasons and spent the major part of his life in England. In 1867 his first volume of the fundamental work “Capital” was published. The second and third volumes were edited and published by his friend *Friedrich Engels* after the author’s death.

Karl Marx considered that economic development was fully defined by the function of economic factors, and one can understand the reasons of the events only through the analysis of the economic forces function. The head stone of the Marxist doctrine is the theory of added value. The last one is the difference between the value of the product and the value of the labour force, which creates that product. Capitalist owns the added value unfairly and exploits the labour in such a way. Karl Marx made a conclusion about the inevitability of the capitalist system failure, because unsolved internal contradictions are laid in it: capitalists eager to reduce their costs in wage, but with that the reduction of the society’s purchasing opportunities takes place, and the crisis of production happens. Finally, the workers, in Karl Marx’ opinion, will throw away the power of the capitalists-exploiters.

“Revolution” of Keynes

English economist *John Maynard Keynes* is considered the greatest economist of the XXth century by the majority. One can read such sentence about him: “theorist who opened up the way for the economics into the XXth century”. Keynes’s ideas really influenced greatly the world development in the XXth century.

The most famous Keynes’s book “The general theory of employment, interest and money” was published in 1936. Some basic economic ideas of the author were presented in it. Among them there are those which allowed to talk about “Keynesianism revolution”.

What revolutionary ideas were presented in Keynes’s theory? First of all, the fact that he reviewed significantly the classical definition of the economic role of the state. In Keynes’s opinion the state must refuse the policy “laissez faire”, take active participation in regulation of economic processes, and realize macroeconomic policy of stabilization.

It is necessary to notice that by that time economic reality had overflowed the frames of traditional schemes, according to which the market “will do everything itself” in the best way. The facts witnessed

the significant level of unemployment, essential fluctuations of the volume of the economic production, unstable general level of prices and other unfavorable phenomena. Keynes theory diagnosed and offered the receipts for the treatment of these economic diseases. In particular, it was supposed that only active financial policy of the state, which stimulated the demand, could cope with the problem of mass unemployment.

Keynes laid the basis of the theory of the mixed economy – the system of interrelation of market and state regulation of the economic processes. At present Keynes ideas are wide spread, state regulation of the economy is considered to be something taken for granted.

Modern tendencies

First of all, the discussions on the great economic problems became characteristic for the economic science of the second half of the XXth century and the beginning of the XXIst century which take place in the aspects of definition of the most effective correlation of the market and state regulation of the economic processes.

In the frameworks of Keynes tradition the ideas of fuller consideration of the factors of economic growth are developed, the models of the state regulation for the different stages of economic cycle, and the use of tax-budget instruments of regulation are developed (*R. Harrod, E. Domar, J. Robinson*). *Neoclassical ideas* of the liberal state influence on the society's economic life are supported by the representatives of monetarism (*M. Fridman*), neoliberalism (*F. Hayek*), theory of the socially-oriented market economy (*L. Erhard*), economy of supply (*A. Laffer*). The special place is taken by the school of the neoclassical synthesis (*P. Samuelson*), which recommends to give preference either to Keynes or liberal approaches, depending on the conditions in the economy.

CONCLUSIONS

1. Economic theory studies people's activity connected with creation and distribution of the goods, that is, the activity directed to achievement of the effective use of limited resources and to the best satisfaction of the needs in the goods.

2. Economic phenomena can be studied at the different levels: macroeconomics – the study of economy as a whole, microeconomics – the study of the activity of the separate economic individuals.

3. The purposes of the economic science are the definition of economic laws and transmission of the gained results to the society's members for the use in the daily life. Economic law (principle, generalization) is the stable, repeated, typical connection between

economic phenomena. The knowledge of economic laws is necessary, first of all, to understand what economic events you have to wait for in these or those conditions, to make effective economic decisions.

4. The main methods of economic phenomena learning are induction and deduction. Induction is movement from separate, particular facts to the general conclusions and generalizations. Deduction is putting forward a hypothesis and its examination on the facts. Economic laws “function” only “under all other equal conditions”. The connection expressed by the economic law has a probabilistic character.

5. Economic policy is the measures taken and directed to solution of economic problems. It is the subject of discussions. Positive economic points of view establish really formed economic connections without their estimation. Normative economic points of view are estimation judgments related to the issues: what economic connection must be, and what decisions must be made.

6. Historical process of development of economic science can be presented by the following main schools: mercantilism, physiocracy, classical political economy, neoclassicism, Marxism, and Keynesianism. Correlation of market and state regulation of economy is the main aspect of modern economic discussions.

The main terms and concepts

1. Economic theory
2. Macroeconomics
3. Microeconomics
4. Purposes of economic science
5. Economic law (principle, generalization)
6. Deduction
7. Induction
8. Assumption “under all other equal conditions”
9. Economic policy
10. Positive economic points of view
11. Normative economic points of view
12. Mercantilism
13. Physiocracy
14. Classical political economy
15. Neoclassicism
16. Marxism
17. Keynesianism

UNIT 2. THE NEEDS, RESOURCES, PRODUCTION POTENTIALITIES

Any person who has decided to start his own business must answer a lot of questions: where to find the sources for the start-up capital, how to find the necessary premises, who to organize a partnership with, and what bank to choose to open an account in and so on. But the first question to answer is – what to produce, what sphere to apply one’s efforts in? This is a key question of any economic activity. The whole society has to solve it, not only an individual.

Modern economy with a lot of indirect, intermediate, and hidden relations hides the evidence of the answer to the question “what to produce”. If Robinson or even a modern summer resident was asked that question, he, of course, would answer: “The thing you need”.

The needs are diverse, versatile and they are constantly changing. At the same time, production relations are always carried out taking into consideration the existing limited resources. Aspiration to satisfy the growing needs for each given moment is faced with the relatively limited resources. The second chapter is devoted to this ***main contradiction of the economic activity***, where two sides of the mentioned contradiction (the unlimited needs and limited resources) and mechanism of its solution through the increase of production potentialities will be analyzed.

2.1. The needs as a driving engine of the economic activity

The essence of needs

The notion of “needs” is very widely used in modern economic theory and some other sciences.

The theory of management, while studying motivation of person’s behavior, discovers that the driving motive of these or those actions from a person’s side are the needs.

Philosophy of marketing, confessed by a lot of modern entrepreneurs, states that the firm’s success is defined by the ability to discern and satisfy the customers’ needs in the best possible way, and that list can be continued. So, what are the needs?

The needs – are the internal driving motives of a person’s activity. In other words, this is the state of unsatisfaction which a person wants to change or the state of satisfaction which a person wants to continue.

An individual, as a rule, is aware of his own needs. He understands that he has to eat, drink, and sleep, to dress himself and so on. However, there are many needs, which he is not aware of. For some

time they are held deeply in him, and one or another stimulus can release these needs.

An ancient hunter strives for a wildfowl to satisfy his starvation, a student reads a book to satisfy his need in knowledge, a family goes to the theater to have a rest and to meet friends...These examples set one thinking that these or those actions of an individual are caused by the needs. But then the problem arises: where do the needs themselves appear from? Is it possible to argue that the need is a flight of a person's imagination, fiction, which arises in a person's consciousness? This statement is true to some extent. But, as a rule, the needs arise not on an empty place, and are themselves a consequence of economic activity. That's why, on one hand, there must be one definite need for a person to be engaged in some economic activity, and, on the other hand, just this activity gives a rise to a new need.

Classification of needs

Versatile persons' activities can be grouped using these or those classification characteristics. Here are some possible *ways of classification of the needs*.

1 *According to the subject* (individual):

- a) final needs;
- b) intermediate needs.

Final needs — are the needs of a person himself as a biosocial being. They can be called the personal needs. An individual himself is created as a result of their satisfaction. The material values satisfying final needs are called the items of consumption. They are the following: food, cloths, shelter and so on. In the result of consumption these material values are consumed and go out of economic turnover.

Intermediate needs are just indirectly related to an individual himself. These are the needs of the economic pattern. Their satisfaction serves the creation of the new material values. That's why such needs are considered as production needs, and material values, satisfying them, are called the means of production (machine tools, equipment, metal, grain combine and so on). These material values are not eliminated in the process of their consumption, but they are transformed and serve to satisfy the other intermediate or final needs later on.

2 *According to the form of satisfaction*:

- a) individually satisfied;
- b) collectively satisfied.

An individual can satisfy the first group of needs without joining other individuals. The following ones can be attributed to them: the need in sleep, food and so on, but, for example, the need in water supply in the cities is satisfied collectively.

3 According to the origin:

- a) primary needs;
- b) secondary needs.

Primary needs are physiological in their nature, and, as a rule, innate. For example, there is the need in water, sleep, breathing and so on.

Secondary needs in their nature are socio-psychological, for example, the need in success, power, respect, and love. The primary needs are laid genetically, and secondary ones are realized when the life experience is gained. As people have different gained experience, the secondary needs of people are different, maybe, to a greater extent, than the primary ones.

Hierarchy of needs

It is impossible to satisfy all the needs simultaneously. That's why a person must decide each time what need must be satisfied at the moment, and what one may be delayed. In other words, he classifies the needs, places them on the stages according to the extent of importance at each given moment. The well-known in economic literature A. Maslow's pyramid can help understand what way such subordination happens in. All the needs can be divided into five main groups (fig. 2.1).

1. Physiological needs, satisfaction of which is necessary to survive.
2. The needs in safety and protection include protection from physical and psychological dangers of the surrounding world and confidence that physiological needs will be satisfied in future, too.
3. Social needs – the notion including the feeling of belonging to something or somebody, the feeling that you are admitted by others.
4. The need in respect includes the need in self-respect, competence, and recognition.
5. The need in self-expression – the need in realization of one's potential abilities and development as a personality.



Fig. 2.1. Hierarchy of needs by A. Maslow

Utility and needs

At each special moment of time an individual will strive to satisfy the need which is the most important and intense for him. Before a demand of the next level will become, the most powerful defining factor in a person's behavior, a demand of the lower level, must be satisfied. Of course, such approach doesn't consider individual needs of a person, but specification of the economic relationships lies in the fact, that they are displayed as tendencies only in mass phenomena.

What criteria does a person follow to define his attitude to consumption of these or those benefits? Evidently, he strives to satisfy firstly those needs, satisfaction of which will bring him the greatest utility.

Utility – is the extent to which a benefit is able to satisfy this or that demand of a person. It is not difficult to notice close connection between the utility of a benefit and its consumed quantity. If you imagine a benefit divided into equal parts (say, a large dish of pies), then the utility of each new consumed part will have a tendency to go out. Let's mark conventionally the utility of the first pie with coefficient 10. Having eaten it, a person has partly satisfied his hunger, and the second pie will have less utility for him, say, 8. Accordingly, the third will have 6, the fourth – 4 and so on. A moment may come, when a new portion of a benefit will have negative utility, that is, not to satisfy a demand, but bring some difficulties to consumer. Thus, one can argue, that portions of some benefit, which are consumed in succession, have the diminishing utility for a consumer.

Marginal utility – is utility of the last portion of the benefit coming at the consumer's disposal. Conventionally, it can be presented by a formula

$$MU=DU:DQ,$$

where MU – marginal utility;

DU – growth of total utility;

DQ – growth of consumed benefit (quantity).

Marginal utility depends both on importance of a demand satisfied with this benefit, and its scarcity. Just with the last one it is possible to explain the difference in consumer estimation of the portions equal in weight, say, gold and ferrous metal.

The law of diminishing marginal utility is illustrated in fig.2.2, which states, that the utility of each new portion of a product for a consumer becomes less than previous during the process of demand satisfaction. Naturally, that the curve of marginal utility has a negative slope. The total utility of a benefit is presented by an area, limited with the axis and a curve of marginal utility.

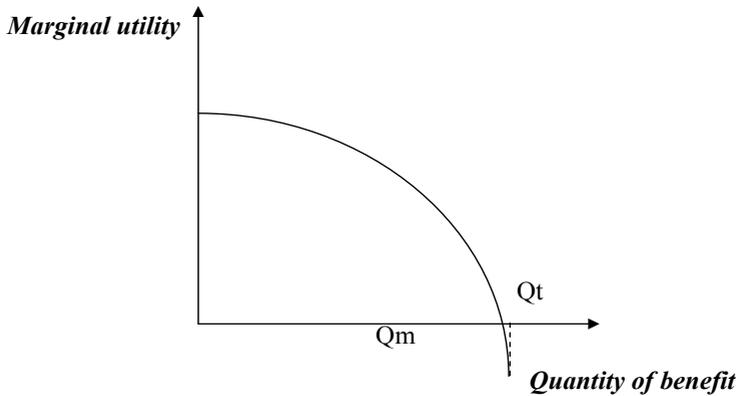


Fig. 2.2. The curve of marginal utility

Marginal utility of a benefit equals zero in Q_m point. It means that there is quality of a benefit, which fully satisfies the needs in it. Its further increase will result in appearance of the negative utility, that is, losses, unjustified consumer costs (it is section $Q_m Q_t$ in the diagram (graph)).

The utility of a benefit is related to its ability to satisfy some definite needs. One and the same benefit can be able to satisfy some different needs. Thus, a car (fig.2.2) can be considered both as a means of transport and as a means to win a definite social recognition, and as a means for self-expression. That's why, one and the same car can have the greater utility for transportation of the harvest from summer cottage and can't satisfy a demand in prestige completely.

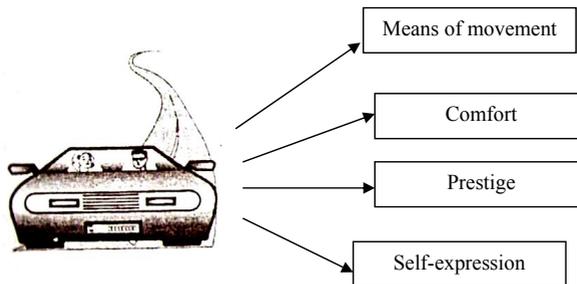


Fig.2.3. Needs satisfied with a car

As a rule, benefits, necessary to satisfy an individual's needs, don't exist in nature readymade. It is necessary to create them, and to

produce using those resources that people possess. Consequently, the second key question of the economic activity is how to produce, and what resources to use.

2.2. Production as a material base for the needs satisfaction

Resources and their kinds

Creation of benefits necessary to satisfy needs, as a rule, is carried out at the enterprises by the way of production reorganization. A person not only adapts himself to the existing natural resources, but transforms them taking into consideration his own needs.

Production is an effect of an individual on the substance of nature with the purpose to give it properties and forms which are useful to satisfy his needs. Production is a social process, because people, as a rule, are engaged in common economic activity with that.

The process of production can be considered as a process of consumption, but special kind of consumption – consumption of resources. New benefits are created under this process. Production is impossible without resources.

Manufacturing (productive) resources (factors) – are all those things necessary to carry out the process of production. These resources can be divided into two groups:

- material factors (material resources or instruments of production);
- personal factor (human resources).

Material resources (means of production) have different origin. Part of them is created by nature and is used by a person in his own purposes, - those are natural resources. They are the following: land, mineral raw materials (oil, gas, iron ore, coal and so on), water and forest resources, and also some other components of the environment, which can be used for production of material values.

The main problem of **natural resources** is their scantiness. Nature is generous to people. But it's true that they are not always considerate and careful in their attitude to it. But environment surrounding us, as a source of resources for production, is not endless. Limiting opportunities of the natural resource base arise even more greatly in conditions when a mankind uses more and more of such resources. Our present dependence on a number of natural resources, for example, oil, gas, water, is just enormous.

Certainly, the XXth century has become that historic period when a mankind began to feel the problem of scantiness of natural resources on a large scale. Economic activity has reached such scales that it

began to influence the nature critically. A real danger to exhaust a number of strategic resources – oil and gas – has raised. The problem of water is aggravated; agricultural areas per capita are reduced. All that put forward the ecological problem among the main limiting factors of economic activity and satisfaction of the persons' needs.

The second component of the means of production has the other origin – it is created by a person's labour. These are the so-called hand-made means of production. They are often defined as *capital* - created instruments of labour (sometime they are defined more precisely – physical capital; it is done to understand: money is not included in it, money is not the direct resource of production).

The presented components of the means of production differ not only in their origin, but in the role they play in the process of production. Natural resources serve as a material base to create a new product. That's why, the matter of nature (iron ore, coal, forest and so on) which the labour is directed on, can be called items of labour. Capital is all that is necessary to carry out the process of a person's influence on the items of labour (machine tools, devices, industrial buildings, equipment to create, store and transmit information and so on). That can be called as instruments of labour. It is just the ability to create instruments of labour that promoted the final distinguishing of a man from the animal world.

Personal factor has a special role in manufacturing process. Human resources of production can be divided into labour forces and entrepreneurship forces.

Labour is a complex of physical and mental features of a man used in production process. A man sets into motion means of production, he enlivens them, they are dead without him. That's why it is impossible neither to use natural resources nor to produce new benefits. Labour resources are limited even though by the factor that there is a definite number of population. Besides, as a rule, there is no necessity in labour services in general, but there are needs in labour services of a definite kind and quality, which are also limited.

The production process presupposes combination of factors of production. Someone has to be its organizer and has to be responsible for the results. "To organize" – is a special kind of activity, special abilities. More often such activity acquires a form of *entrepreneurship*.

It is believed, that the term "entrepreneurship" firstly was put into scientific circulation by R. Cantillon in the XVIIIth century. He wrote: "An entrepreneur is a person who purchases means of production at some price to manufacture some product and sell it with the purpose to earn profit, and who, assuming commitments on costs, doesn't know what prices a sale will be carried out at".

Entrepreneurship production has become its main form in modern conditions. An entrepreneur carries out a search and attraction of the resources available in a society, studies the consumers' needs and defines what to produce, how much and what way to produce in, where and how to sell, and how to use the earned profit.

Entrepreneurial skills are the skills to organize economic resources (forces) as a united process of production. They are an important resource of production, a main component of production process. Entrepreneurial skills can't be set equal to usual labour services. Not everybody of us has the gift of an entrepreneur and not everybody of us is ready to assume such a responsibility. Let's remember that in *A. Maslow's pyramid* the needs in stability and risk avoidance follow the physical needs immediately.

A risk, a serious risk is an integral element of entrepreneurship activity. That's why entrepreneurial skills are limited as a resource and have a general feature for all economic resources, that is, scarcity.

Efficiency and effectiveness of production.

A process of production can be presented as a definite system having an input, through which the resources are put into it, and an output from which a product goes out into environment (fig. 2.4).

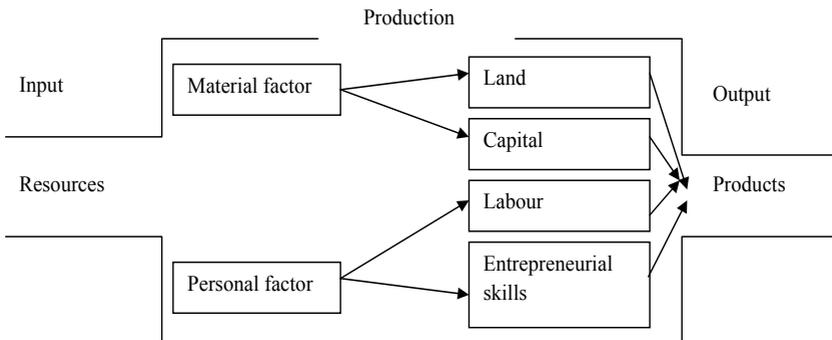


Fig. 2.4. Production as a transforming system

One can judge about *the efficiency* of this system on the base of comparison of the quantity and kinds of produced material values with the society's needs. To work effectively means "to produce the right things". The parameter of the production efficiency can be the extent to which the needs are satisfied:

The extent of needs satisfaction = Actual intake / needs.

The closer this index is to the unity, the more efficient production process is.

The second important estimated figure of production process is ***effectiveness of production***. To work effectively means “to produce the things properly”. It can be judged while comparing the output results with the input results.

$$\textit{Effectiveness}=\textit{Result}/\textit{Resources}.$$

The role of this parameter is extremely important for the economy. The growth of needs directs to maximization of the result, and limited resources require rationalization of their use. That’s why the task the production is facing with can be formulated as follows: either maximization of the result with the use of available resources or achievement of the assigned result with minimization of the costs of resources.

Interaction of the factors of production

The formulated tasks can be solved with rationalization of combining of the factors of production. There is a close and rather complex connection between means of production and the workers participating in the production process. Let’s consider some its aspects.

1. Conformity of the factors of production. The greatest effectiveness of production under all other equal conditions can be reached when quality characteristics of the workers (their level of education, qualification, personal characteristics and so on) correspond to the state of the applied means of production. It is necessary to notice that the effectiveness decreases not only when the level of workers’ qualification doesn’t allow to realize all potential opportunities of the means of production, but also when the applied means of production do not allow to realize the workers’ potential. It is difficult to define the leading side in the emphasized interrelation. Everything depends on the period of replacement of the generations of the means of production and workers. In the XIXth century, when some generations of workers applied one and the same means of production, it was necessary to adapt the level of personal training factor to the state of the social one. At present, when the used machines are substituted several times during the period of working activity of the worker, their developers have to be oriented to the requirements brought by the personal factor.

2. Relation of the factors of production. There must be not only qualitative but quantitative conformity as well between workers and means of production. For each given level of development there is some optimal relation between the value of capital and quantity of labour, which is able to set it into motion.

3. *Interchangeability of the factors of production.* One and the same result can be achieved with different relation of the *factors* of production.

Let's imagine that two resources are used in the production process: labour (L) and capital (C). One can define different relations of labour and capital providing the obtaining of the given result. They can be shown in the corresponding graph (fig. 2.5).

Coordinates of any point of the curve show the relation of labour and capital giving one and the same result. From the point of influence on it, the decrease of the labour costs for the value L_1L_2 is equivalent to the increase of capital for the value C_1C_2 .

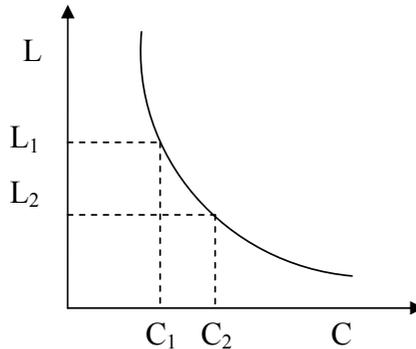


Fig. 2.5 The curve of the resources substitutability

Tendencies of development of the factors of production

While investigating the process of development of the factors of production, one can find out some definite tendencies both in the development of each of the resources and in their relation.

Labour and land played the main role in the production process in the history of mankind for a long time. It was just a man who was the main motive power and executor in the production process. Manual ineffective labour of the separately working people was predominant. In the XVIth-XVIIth centuries the incorporation of the isolated craftsmen in joint premises began.

Simple cooperation was a form of organization of their labour; the workers produced the products the same in intention in parallel. And such incorporation gave a great economic effect, so far as:

- the economy in common conditions of production (lightning, warming and so on) was achieved;
- the element of competition, rivalry among workers appeared;

Personality factor is a specific of realization of the ability to labour, which is defined by psychological peculiarities and values peculiarities of the worker's personality. When manual labour dominated, the personality peculiarities played an important role, they were connected mainly with physical abilities of a man. When machines and conveyor system appeared, significance of some personality qualities decreases.

But at the same time, in conditions of the mass use of machines and automated processes, significance of creative component, role of a man as an original ideologist, designer of such facilities, which would ensure competitiveness of the manufactured product and demand for it, increases.

However, whatever relations of different kinds of resources could be, whatever changes inside each of them could happen, society always faces the scantiness of natural resources, capital, labour, and entrepreneurial skills. Consequently, if the scantiness of resources doesn't allow to satisfy all the needs, then the mankind will always face the problem of choice.

2.3 Production potentialities and economic growth

A table and a curve of production potentialities

For better understanding of the mechanism of production choice let's imagine that a society owns some fixed volume of resources which it is able to use for production of specific material values. And all the needs, which can be satisfied under production use of available resources, will be divided into two groups: final (articles of consumption) and intermediate (means of production).

Production potentialities of a society are the maximum possible volume of production of material values under complete and effective use of available production resources of a society.

As the resources are limited the production potentialities are limited too. The increase of production volumes of one product can be reached only under partial or full refuse from production of the other product. So, there must be some possible sets of consumption products and means of production which one can get using the available quantity of resources.

Data of the table 2.1 testify that a society, striving to maximize satisfaction of its final needs, could refuse to produce means of production in general and to embody all resources in 4 units of items of consumption. But all this will result in a decrease of resources in the following years, and, consequently, of production potentialities, as capital will not be recovered. It means that a society has to limit its

wishes in production of consumer products (current consumption) to ensure the growth of production in future period (at the expense of the increase of resources).

Table 2.1

Production potentialities of a society

Kind of product	Production alternative				
	I	II	III	IV	V
Items of consumption	0	1	2	3	4
Means of production	20	18	14	8	0

More clearly these conclusions are presented in the graph (fig. 2.7)

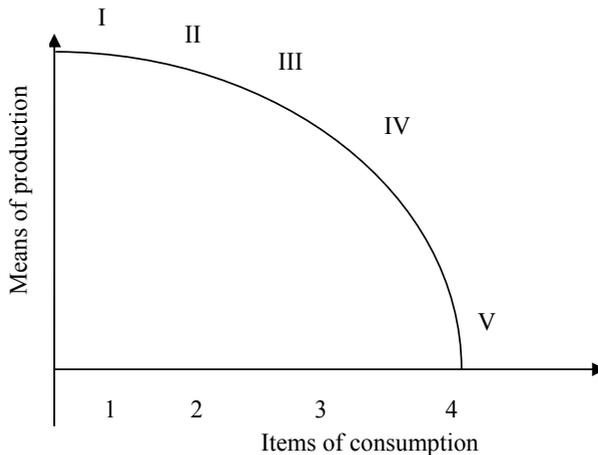


Fig. 2.7 A curve of production potentialities

A curve of production potentialities is a complex of points, the coordinates of which mean possible sets of products, obtained after the use of available resources. Any point out of the curve will mean either short-used resources (to the left of the curve), or principle impossibility to reach it under given resources (to the right of the curve).

Law of increasing imposed costs

Let's consider the situation of transition from production of 18 units of means of production and 1 unit of items of consumption to

the other complex – 14 and 2 units, accordingly. It turns out, that to increase production of items of consumption up to 1 unit, one have to refuse to produce means of production for 4 units. Quantity of the other product (set of products), which you should refuse or which you have to sacrifice to get some quantity of the given product (set of products), is called *imposed costs* of production of the given product (set of products). In our case, such imposed costs to get the additional unit of the items of consumption are equivalent to 4 units of the means of production.

Every man has to make the analogous choice constantly. Time is the most limited resource which is available. A student, for example, has a lot of alternative variants of its use: to read a course book in economics, to play games on mobile phone, to work for a firm on the terms of part time weekday, to sleep a little more and so on. How can one define the cost of the spare hour used for computer games? Naturally, it will cost that thing you had to refuse, say, the preparation for your studies. A student pays off with the short-received specific knowledge and problems in his progress for the time spent for pleasure.

While analyzing the alternatives, one very important regularity is discovered: in the process of movement from one alternative to the other, the value of costs to obtain each additional unit of benefit is increasing. In our example (fig. 2.7) with transition from the IInd to the IIIrd position the additional unit of the items of consumption is worth of 4 units of means of production, from the IIIrd to the IVth position it is worth of 6 units, and from the IVth to the Vth position it is worth of 8 units. Why does it happen?

The most convincing explanation of the effect of law of the increasing imposed costs is the fact that the available resources in a society can't be in full volume and equally suitable both for production of means of production and items of consumption.

Thus, the further we move the more we have to use the resources which can be called not suitable enough or “adjusted”, and that decreases the effectiveness of the whole production process.

Accumulation of production potentialities

While modeling a curve of production potentialities, the assumption of unchangeability of the quantity of resources and effectiveness of their application was used. But in reality both of these factors don't stay unchangeable, they are dynamic. The curve can shift to the left or to the right under their influence.

An increase of production potentialities of a society can be reached by increasing the quality of the applied resources. This is *an extensive way*. The examples of this way can be the growth of the population

capable for work, discovery of new mineral resources deposits, an increase of capital at the expense of exceeding of its input against its output. However, one must remember that this is just an accumulation of potentialities, but not of a real production. Thus, it is necessary to create the new job places to obtain benefits from the growth of labour resources.

Production potentialities can be accumulated in the *intensive way* as well, that is, at the expense of the factors that allow to increase effectiveness of the use of quantitatively unchangeable resources. These factors include the following:

- improvement of material and technical base of production process. The critical condition of the increase of effectiveness is substitution of the means of production used in production with new ones, more productive;

- improvement of the technology of production. One can use an increase of effectiveness of production process and quality of produced products as criteria for progressiveness of the technological processes;

- improvement of the organization of production, which is displayed, particularly, depending on labour division, effective cooperation, planning and so on;

- improvement of a man himself as a resource factor. This is expressed in development of mental, physical and spiritual abilities of a man, growth of workers' qualification and education. Being, on one hand, the purpose and the result of the economic growth, improvement of a man, on the other hand, is its condition. Understanding of this interrelation allows to explain many modern processes. A society striving for a progress, must provide appropriate development of a man.

Scientific and technical progress is the material base of the intensive way of accumulation of production potentialities. As a rule, it is realized in the evolution form, that is, by the way of improvement of the well-known technical and technological solutions. However, at some stage of development, in the result of accumulation of specific scientific and technical potential, conditions are created for transition to a new state of resources on principle. In other words, evolution form of scientific and technical progress is changed into revolution one, which is called scientific and technical revolution. The XXth century was a rather illustrative one concerning that.

Increasing production potentialities by intensive way, people somehow move away the frontier set by the scantiness of resources. This is the way of solution of the key economic contradiction between the limit of resources and growth of needs. Production creates material base for satisfaction of needs. During consumption they are satisfied and gradually transit to a new stage of their existence. In this new state they discover "new reserves for development". At the same time, the

process of production itself leads a man to discovery of his new powers, gives birth and stimulates new needs, which would be impossible to satisfy at the previously reached stage of production development. The public “engine” of the economic growth functions that way.

The need is always the initial stimulus, the inner motive of a man’s activity. The awareness of the need gives birth an interest. This is a subjective reflection of the objective need. But the awareness of economic interest doesn’t stimulate economic subject to some activities. The appearance of stimulus is necessary as the awareness of the ways of realization of economic interest, and satisfaction of the appropriate need. Thus, a specific closed chain of relations is formed (fig. 2.8).

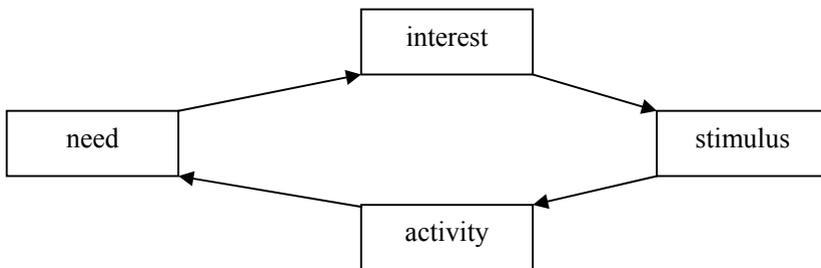


Fig. 2.8 Mechanism of the revival of contradiction between production and consumption

The other contradiction, stipulating the economic progress, is the contradiction between factors of production. Moved by these or those stimuli, the workers first of all realize their potential abilities to increase the volumes of production. However, under the unchangeable technical equipment these abilities are rather limited by the level of physical forces, the speed of managerial reaction, inadaptability to work in extreme situations (high or low temperature, high pressure, harm environment and so on). Then the need appears to change an agent between a worker and the subject of labour, or the subject of labour itself, to obtain more effective result. This results in creation of the new means of production.

However, even the high rates of accumulation of production potentialities of a society are not able to solve the problem of scantiness of resources in full. So people have to decide constantly what to produce, and what needs satisfaction to refuse.

CONCLUSIONS

1. “What to produce” is totally defined by the needs. The needs are the internal motives of a man’s activity. They can be classified according to subjects, form of satisfaction, and origin.

2. While solving the problem of satisfaction of the needs a man is guided by the principle of maximization of utility. Utility is an extent to which a benefit is able to satisfy this or that need of a man.

3. Marginal utility, as utility of the last portion of a benefit which is available for consumer, is decreasing depending on the saturation, and that is reflected in the law of diminishing marginal utility.

4. The material base of the man's needs satisfaction consists of production during which the used resources (natural resources, capital, labour, and entrepreneurial skills) are changed into benefits suitable to satisfy the needs.

5. Efficiency and effectiveness of production are defined by the relation of resources, their correspondence to each other both quantitatively and qualitatively. Resources have the characteristic feature of substitutability.

6. Production potentialities of a society are the maximum possible volume of production of benefits under full and effective use of available resources. As the resources are limited, the production potentialities are always limited as well. There is a constant problem of choice – what to produce, what to refuse. The imposed costs of production of some specific product are the quantity of the other product you have to sacrifice to obtain the given one.

7. Production potentialities can be accumulated extensively and intensively. This widens the possibilities to satisfy the needs, but does not eliminate the problem of resources scantiness.

The main terms and concepts

1. The needs
2. Classification of needs
3. Hierarchy of needs
4. Utility
5. Marginal utility
6. Resources
7. Production
8. Labour
9. Capital
10. Entrepreneurial skills
11. Efficiency and effectiveness of production
12. Substitutability of resources
13. Production potentialities of a society
14. Curve of potentialities of a society
15. Curve of production potentialities
16. Imposed costs of production
17. Extensive and intensive way of growth

UNIT 3. DIVISION OF LABOUR, EXCHANGE, MONEY

What do you do for your living? We are interested in this question, when we meet a new man. The possible answers may be: an engineer, a doctor, a miner, a teacher, an office worker at the bank, a roller, an agronomist, a director of the shop...The list can be very long. And just because of that you can guess: people have divided between themselves fulfillment of economic activities which are necessary for them on the whole. At present there is no a man, who would simultaneously grow the grain, smelt metal, carry out banking operations, produce sausage, deal with insurance, teach economics and so on, as there is no a business which would produce all necessary to provide their employees. Having divided labour and having refused the primitive opportunity of self-production, a society organizes a regular exchange of commodities and services.

None of the households, none of the businesses at present can satisfy all its needs in full without obtaining commodities and services from the others. And one of the conditions of our economic well-being is the availability of the effective system of exchange.

The existence of such important element of our economic life as money is connected with the effectiveness of exchange. Commodities are usually exchanged into money, and not directly into other commodities.

Money is a great achievement of man's mind; its use allows to organize economic cooperation of people in a better and more effective way, to carry out specialization. At the same time there are conditions which can cause instability of money. Money is able to trick expectations of its owners, perfidiously.

The way how the use of labour division, exchange and money allows a society to solve the problem of economics better to increase its production potentialities is explained in this chapter.

3.1. Division of labour

The essence and levels of labour division

There was a division of labour even in a primitive society. It was built taking into consideration physiological peculiarities, sex, and age of people. A thin man was usually a hunter because quickness (speed) and adroitness were necessary; a stout man was a fisherman, because this activity didn't contradict his physiological state and abilities. Division of labour according to sex appeared as well; a woman performed duties about the house, paid more attention

to children and a man devoted his time to getting subsistence, and building. Intellect and experience prompted the most suitable order of division of economy activities among the members of the groups. This division had a stable character, that is, it was fixed for a long period of time. People specified a benefit from this organization of economic life such as: better provision with the necessary material values, and better satisfaction of their needs.

Division of labour — is a distinguishing and stable fixing of different kinds of labour activity for different people or their groups.

At present division of labour is a fundamental base of modern economics. If in the Middle Ages a watchmaker carried out all necessary parts of mechanisms and the stages of the job out independently, then, at present, the watches “Citizen”, “Orient”, “Seiko” or any other brands which you prefer are not the result of the activity of one watchmaker. It goes without saying about such things as a computer, a car, an airplane and so on.

One can mark out several levels of labour division (fig. 3.1)

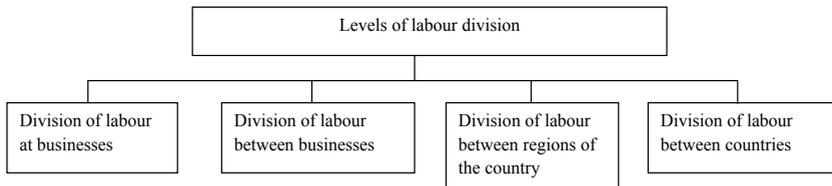


Fig. 3.1. Levels of labour division

1. Division of labour at businesses. This is specialization of the workers at a definite business: management, resource supply, production, and distribution. Some specialization will naturally be inside of these groups, and rather diversified one.

2. Division of labour between businesses. This is specialization of businesses in output of special goods or services. Speaking about some business we, as a rule, point out its production specialization: a sewing factory, a pipe plant, an insurance company, - commercial bank, a combine plant, an agricultural firm, an investment company and so on.

3. Division of labour between regions of the country. This is specialization of separate territorial formations of the country in output of special goods and services. Usually division of labour between regions is connected with their territorial peculiarities, which will be investigated further.

4. Division of labour between countries. This is specialization of different countries in output of special goods or services with a purpose of their delivery to the world market. These are potentialities of the country as to the export of definite goods (for example, metallurgical production for Ukraine). A country in definite sectors of its economy is oriented not only on the domestic consumer but on the foreign one as well, and volumes of production are defined not only with consideration of potentialities of national consumption, but to a greater extent (if not decisive) with consideration of potentiality of the sale on the world markets. It is important because practically any country is at the same time an importer, that is, buys products abroad. Currency is necessary for such operations.

What **factors** are in the base of labour division, what conditions do really define specialization of people in carrying-out these or those kinds of job (fig. 3.2)?

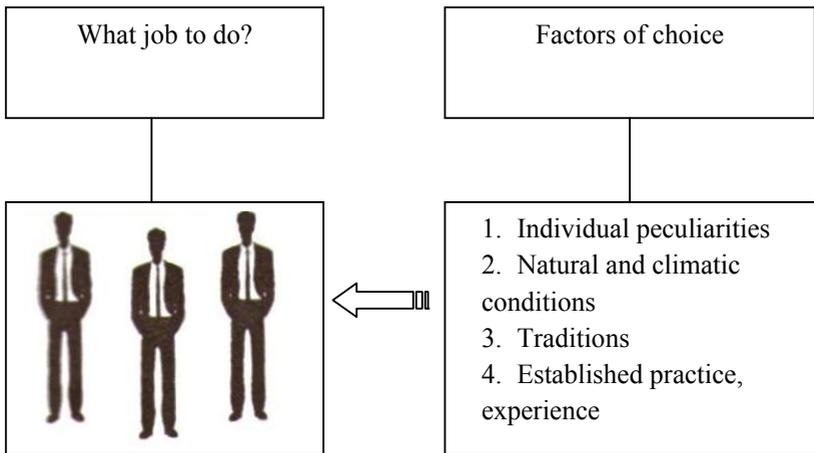


Fig. 3.2. Factors of labour division

1. Individual peculiarities of people. We have already given the examples of physiological differences, causing a definite extent of adaptation of individuals to carrying-out of different jobs. One can remember about age and physiological potentialities. It is difficult for an elderly man to do the job which assumes intensive physical load: you, as a rule, will not see such people, for example, in the police detachments of special purpose, fire-brigades, and mountain rescue teams.

At the same time, short of experience is the problem of young people, that's why we can seldom meet a young man at the age of 20 among the top managers.

Psychologists divide people according to their temperament into four kinds: sanguinics, choleric, phlegmatics, and melancholics.

It is difficult to wait a choleric to have more predisposition to the job of an accountant, than, say, a phlegmatic, and a melancholic to have more predisposition to the job in public relations department, then, say, a sanguinic. The important characteristic features for the job of an accountant are just even-minded thoughtful, diligent, and for the job where the ability to establish contacts is necessary, one must be sociable, initiative, accessible, and approachable.

2. *Natural and climatic conditions.* This factor of labour division is connected with living and activity of people on definite territories, which differ in the following:

a) *Availability of these or those mineral recourses.* For example, concentration of a large number of metallurgical enterprises in Dnipropetrovsk region is connected with availability of large reserves of iron ore, manganese, coal in it, that is, in the region there are the main natural resource components of metallurgical production, and that causes the appropriate specialization.

b) *Climatic conditions which influence agricultural production particularly.* Climate of Chernigiv region, for example, is not favorable for growing grapes, but here one can get good harvests of potatoes. In Crimea it is quite the opposite. In Zaporizhzhya or Khmelnytsky region there no favourable conditions for growing lemons or oranges, but one can grow grains successfully;

c) *Geographic position and connection with river and sea systems.* Geographic position, for example, of Mykolaiv contributed to a number of shipbuilders in the city, and a number of sailors and dockers in Odessa, a significant part of people is engaged in the sphere of tourism, rest, sanatorium and health resort treatment in Crimea.

3. *Traditions.* Most likely, Petrikovka painting is well-known for many people. Wonderful works of art are created by people living in Petrikovsky region in Dnipropetrovsk district. It is difficult to assume that the nature of that district has a miracle power for creating talented masters, that they are able to find some special components for their paints inaccessible for others. No, the matter is in traditions, when generations are connected by the devotion to one and the same occupation, and love and skills to this occupation are transmitted as some hereditary signs. Some family professional traditions are known, the family dynasties, among circus artists, metallurgists, miners, sportsmen, actors and so on.

4. *Established practice, existing experience.*

The choice of economic activity and definite specialization can be stipulated by the established practice which is not based on some

special natural and climate conditions or on the rich reserves of definite mineral resources. For example, there are businesses in many regions in Ukraine specializing in production of dairy products, meat products, bread and so on. They keep to their specialization, reproduce it constantly, taking into consideration the established needs and economic interrelations, and using experience of many years in the chosen spheres, adjustment of the equipment, buildings, facilities to the manufacturing of special production, technological orientation, qualification and special experience of their workers.

Significance and problems of labour division

Division of labour, specialization of workers, businesses, regions, and country gives an economic benefit for a society.

Totally this benefit is expressed in higher level of labour productivity, that is, the output of production for a definite period of time is increased, and it means, that a society gets an opportunity to satisfy its economic needs.

The growth of labour productivity is reached at the expense of better use of economic resources. *Firstly*, individual peculiarities, predisposition, advantages of people in some kinds work are considered. *Secondly*, constantly dedicating themselves to a definite business, economic subjects (entities) reach greater skills and perfection in carrying-out the business. *Thirdly*, geographic, natural and climate advantages in production of definite goods and services are considered and that gives an opportunity to produce them with lower costs and of better quality.

Along with incontestable advantages, specialization brings *problems* for a society. It is obvious, that the main problem among them is intensification of dependence of economic subject position from the activity of the others. We are used to such dependency, and often even forget about it. But there are situations in everybody's life which force to feel it sharply: you have bought a ticket and have come to the autostation wishing to leave for relatives at the weekend, but a dispatcher announced the trip cancellation; a water tap has broken down in your apartment and a careless plumber from the housing and communal services office doesn't hurry to arrive to carry out repair works; the miners have gone on a strike and, in result, power engineering specialists and metallurgists have great problems and so on. Thus, organization of exchange, establishment of stable and reliable cooperative relations take on an exceptionally important significance in these conditions.

3.2. Commodity production and forms of exchange

Commodity production and subsistence (natural) economy

As a result of labour division the majority of people do not produce those goods and services which they consume themselves. Production manufacturers are very seldom its consumers themselves. They carry out commodity production.

Commodity production – is such form of economic activity under which the manufactured product is intended for exchange, to satisfy needs of a “stranger”, very often unknown consumer. The product itself, intended for exchange, is named *commodity*.

At the same time mankind has not come to the commodity production right away. For a long period of time, economies kept an isolated economic activity, didn't enter into stable contacts with each other, only sometimes exchanged surplus of goods. Such economies were called subsistence (natural) ones.

Subsistence (natural) economy – is such form of economic activity when labour products are intended to satisfy domestic needs of manufacturer and which change over from the production sphere into consumption sphere.

Natural economy is a principle of self-sufficiency. Self-sufficiency takes away the problem of foreign dependency, that is, dependency on other economies. Natural economy is not a specialized economic structure, it doesn't take part in special labour division. Analyzing the shortcomings of natural economy, one can at the same time demonstrate both inefficient self-sufficiency, which is an alternative to labour division, and specialization.

Natural economy is able to satisfy rather narrow range of needs. Its universality is limited and is an obstacle to perfect manufactured production. Natural economy is conservative: rather slow technical, technological, organizational changes are carried out here. There is no “outside control” of quality of manufactured goods in it, and competition can play that role. Natural economy is nonsense for modern economy. At the same time, in modern economic vocabulary one can find, but seldom, an expression “naturalization of production” or “naturalization of economy”.

Naturalization of economy (production) is an economic activity dealt with the self-sufficiency expansion, expansion of the range of produced goods, and that is generated due to unstable economic relations, high level of inflation, crisis situation in national production.

Naturalization can be characteristic both for business activity and households activity. Its development one could watch, for example, in Ukraine in 1990s when in conditions of deep economic crisis

inhabitants of cities had mass interest to obtaining land sites for market-gardening and horticulture. Of course, a lot of people like to devote their free time to such activities. But in this case another motivation dominated: people looked for the ways to reduce their dependency on food supply. A lot of industrial enterprises started their own farms, fattening complex, hothouses with the purpose to help their workers decide food problems in a better way. Of course, naturalization- is, first of all, one of indicators of economic problems arising in the process of people's economic cooperation. Naturalization negatively influences total effectiveness of economy, it is an enemy for specialization, which, and it is proved, is a necessary instrument to society's production potentialities. Naturalization is one of symptoms of society's economic ill health. It is understood, one should struggle not with naturalization itself but with the reason causing it, such as instability of economic relations, general recession in production and inflation.

What problems would ever arise in modern society, nevertheless they are not able to fluctuate the commodity base of production management.

Forms of exchange

Exchange in conditions of commodity production acquires important *meaning*:

- a) it becomes a condition of labour division existence;
- b) it provides cooperation of production;
- c) it gives opportunity for economic subjects to get goods necessary to satisfy their needs;
- d) it sets the order of interaction between producers and consumers;
- e) it reveals the value of the manufactured product, and the extent it meets consumers' requirements.

Exchange can be carried out in two *forms*: natural or money form (fig. 3.3).

Natural (barter) exchange – is the form of exchange under which one product is directly exchanged into the other one. Natural exchange was the first form of exchange historically. It has its place in modern conditions, its scales even increase in the periods of economic instability.

However, spreading of natural exchange in developed countries of the world is not large. It is connected with those drawbacks which are distinctive to this form of exchange.

1. *Difficulties in reaching coincidence of the exchange wishes of different economic subjects appear.* Let us image the situation: the worker of the hardware factory was given several dozen kilograms of

nails for his labour, money in this society is not used; to satisfy his needs he must exchange nails for food stuffs and other necessary goods. But will it be easy for firm not just to find those having the products necessary for him, but those who would like to exchange them exactly for nails? Obviously, not. Somewhat easier it will be to exchange large-scale goods, but here too, there are some problems, and substantial difficulties which are rather evident. The more names of the exchange subjects exist, the more difficulties are there in coincidence of the exchange wishes.

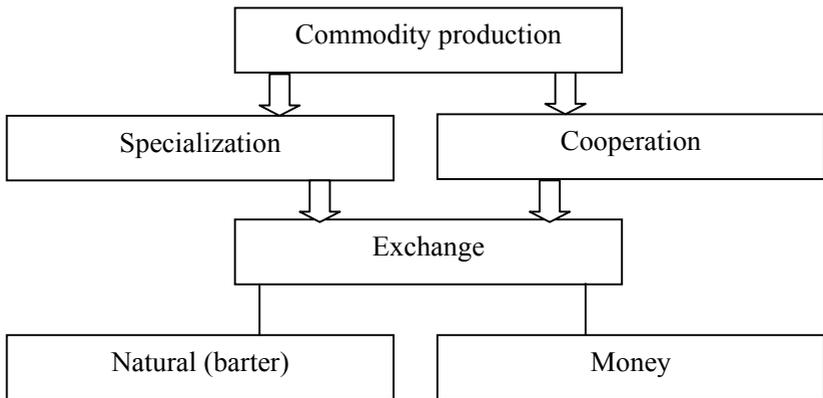


Fig. 3.3. Commodity production and forms of exchange

2. *The exchange time extends.* It is connected with the fact that in conditions of natural exchange more time is necessary to search for counterpart, that is, a partner in exchange operation. It is necessary to find an economic subject with the suitable exchange wishes. It is worth to notice, that in economics, as in the other spheres of peoples' life activity, the factor of time plays a very great role.

3. *Production development, expansion of economic patterns are restrained.* The more difficult is the sale of goods, the longer is period of time necessary for its carrying out, the more moderate is attitude to production development and expansion. Who will increase the volume of production if the earlier produced consignment of goods is not sold yet, if the consumers, and a counterpart are searched for it? Under natural exchange all phases of economic cycle – attraction of resources, production, distribution – are more stretched out, and the speed of capital turnover is less.

4. *Costs for marketing and storage of goods are increased.* This is the result of exchange time extension, and big difficulties in finding out of a counterpart.

These drawbacks, characteristic for natural exchange, stipulated the search for other exchange form which would be able to make it more effective, and as a consequence, more stable specialization.

Appearance of money exchange form gave the opportunity to overcome the drawbacks characteristic for barter exchange.

Money exchange – is a form of exchange when people firstly exchange goods for money and then get the other goods with the help of money.

Money plays the role of a middleman, intermediate link in exchange operations. Now, to satisfy the needs in same material values, it is necessary firstly to exchange one's own product for money, and then to exchange the received money for the desired benefits. Outwardly, it looks like the exchange relationship have become complicated. However, it is just the case, when two bargains are simpler than one bargain.

Money is the means of exchange facilitating, its application has become a powerful factor for acceleration of society's economic progress. It is difficult to imagine our life without money today. Money is one of the fundamental elements of society's economic organization in all countries of the world.

3.3. Money nature and function

Money nature and kinds

Money is universally recognized means of exchange in economic relations.

Money history is very interesting. A lot of rather different things and materials played the role of money. This story begins from money-commodity. **Commodity money** is any product that is valuable not only as money. At the early phases of money exchange, such goods, necessary for everyone as salt, livestock, grains, furs, skins-played the role of such money-commodity more often. The means of exchange in different countries were also powder, fish, tobacco, shells, sharks teeth and other things. In spite of the fact that those were rather inconvenient money they have been used for many ages.

Then appeared money made of precious metals. There is no enough information about one who was the first to use them. There is a statement that the Chinese used gold bricks as early as 2100 B.C.

Historians think that the first coins – Byzantine and Eastern appeared on the Ukraine – Russian territory in the VIth century. And at the close of the Xth century, they began to mint their own money in Kyiv Rus.

Money made of precious metals had unquestionable advantages against other kinds of money. They were well preserved, were attractive and portable, gold and silver were rare metals, and were greatly esteemed by many nations, they had such characteristic feature as divisibility.

At the same time, gold and silver coins as their historic predecessors in the role of money were not highly stable, that is, relatively stable exchange and purchasing power. For example, successful military operations, delivery of gold and silver trophies resulted in price declining of the money, one could exchange just less other products to the money. Delivery of much gold and silver money was far not safe.

In medieval Europe new money, paper money began to spread. A new stage in money history began. *Paper (symbolic) money* is the means of payment, the value of which as money exceeds production costs or value when used alternatively.

In majority of European countries the paper money was introduced during the XVIIIth century. China is assumed to be the homeland of paper money. Now, the paper money, we use while settling, is “legal payment means”. Its legality is based on the fact that the state, using the power of its authority and the power of the adopted legal laws, orders all participants of economic life to take the money as payment for all goods and services. The state is a guarantor of the universal use of the given exchange mean.

It is worth to notice that during a rather long period of time paper money kept relation with gold and silver. Paper money was like symbols, like representative of precious metals. The gold base was shown on the banknotes, that is, the quantity of gold which that banknote substitutes, represents. That was important- to prove that the paper sheets are supported with gold. Exchange of banknotes to gold in a bank was guaranteed for banknotes at the first request. Such money system was named as gold-standard. However, during the First World War, free exchange of money to gold was practically ceased in all countries. A little later, in two decades, the USA did that. And the process was finished in 1971, when the USA made a decision to refuse the commitments to convert dollars, which were presented by foreign financial bodies, to gold at the fixed price.

At the same time one can't contend that the interest to money system construction on the gold standard has finally disappeared. There are supporters of returning to the gold standard among modern economists. They suppose that its application can discipline economic policy of the state, safe economic system from ineffective decisions of the state in the sphere of financial, credit and monetary policy. Critics of the gold standards agree that its application is one of the reasons of economic instability.

Side by side with cash paper money and coins the so called credit or bank money is used in modern economy.

Credit (bank) money is liabilities of banks to transfer money to other persons in the form of payments for goods (services). This is noncash money. Banks are the institutions supporting economic subjects to carry out mutual settlements for the goods. Money available at business is recorded on special accounts of those businesses in special commercial banks. Payment for the purchased goods is a decrease of money on the account of one business and is a decrease of money on the account of one business and an increase of money on the account of the other one.

Sums, recorded on the accounts of economic subjects make a significantly greater part in the total money supply (75–95%) than the sum of cash money.

Technologies of bank transactions and their forms are constantly changing and perfecting. Achievements of scientific and technical progress are actively used. In particular, plastic cards are widely spread, which help their owners purchase goods in special shops, pay services, and receive necessary cash (money).

Bank money has its own structure too. There are several types of bank accounts, for example, current accounts, fixed deposits and so on. Banks' certificates and government bonds can be included into money supply.

Money functions

Issue about money functions — is an issue about the role, which money fulfils in economic system. Such functions of money are known.

1. Means of commodity circulation.

We have already noticed that a barter exchange is not characteristic feature for modern economy. Foods, as a rule, are not exchange directly one to another, but through the mediation of money. This simplifies the exchange, makes it more effective. Money is a convenient subject-agent, which can be used in any purchases. A miner, for example, would face a lot of problems, if he got wages for his labour in terms of coal. The workers of metallurgical plant wouldn't like to get wages for metal, for example, in terms of excavators or cargo wages carriages. People and businesses use the other, much better way if exchange — through money.

2. Measure of commodity value

Money plays the role of a conventional measure or a unit of record of different goods value. It is much more convenient to compare commodity values using the unitary money term, than to find out, for example, how many refrigerators “Nord”, or vacuum cleaners

“Rocket”, or kilograms of sausages will be equal to one motor-car “Slavuta”. It is enough to express the price of any commodity in money, and we will obtain comparative concepts, comparative characteristics of commodities and service value.

3. Means of value protection or saving

Having purchased some commodity, for example, labour services or things, we save under special conditions their exchange value in received money – money at any moment can be used to purchase a new commodity. Money, in such a way, accumulates, presents an exchange value. The money is the most liquid commodity, that is, that which can be turned into the other commodity most quickly.

At the same time money is not absolutely a reliable means of saving the exchange value, and purchasing power. Money has advantages in liquidity in comparison with saving wealth in the form of real estate (house, garage, country-cottage) or securities (shares, bonds), but those are not the leaders in reliability.

Extent of money reliability as a means of saving wealth depends on money stability, its value stability.

Nature of money is often inferred from money functions. Nature of money is in its activity in economy, as some economists think. Consequently, one can define money as any commodity, functioning as a means of circulation, measure of value, and a means of value saving.

Value of money

Money is important not because of itself. It is a means of purchasing goods necessary for living and production of goods and services.

Money has nominal and real value. ***Nominal value*** of money is defined by the value of figures which are shown on money. Its ***real value*** is defined by the quantity of goods and services which can be purchased for money unit.

Firs of all, we must be interested in just a real value of money. At the same time, a real value of money may be changed in time, that’s why one and the same nominal value of money will have different commodity cover, and give different quantity of commodities and services.

Real value of money is influenced by prices for commodities and services. When the total level of prices rises, then inflation comes, which results in decreasing of real value of money. When it decrease, the deflation comes, – real value of money increases. The most characteristic, unfortunately, is inflation trend of a price change.

CONCLUSIONS

1. Modern economy is characterized by labour division, diversified exchange, and money application. Use of those factors gives the opportunity to increase economic chances of society.

2. Labour division is assignment and stable fixing of different types of economic activity to individuals and groups of them. Labour division is carried out at businesses, between businesses, between regions of countries, and between countries. Its factors are individual skills, natural and climatic conditions, traditions, the practice existing, and experience.

3. Modern production has commodity character – its product is intended for exchange. Commodity production has forced out natural, self-sufficient economy. At the same time modern economy during some periods of time can face the problem of naturalization of economic activity.

4. Exchange in modern conditions is carried out mainly in money form, which has unquestionable advantages against natural (barter) one. Money is a universally recognized means of commodity exchange in economic relations. Historically money was presented as commodity money, money made of precious metals, paper and bank money.

5. Money plays the role of a means of commodity circulation, measure of commodity value, means of value saving or protecting. How successfully money fulfils its functions depends on its value very much. Real value of money is defined by the quantity of commodity and services, which can be purchased for the money unit. It depends on prices for commodities and services. Inflation is an increase of the total level of prices, deflation is its decrease.

The main terms and concepts

1. Labour division
2. Levels of labour division
3. Factors of labour division
4. Commodity production
5. Natural economy
6. Naturalization of economic activity
7. Money exchange
8. Natural (barter) exchange
9. Money
10. Types of money
11. Money functions
12. Nominal value of money
13. Real value of money
14. Inflation
15. Deflation

UNIT 4. PROPERTY AND ITS ECONOMIC ROLE

Material values which we need are limited. The same is with economic resources necessary to produce those benefits. A special order of distribution of economic resources and final goods is established in each society. In modern economy this function is realized by the market and state, sharing the appropriate duties between themselves.

Factor of limited benefits and economic resources requires not only development of a special order of their distribution, but establishment of some rules of their monitoring. Final commodities and economic resources if they are limited can't be equally available to manage and apply by every member of the society. If the fact would be such, then there was a chaos in society. Imagine that you have bought or built a house; if there were no rules of material values monitoring, than, in principle, that would mean, that your house would be constantly visiting with the purpose to have a rest, to warm oneself, to sleep, to watch TV almost by all those who desire. Would you like such an order, would such a "democratic" way of benefit use satisfy you? Obviously, not. That means that a society has to decide without fail, which norms will defend the monitoring power for special participants of economic life, for obtained final goods and economic resources in result of market and government distribution. This is one of conditions of their effective use and reproduction.

To solve the problem in modern society some norms of property are used. In this chapter we would like to show the nature of property, forms of property, its role in economic life of society, the way the powers of private property are regulated, the tendencies of property development in Ukraine.

4.1. Property concept, its significance

Property nature

Needs, as recognized, cause production (there is a feedback). Production uses resources and produces a product. The use of resources and material values assumes absorption of their useful effect, application of which can have two forms:

1. Free use. In this case it goes about application of unlimited, available and sufficient for all resources and benefits: absorption of oxygen, energy of sun, power of wind, smell of flowers, beauty of architecture forms. These and some other benefits mustn't be distributed among the members of society, they are enough for all.

Consequently, there is no necessity in fixing monitoring power over them, in defining properties for individuals or groups of them, there are no special limitations to access them.

2. Limited use. Economic resources, material values are limited and scarce in their majority. Who has to get preference, special powers to use them? Should people's opportunities in getting benefits from limited resources and benefits be regulated?

Property is fixing of supervision power over economic resources and material values to special subjects. *Power of supervision* is a power to use and regulate the object.

Property makes the process of getting benefits unfree, it sets owners – “commanders” to resources, benefits, and money. Just an owner, a proprietor, has the authority to manage, define the order, time and character of property object use.

Only the owner can give the access to this object for other people. That's why, property is always alienation of some thing from other people which are not its owners.

Property divides people, but it is necessary condition for absence of chaos in society, for presence of some order and coordination. Of course, one can argue about the nature of the order, principles and forms of property to use, but the very existence of property is absolutely unavoidable and useful for effectiveness of society's economic life.

Fixing of supervision power over resources and benefits to special subjects can be realized in different ways. Not all of them deserve moral approval and correspond the norms of civilized society. Let's define possible ways of *such powers fixing*.

1. Power. It can be military force, with the help of which some special territories are captured and supervision is set up over the available mineral resources, land, transport communications, capital and other objects. And, unfortunately, even in modern conditions a mankind has not found reliable ways to prevent such operations. Wars, armed conflicts existing now in some parts of the world are the evidence of that. There can be some other, mean, methods of some things capturing, such as physical violence, robbery, stealing applied to families and individuals when they are illegally forced to leave the objects of ownership.

2. The achieved consent. This is a kind of agreement – public or secret. People, basing on their concept of economic cooperation, agree to recognize the special rights of someone of them for special objects. There are no any guarantees that this agreement will be observed, only adopted moral and ethical norms of relations. All is based on a world of honor, as they say. In old times people divided places for

fishing, hunting, pasture of cattle and so on this way. Such agreements could exist in the form of traditions, they could be supported through religion. As a whole, it is not difficult to imagine their unsteadiness, insufficient durability, existing of many potential reasons leading to breaking agreement.

3. Legal norms. This is a typical modern way to fix the supervision power over resources and benefits to special subjects. The society forms state, government bodies adopt the laws – obligatory rules, norms of behavior for all and control their observation. A problem of property is reflected in those laws. In particular, a special law on property functions in Ukraine. Besides, and this underlines the significance of problem, an issue on property has its reflection without fail in Constitution – The Main Law of the country. The state in such a way protects special powers of individuals to control special objects this way.

Taking into account the case, that legal norms became the main, absolutely dominating way of supervision power fixing over economic resources and benefits, the concept of property is more narrowing, and is identified with one method of supervision power fixing – legal method.

It is necessary to notice that, in general or widely used meaning, the property is understood as a thing, supervision power over which belongs to an individual (individuals). That's why we can hear the expressions like the following: “the land is in property of the state”, “dramatic theatre is in property of our city”, “this house is my property”.

Significance of property in economic life

Factor of property plays a noticeable role in people's economic activity, in organization of their cooperation.

Firstly, property regulates economic interaction in society, is an important element of economic organization. In the beginning of this chapter, in the example with a house, we demonstrated the chaos that could dominate in a society under property absence. There must exist not only some special order of distribution, benefits and resources exchange in a society, but the order of control from the side of economic subjects over those values too.

Property sets up legal rights for resources, final commodities, and incomes.

Secondly, property creates special interest in effective use of limited economic resources under certain conditions.

Everything around can't be common, the rights of everyone for all objects can't be equal because economic interest and responsibility

for effective use of resources and material values smooth over and dissolve in such conditions.

Property distinguishes a certain economic interest, and allows to personify responsibility for certain economic objects. At the same time it by itself doesn't guarantee their effective use. The last one depends not only on the fact if there are owners or not, what kind of property it is – private or state property – but on the owner – what owner he is, if he is able to manage effectively the object of property by himself or through managers.

That's why, we can see private houses well-groomed or not, dirty, with outside defects, private motor-cars with not adjusted engines and well exploited, effective and ineffective private businesses, neglected parks and those causing joy with beauty of life and order, those that are in municipal property and so on. But property is one of the preconditions of effectiveness.

Thirdly, property specifies the one who has the rights to determine direction and character of the item use, whose interests must be supported. You understand rather well who decides the way the TV set, video system, tape recorder, refrigerator and other things in your house should be used in. It is not difficult to determine who decides how to use the business capital, areas of private shop, ambulance car, the underground and so on. There will be the only answer – the owner or persons invested with full powers to decide those questions.

Object of property which is used not in the interests of its owner is nonsense, though, that doesn't absolutely mean, that such thing can't exist at all. It, for example, state capital is leased out to private persons at unjustified low rent, is the owner's interest realized in that case? Obviously, not. In that case we can say that the mechanism itself for the owner to carry out his powers and control functions is not perfect, and is not adjusted in the appropriate way.

Fourthly, private property is one of the conditions of free entrepreneurship. People at their own initiative, fear and risk will organize businesses only having available special guarantees from the state. One of such guarantees is ownership of capital, property in manufactured goods, ownership of entrepreneurial income, and government protection of those.

Property also creates economic protection of a man, family, and business. People know: I and my family always have those objects available. They are separated from others, and our right for them is assigned. That is the wealth we have available. We would like to reach greater economic success to increase it. We are interested in that and strive for it in most cases. Property becomes a stimulus for us.

4.2. Forms of property. Privatization

Forms of property

Despite that, in particular, in home practice, it is accepted to speak and write a lot about property, there are still a lot of questions with a rather high degree of disagreement. Interpretation of forms of property is one of such questions.

The issue of property forms is the issue about owners, proprietors, who have legally protected power of control over certain objects in modern society. The type of owner is laid in the basis of property form definition. As a rule, there are two forms of property which are universally recognized – private and state property.

Private property is a fixing of supervision power over economic resources and material values to individual or their groups. Private property assumes a certain alienation from other individuals who are not the owners of supervision power over certain objects – capital, land, profit, final commodities and so on. Now they all become personified and have specific owners.

The use of private property is one of the basic elements of mixed economic system. A significant part of capital is in private ownership. Private ownership of capital, manufactured goods, and earned incomes is an important condition for supporting the system of free entrepreneurship.

Private property is divided into *such types*:

a) Individual or family property is a power of direct supervision over the property object which belongs to one person or a family. Farm economies, small shops, repair shops, and cafes can be based on this form of property. It can be also called unconsolidated private property.

b) Corporate share property is consolidated private property where the power of direct supervision over the object belongs to the group of subjects, who agree on the way of their management. These subjects are called joint owners, or shareholders, everyone of them has a certain part (share) in the object of property. Usually the amount of that share is set in money terms. A shareholder is the one who has contributed a special share to the capital of a business and obtained a title of ownership in return: a security – a stock. Under condition that a business is functioning, corporate property can't be ever physically divided, disposal or acquisition of part of property can take place only in the way of alienation of the appropriate stocks.

c) Uncorporate share property assumes the ability to single out a share of the joint owner physically in the case he is leaving the owners membership.

d) Property of public organizations is a property of groups of people joint in some public organizations: political parties, trade unions, unions of warriors-internationalists and so on. This is unpersonified private property, that is, individual shares in the object of property, which could belong to the members of those organizations are not fixed. For example, if the authors of this course book are the members of the branch trade union of the educational workers which owns a sanatorium or holiday hotel on the Black Sea coast, it doesn't mean though that each of us can claim to his share in that attractive object. The object which is in the ownership of the public organization can't be divided into individual shares.

State property is a fixing of supervision power over the objects to the state. In any country there is a large amount of objects, which are directly controlled by the state, - they are the state property. There are state businesses and institutions, the major part of land is a state property, the state controls mineral and water resources, highways, pipelines, communication systems and many other. Control over these objects must provide realization of interests of the whole society, production of a line of "public" goods and services, realization of macroeconomic stabilization policy and so on. At the same time, as experience demonstrates, management of the objects of the state property, revealing and realization of public preferences turn out to be very complicated question in practice.

Any state has a certain form of administrative-territorial organization. In each administrative region (province, land, state, and so on) there must be their own bodies of state government. To effectively carry out their functions they must have the property right to a range of objects.

State property in Ukraine is divided into:

a) A joint state property – main regulation and management functions over objects of property belong to the state institutions. There are large businesses, systems of power supply and communication, pipelines, auto and railway main roads, structures of National Bank, military production, national nature sanctuaries, factories producing banknotes and so on.

b) Communal property – regulation and management functions related to the objects of this property belong to the local authorities. Such objects usually include a lot of educational and medical institutions, sports and cultural buildings, theaters, trading organizations, communal service, some other small businesses, and so on.

Types of state property can be called in different ways. For example, in countries, where federal state organization is adopted, a joint state property is usually called a federal ownership. Some other

levels of state property can be called as property of states, municipal property, local property and so on.

State and private property can be connected, combined in a certain way. That can be carried out through a share (joint stock) form, when owners of shares in the object of property are private persons and a state.

Privatization

Significant changes related to property forms took place in Ukraine in 1990s. They were caused by a scale privatization which was considered as one of the basic elements of market transformation of Ukrainian economy.

Privatization is an alienation of state property in favor of private subjects (households, businesses and other). Alienation of state property means both opportunity to sell subjects of property and their handover to the new owners free of charge.

The objects of mass privatization in Ukraine were the following:

- assets of state-owned enterprises;
- state-owned amount of housing;
- state-owned land fund.

Privatization of business enterprises, as economic phenomenon, is characteristic not only for the countries with transition economic systems (as, for example, for Ukraine), but for countries with developed systems of mixed types (such as widely known and rather scale privatization measures carried out in the end of the XXth century in Great Britain, FRG and some other countries). At the same time, the ways, scales, and purposes of privatization in groups of those countries are quite different.

In Ukraine a significant place was taken by free of charge privatization of business enterprises by the way of assignment of privatized assets, concession of a right to every citizen of Ukraine to get privatization certificate on assets with an equal nominal value and the right to exchange it into shares (stocks, parts) of privatized business enterprises. The way of privatization of practically all middle and large business enterprises is their transformation into joint stock companies and subsequent sale of shares (put up for auction in exchange into assets certificates or for money).

Small production facilities (shops, cafes, repair shops and so on) were privatized in one of the following ways:

- buyout by work collective;
- sale at an auction;
- sale on a competition basis.

If in the countries with developed market systems privatization of market (money) ways of alienation is directed first of all at the

recovery of public finances, at the cuts in expenditure of state budget to maintain ineffective government-owned enterprises, at the increase of the budget revenues at the expense of capital sale, and large tax incomings from the “cured”, in private hands, business enterprises, then, in countries with transition economy, privatization has other parameters. Here the purposes of privatization are acceleration of development of free entrepreneurship, widening of private sector in economy and an increase of effective use of production assets in future at the expense of involvement of free economic initiative, high personal interest of new owners in effective use of the economic resources owned by them.

4.3. Regulation of the private property right

The rights of the owner: potential and real

The owner controls the object of the property. It is his prerogative to determine a direction and character of the object use, to manage it (to sell, to grant, to leave by will and so on).

At the same time the opportunities and the rights of the owner are limited in a certain way. In fig. 4.4. the whole aggregative sector (complex of sectors 1,2 and 3) presents the potential rights of the private owner. Real situation is that the pointer is never in horizontal position: firstly, a society, using a state, always limits, “cuts” the rights of the owner (sector 1), and secondly, the owner himself quite often consciously “cuts”, decreases the range of his rights for the object of property (sector 2). As a result, sector 3 is the “rest” of the rights of the private owner, or, in other words, those real rights he really has.

Public limitations

A state forms real rights of the private owner. As a result, they are always less than those potential opportunities, which private owners could have. This is required by the common or *public* character of economic activity and the whole life of people. There, where there is cooperation, interaction of people, undoubtedly can be limitations and public norms of behavior.

Is it normal for someone to organize a woodworking work-shop in his flat or for an admire of hard rock music to listen to the records in balcony or loggia at full power of the equipment? It is inadmissibly – will be the answer of an ordinary person, and, of course, he will be right. It is inadmissible to throw down dirty toxic discharges of production into the Dniپر river and other water reservoirs, to bake pies in unsanitary conditions, to carry out production of drugs and

create pornographic films, to run an unfair competition, to open private school without teachers with enough level of qualification.

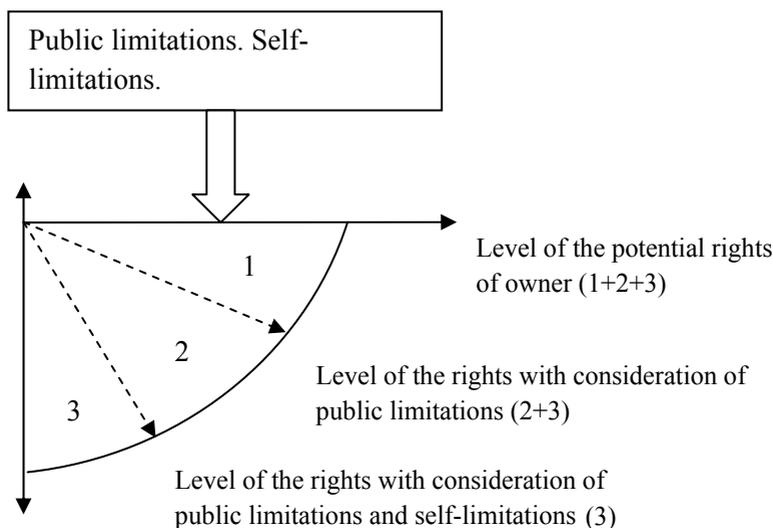


Fig. 4.1. Regulation of the private property rights

A state regulates formation of incomes through taxes, prohibits to use capital for some kinds of activity, carries out licensing in some spheres, sets the order of inheritance, works out normatives in technical safety and ecology, the order of work force involvement and so on. Even the land, buildings, houses which are privately owned can be, as the world practice reveals, alienated legally with compensation payment to the owners when it is necessary to build highways, pipelines, new buildings, and constructions. That is why the private property is not unapproachable fortress, but it is protected, and supported and conditions are being created for normal interaction of different economic interests.

Self-limitation of the rights

The owner can himself voluntarily limit his rights for the object of the property without any outside compulsion. What is the reason for such strange, at first sight, behavior of the owner? What forms can it be carried out in?

Firstly, the owner can lease the object to use to some other person, any business or an individual. For example, buildings, equipment, land, transport facilities can be leased. Many people, having land in

gardening, country-cottage partnership or under individual housing buildings, have got that land from the state to use it for unlimited period of time. Handing over the object into use and lease, the owner, at the same time, gives the part of his rights for it, too. The owner and user, as a rule, make an appropriate contract between them where the directions of the object use can be stipulated, however, it is evident, that the owner deprives himself of the range of the rights voluntarily. The reasons of his behavior can be different: it is goes, for example, about the transfer of land under the housing construction by the state, then the owner in such case doesn't pursue the object of obtaining direct economic benefits in the form of income; if the capital is transferred in a lease, then it has to bring income in the form of lease payment to the owner. Of course, among such operations dominate those motivated by the economic interests of the owner.

Secondly, the owner can hand over, delegate part of his authorities to managers – the hired management personnel. Managers will help to use production and money capital of the owner effectively. They can get a rather large power over the object of property, and in that case the owner will control not the object of property as itself, but managers' activity in effective management by this object. Efficiency requires professionalism, including the management sphere, and it can be first and foremost.

Losing the power over the object, the owner gains in efficiency and gets larger economic benefits. Analogous arguments are applicable to one more form of transfer of his powers by the owner, to fiduciary transactions. Such transactions assume trust management by the object of property (shares, capital, real estate, other financial assets). Usually specialized organizations deal with such operations. The terms of fiduciary transaction can assume different degree of "self-refusal" from the right of property, different motives can be laid into the base of such owners' decisions. However, the purposes of their activities usually coincide – aspiration for larger economic benefits in comparison with conditions of self-government by the object of property. At the same time the fiduciary transaction itself doesn't provide automatic achievement of this goal. It is a chance, but not a guarantee.

Thirdly, the owner can join his object of property with the objects of other persons. For example, people can, joining their efforts, resources and money, create a business in the form of economic partnership. Each its member, of course, will lose more or less part of his rights for the object of property, it will be then given to some joint management. The peoples' activities are connected in that case with the search for more economic benefits, and ways to enlarge their incomes. Losing rights, they hope to get economic compensation in the form of larger profits.

CONCLUSIONS

1. Appropriation of resources and material values can be free or limited. The last one is more characteristic. Property is a fixing of supervision power over economic resources and material values to certain subjects. Supervision power is a power to use and manage the object. Fixing of property right can be carried out on the base of force, achieved agreement and legal norms. The last one is a typical modern phenomenon.

2. There are private and state property forms. Private property has the following types: individual, share corporate, share uncorporate property, and property of public organizations. Varieties of state property are the following: national and communal property.

3. Property regulates economic interaction, is an important element of its structure; creates, under certain terms, a special interest in effective use of limited resources and material values; sets those who must determine direction and character of the object use.

4. A society forms the rights of private property. Real rights are always less than potential rights, as a society sets special economic, social, ecological and other norms of property object use with the help of state.

5. At the same time, the owner himself quite often limits his powers. He can hand over the object to use it, lease it, delegate powers to managers, hand over the object into trust management. He strives for economically benefit forms of organization of property object use.

6. A scaled transformation of state property was carried out in Ukraine in 1993s. Privatization is an alienation by the way of selling or uncompensated handing over of state property in favor of private individuals. Purposes of privatization in different countries can differ. Ukraine considered privatization as an accelerator of the process of formation of scaled private sector in economy, involvement of factors of free initiative and personal interest in more effective use of capital.

The main terms and concepts

1. Free appropriation
2. Limited appropriation
3. Property
4. Forms of property
5. Types of private property
6. Types of state property
7. Significance of property
8. Potential and real powers of private property
9. Public regulation of private property powers
10. Self-limitation of property powers
11. Privatization

UNIT 5. TYPES OF ECONOMIC SYSTEMS

In conditions of scantiness of economic resources, production opportunities, and unlimited needs, a society has to choose and decide what to produce and what to refuse, where and which productions to direct economic resources to, how much and how to produce, how to distribute the produced goods limited in quantity, too. A society has to work out some order to solve those issues. Only having the mechanism of agreement, coordination of economic activity of individuals, businesses, and organizations, it is possible to achieve fruitful economic cooperation between members of a society.

Each country has its own system of coordination due to different circumstances. We'll not be able to find quite similar economic systems. If, however, we try to make some generalizations and classify economic systems, then relation of market and government regulation existing in the economy of this or that country will be the main distinctive feature in that case. Market and state are the two main forces which carry out the regulating function in economy. Relation between them is formed in different countries and in different historic periods differently.

It is usual to distinguish three types of economic systems: free, or clear, market, mixed economy, centrally planned, or command economy. There is some conditional character in this classification because in more accurate meaning, practically any economic system is "mixed", that is, there are market and government regulators functioning in it. However, relation between them can differ significantly, that is why the relation itself is taken as a distinctive feature.

Ukraine's economy, in the main part of the XXth century, developed as economic system of a centrally planned type. However, in 1990-s economic system of Ukraine was mainly transformed into market one on the whole.

In this chapter we'll learn main characteristics of the listed types of economic systems, and peculiarities of Ukraine's economic system.

5.1 System of free or clear market

Last musical album, which was recorded in 1969 by the world famous group "Beatles", was called "Let it be". This name is roughly translated as "let it go, as it goes".

The wish "let it go, as it goes" relatively to economics was earlier formulated in the the XVIIIth century by French physiocrats as a

principle “*laissez faire*”, which was further actively supported and developed by representatives of classical political economy, and, first of all, by *Adam Smith*.

“*Laissez faire*” is a principle of free economy, clear or free market.

System of free (clear) market is such economic system under which government regulates economic processes in the least way, and forces of free competition, market self-regulation achieve the greatest spread. Rough historic frameworks of such economic system existing in the world developed countries can be defined that way: from the second half of the XVIIIth century to the end of the XIXth and beginning of the XXth century. However, its many characteristic features were preserved up to the present day.

What are the ***main features of the free market system?***

1. *Private property.* The right of ungovernment, private property to economic resources – capital, land, natural reserves – is carried out. A rather significant part of material resources is privately owned.

2. *Free entrepreneurship.* Individuals and groups of people in their own initiative act like free entrepreneurs and take function of organizing economic forces: they mobilize necessary resources, organize production processes and manufactured products marketing. They undertake in full all economy risk which is absolutely unavoidable, as no one can know beforehand, whether they will be able to market goods, the price of their marketing or whether the profit will cover the costs. Free enterprise becomes a mass phenomenon and provides the greatest part of national product manufacturing.

3. *Personal interest.* Economic subjects act according to their personal economic interests. Striving for better realization of personal interest is the main motive of economic activities. Everyone strives for maximization of his profit: entrepreneur strives for profit maximization, a hired worker strives for wage maximization, a creditor strives for maximization of interest on loan charge, real estate owner strives for rent maximization and so on.

4. *“Invisible hand”.* There is, according to *Adam Smith*, “hand which is invisible for the world”, directing individual behavior, personal interests to public purposes, to satisfaction of other economic subjects’ interests. Economic subject works for public benefit. “In most of cases, - *A. Smith* argued in his book “*Research on nature and reasons of nations’ wealth*”, - he supports public interests much more, considering only his own interests, than when he deliberately chooses the road of service to a society”.

What is this wonder-working “invisible hand”? It is a market, as coordinating mechanism, with its elements: demand, supply, and price. Intentions of consumers are expressed in demand, opportunities,

and wishes of manufacturers are expressed in supply, agreement of their decisions and activities is expressed in price. Through interaction of those elements decisions of manufacturers and consumers are delivered and coordinated. This is a self-regulating system requiring no outside interference.

5. Free competition. There is a so-called perfect or free competition. It assumes existence of many independently acting both sellers and buyers of each resource, final product or service. Each of those economic subjects itself is not able to influence a price according to which this or that product is marketed. As a result, economic power is widely dispersed.

6. Minimal government influence. Government influence on economics is mainly limited by protection of private property and formation of certain legal environment of economic subjects' activity through laws, decrees, acts and so on, that is, - "rules of the game".

A. Smith argued: that state regulates economy in the best way which regulates it least of all.

In modern conditions there are no economic systems of the free market type. But some economists and historians make up their mind to answer a question if there were such systems at all. The answer for the question decisively depends on what is meant by the system of free market at all, which feature is laid down into the basis of economic systems typification.

Market and state

Let's ask extremely simple question: what is a roll made of? Most people will answer immediately the rolls and buns are made of flour. But everyone understands that other ingredients are in them, too. However, there is one dominating, prevailing, determining the main properties of the given product.

And now, try to answer the question, what is "Olivye" salad made of. The very different products are combined approximately in equal proportions in this dish and it would be wrong to give the palm to some of them.

It is obvious, that the reality is that certain relations are formed in economy between market and state regulation, those regulators can have different "coordinating weight" in society's economic life, all depends on time and place.

A system with the least "coordinating weight" of the state is distinguished as a *free market system*, and that one with the greatest "coordinating weight" is distinguished as *centrally planned or command one*, and a system with a roughly middle "coordinating weight" is distinguished as *mixed one*. (fig. 5.1). The extent of inclination of the

listed economic systems to the poles fixing certain extremes, only market or only government, is shown in the picture. Such typification has historic meaning in a large scale. Mixed economy system absolutely dominates in modern world in that way.

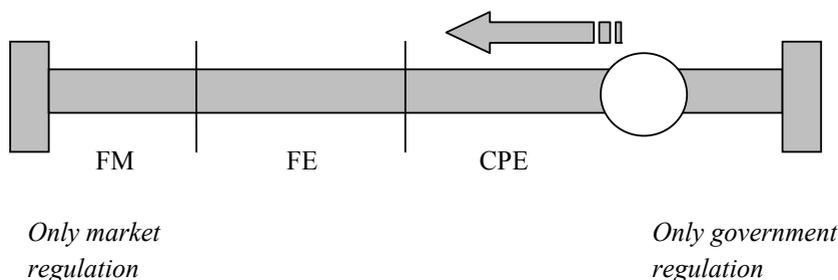


Fig. 5.1 Types of economic systems

○ – Position of Ukraine at the beginning of the 1990s and direction of economy transformation

Mixed economy system is obvious dominating type. In the middle part in fig.5.1 one can dispose economies of practically all developed countries of the world. But a certain position, inclination to this or that pole will be different.

Ukrainian economy, by the beginning of the 1990s, had obvious inclination to a strong government regulation of society’s economic life which had large scale and deeply penetrating character, while market elements acting at the very limited area.

5.2. Mixed economy

Economic system of mixed type preserves many features characteristic for free market: wide spread of private property to economic resources, free initiative of people in organizing economic forces, free enterprise, striving for economic activity to organize personal interest in the best way, and functioning of market coordinating mechanism.

At the same time, new, in comparison to the free market system, properties of economic cooperation between people appear. They are connected, first of all, with the changes in competition and with new economic role of state.

Changes in competition

Realization of many kinds of goods and services is carried out already not in conditions of free or perfect competition, but under different state of competitive environment. For the majority of markets, a restrained or imperfect competition becomes characteristic one.

Manufacturers' striving for concentration of goods supply or carrying out measures to pursue coordinated policy in pricing, and determination of sales markets which threatens the equality in "seller-buyer" relations, is observed in new conditions. Such aspirations, by the way, were noticed long ago. A. Smith noticed, with unsatisfaction, a bad habit of private capital: "Capitalists can't meet, even if it concerns only merriment or entertainment, without finishing their acquaintance with some plot against universal benefit or some secret agreement on price boost".

Technical progress, appearance of new technologies and goods, which require large-scale combinations of economic resources, such as metallurgy, motor-car construction, shipbuilding and other promote development of tendency of competition restriction. Large economic structures are formed, which concentrate production of certain goods.

Concentration of significant part of proposed production in the hands of the limited number of economic subjects, gives opportunity the last ones to influence prices to some extent while choice conditions for buyers are restricted, and circumstances and the order of interaction between participants of economic life are changed too.

As a result, insignificant place is left for the markets with free competition in mixed economy. For example, marketing some kinds of agricultural products, operation of some share markets, where the objects of purchase and sale are the securities (shares and bonds), can be related to them. Some economists even declare in such a way: it is not easier to find markets with free competition in modern economy, than to find water in a desert.

Imperfect competition dominates in mixed economic system. It can exist in one of three types:

a) *monopolistic competition* – sellers, independently from each other, offer similar goods, that is they meet one and the same need trying to give them peculiar, different from other, properties (mobile phones with photofixator of the calling person, Chinese restaurant, shampoo with rich foam and so on);

b) *oligopolistic competition* – some large businesses provide base production of certain goods (for example, markets of motor-cars, steel, refrigerators, video- and audiotechnics, computers);

c) *absolute (pure) monopoly* – a product is offered by a single seller (water supply in cities, railway road, mail service, production and sale of armaments, gas pipeline system, a unique resort and so on).

Correction of market mechanisms operation takes place in those conditions in comparison with conditions of free or perfect competition.

New role of state

Economic activity of state undergoes essential changes. It expands its economic functions and carries out regulation of economic processes actively.

New role of state in economy is dictated by a lot of *circumstances*. Let's distinguish the main ones.

Firstly, a market needs a help, it needs protection against influence of forces causing limitation or real removal of competition. At the same time there is a certain level of competition which is a necessary condition of standard operation of market mechanism in distribution of resources, goods, in revealing public preferences in these or those goods. Competition problem is a problem of market coordination efficiency.

Secondly, spread of economic activity scale, economic cooperation development, and strengthening of economic structures independence promoted formation of the integral economic complexes – national economies. Such degree of interconnection was achieved under which the situation in national economy as a whole influenced significantly the position of its very part – business, household. It was found out that periodically such “diseases” in national economy appear as fluctuations of business activity (volumes of national production), fluctuations of the general price level (inflation and deflation), problem of unemployment for a certain part of people wishing and able to work, problem of income availability for certain groups of population and so on.

It turned out that market was unable to regulate the problems appropriately. State regulation played a role of active supplementary element of market self-regulation.

There are businesses owned by the state in modern economy of mixed type. Government pursues an active stabilization policy, using tax-budget and monetary systems, carrying out measures to protect competition, regulate foreign economic relations, while implementing certain insurance and social programs.

Thus, *mixed economy* is such economic system under which regulation of economic processes is carried out both by market and state without decisive domination one of them.

Market determines majority of economic decisions in many developed countries of the world, however, the state role in distribution of economic resources and goods and in coordination of economic

subjects' activity is rather significant. This system of "partnership" in regulation of economic processes – market and state, but not domination one over the other.

It is experienced that combination of market forces and participation of state is able to make economic system rather effective. The same experience testifies that there is no universal receipt of effective "distribution of responsibilities" between market and state for all countries. Each country has to find its own optimal combination. And the search itself is determined by not only economic circumstances, but by social and political factors too.

Economic system of mixed type is characteristic, dominating in modern conditions.

5.3. Centrally-planned economy. Market transformation of economy

Features of centrally-planned economy

Centrally-planned economy is such economic system under which state regulation of economic processes is absolutely dominating and its main instrument is central (vertical) planning.

This system as, for example, mixed economy, is a certain mechanism of coordination of economic subjects' activity. Experience of some countries, USSR first of all, including Ukraine as a republic in USSR structure, testifies that it is really able to provide economic coordination. One of the main features of the countries, which were called socialist in the second half of the XXth century, is just an existence of centrally-planned economic system. It is obviously an economic bar, main economic feature of the socialist economic system.

State plays the main role in centrally-planned economy. It is just the state, and not a consumer through "voting" with his money for these or those goods, which determines the needs that are the most important and must be satisfied in first priority. The desired levels of production and necessary resources are calculated on the basis of those decisions. As the available resources are always insufficient to meet all the necessities, state bodies have to find additional resources or to correct the necessities to be met.

The following stage of the state regulation of economy assumes carrying out tasks in the form of directive plan for executives (economic entities). This plan, as a rule, includes certain volumes and assortments of production, suppliers and consumers of production, prices, ways of income distribution and so on.

System assumes tight control from government bodies over directions and effective use of resources, distribution and appropriation of profits. Of course, even under centrally-planned economy there are elements of market relations, but the degree of their influence on directions and character of economic processes is rather insignificant in comparison with the state role. Centrally-planned economy has principle distinctions from the market type system. This circumstance significantly complicates the process of market reformation in such economies.

Let's distinguish *the main features of centrally-planned economy*.

1. Tight centralization in distribution of resources and activity results. If under conditions of market, resources between different areas of activity are distributed mainly through market mechanism of relations between consumers and producers which forms demand, supply, and price, then, under command economy, this role is played by the state. The same happens to the final goods.

2. Absolutization of state property.

A state must have real economic power to carry out its functions in economy regulation. As this regulation is universal under centrally-planned economy, then the power has to be absolute. As a rule, it acquires the form of unlimited domination of state property. Being the owner of the major part of public wealth legislatively, the state gains opportunity to manage it really according to the planned purposes. But governmentalization arises in relation to public property. Thus, collective farm-and-cooperative property existed as formal-legal one, which could be related to collective property forms. But, being in the system under which the state regulates tightly all economic processes, this property form was distinct from state one practically in nothing.

3. Significant restrictions or even banning of free enterprise.

Initiative to organize economic forces is undertaken by the state. In some countries a small space is left for free enterprise, and in some places such form of economic activity is practically excluded. Being monopolistic organizer of economic forces, the state strives for maximum involvement of all available resources into production, including labour ones, not refusing the use of compulsory measures.

Thus, *centrally-planned economy* is an economic system under which main economic decisions are made by the state undertaking functions of organizer of society's economic activity. Objective character of centrally-planned economy assessment as public phenomenon requires to analyze its both positive and negative sides.

Arguments “pro”

1. Concentrating efforts on certain directions of economic activity, centrally-planned system can provide achievement of the most advanced positions even under the general lag in economy from the most advanced countries. It is enough to give examples of USSR's achievements in space, atomic power engineering, and armaments production.

2. Command economy is able to provide economic and social stability. The applied system of social protections forms individual's confidence and feeling of stability. People practically have no opportunity to become very rich, but they have no a threat of the significant decrease of life level too, not mentioning the impoverishment, threat to find themselves at the bottom of a society. Social differentiation is but very moderate one. Work is guaranteed for everyone, though not always prestigious, but stable one, and usually constantly growing wages.

3. Centrally-planned economy testified its ability to mobilize and concentrate resources. That was viewed both in critical periods of country's history (war, liquidation of its effects), and in making decisions in large-scale economic tasks in peaceful time (development of new agricultural lands and new territories). A state, being practically a single manager of resources, is able to mobilize them in necessary direction, consciously restricting consumption in other spheres.

Arguments “contra”

1. Centrally-planned system excludes the use of such factor of human civilization development as private property over economic resources. Having declared all citizens the joint owners, but without creating mechanism of their real participation in this power implementation, centrally-planned system has separated legal owner from property object management. A state apparatus becomes real manager.

2. Command system leaves very narrow frameworks for free economic initiative, excludes or significantly restricts free enterprise, which, that is proved by history, is a powerful driving force of economic progress.

3. The applied forms of economic managing restrain an increase in production efficiency, encourage costs but not economy. Here we find out such phenomenon as follows: an increase of production capacities takes place in high speed until there are opportunities of extensive growth, and mobilization of new and new resources. Potential for intensive growth of this system turns out to be rather restricted.

4. Sponging on society. Any economic result is paid, in principle, under centrally-planned economy, even if it is not able to meet the requirements of those it is intended for. Recognition of the result is the state's prerogative, but not consumer's one. Direct consumer doesn't control producer, competition between businesses is not developed. Bad result will be paid by good results of other businesses. State controls income generation completely.

In the whole, we have to admit that historic experience revealed the restriction of the centrally-planned economic system. Large-scale and deep interference of the state into economy reduces its efficiency, restricts people's economic opportunities, leaves little space for free economic initiative.

In 1980-s–1990-s of the XXth century a large group of countries including Ukraine carried out market reform, the essence of which was transition from centrally-planned economic system to mixed economic system. At present the existence of centrally-planned system in its traditional form is a rarity. At the same time, there are countries which are successful in economic development, and a state plays a key role in their economy (for example, China). But it is obvious that it is difficult to achieve efficiency in economy without free enterprise and market. That is why even in systems with obvious dominating role of state those factors are real and significant. Specific combination of market and nonmarket factors in economy depends on a range of important circumstances, such as political system, historic traditions, religion, provision with economic resources, mentality, culture and so on. To provide their effective balance in a specific historic period of development it is obviously the main and rather complicated task.

Market transformation of economy

Economic market reforms began in Ukraine in the end of 1980s, when Ukraine acquired a status of independent state, and thus institutions of country's power have got the necessary control levers to determine directions and sequence of market reforms in society – transition from centrally-planned economy to mixed economic system.

The main directions of market transformation of Ukraine's economy in 1990s are the following:

1. Creation of conditions for evolutionary formation and development of private (enterprise) sector in economy. Free enterprise is one of preconditions of market existence. People must have opportunity to run independent economic activity, independent from state to some extent, to create and develop their own business. That's why, creation of conditions for free enterprise and its development is necessary element for market reforms. At this time individual businesses,

different economic societies, other public forms of economic activity were started in Ukraine.

2. Reforming of state sector in economy. Its share in national production was about 90% in the beginning of 1990s. It is clear, that reforming of state sector was decisive for the whole economic development. This sector transformation took place in the following directions:

- commercialization of economic activity conditions. In this case the owner of production assets was a state, but terms of its use by the work collective became rather free, market ones;

- transfer of state assets into leasing to work collective. The owner, that is, a state, its representatives made a lease contract with an organization of leasers which included the number of workers from that organization;

- privatization of state assets. This is the most radical measure related to alienation of state property in favor of private persons.

3. Formation of market infrastructure. Infrastructure is the most important market component. Its institutions have to promote better interaction of goods producers and consumers according to their purpose. They include commercial banks, brokers firms, investment companies, exchanges, trading houses and so on.

4. Liberalization of economy, introduction of alterations into state regulation. Movement to mixed economy requires the state, firstly, to reduce significantly direct state influence on society's economic life, and, secondly, to master new methods of economic regulation.

The first task, first of all, assumes the following:

- a) price liberalization, that is, price establishment must be carried out on the market basis, but not by a state;

- b) rejection from directive planning, planning of business activity becomes their home affair;

- c) removal of special system of material and technical provision of businesses, they become independent while determining where, with whom, and on what terms to buy necessary resources.

Second, and as Ukraine's experience testifies, more complex task is mastering new approaches, methods and instruments to regulate economy by a state. The role of state in period of market transformation in economy is the role of reform constructor from one side, and the role of manager in reformation process, from the other side.

Constructing or modeling market reforms assumes determination of directions and duration of the main transformations, methods, and sequence of their implementation. Obviously, we can speak about two models of economic transformation related to this: evolutionary transformation (for example, China) and accelerated one (Ukraine,

Russia). The first model assumes gradual market transformations, the second one is oriented to intensive changes, their relatively short duration terms. The choice of model depends on the complex of factors, such as political, economic, historic, set in this or that country.

For Ukraine the use of radical variant was predetermined mainly by those conditions under which it found itself at the beginning of the 1990s: mass and acute shortage of goods; tough imbalance of revenue and expenditure part of state budget; crisis situation in monetary system; violation of foreign economic relations; decline in paying capacity of consumers in the country; deprivation of manageability in state sector of economy; availability of other serious destabilizing factors. It is necessary to recognize, that by the moment when Ukraine had obtained the status of independent state, there were practically no opportunities to apply evolutionary model.

CONCLUSIONS

1. Depending on relation of the role of market and state in regulation of economy, one can differentiate the types of economic systems: free, or pure, market; mixed economy; centrally-planned, or command, economy.

2. The system of free (pure) market assumes domination of private property, free enterprise, behavior of economic subjects according to their personal interests, free competition and minimum state influence on economy.

3. The changes that took place in the beginning of the XXth century required to review the state role, to strengthen its effect on economic processes. In majority of countries the state has undertaken functions in supporting competition, making decisions on the number of national problems (inflation, unemployment), and social protection. Mixed economy was formed, under which state regulation acts as an active “partner” factor of market self-regulation.

4. Centrally-planned economy has practically become a full denial of market. Full governmentalization of economy, the basis of which is unrestricted domination of state property, is its characteristic feature. All the most important components of economic processes are regulated by the state. Having certain positive features, command economy has yielded to in economic efficiency in the whole.

5. Reforming of Ukraine’s economy is transition from centrally-planned system to mixed one, including establishment of private economic sector, reforming of state sector, formation of market infrastructure, introduction of new approaches into macroeconomic regulation.

The main terms and concepts

1. Types of economic systems
2. Free (pure) market
3. Features of pure market
4. Mixed economy
5. Imperfect competition
6. New role of state
7. Centrally-planned economy
8. Main features of command economy
9. Market transformation of economy
10. Main directions of market transformation

Part 2.

SYSTEM OF MARKET

UNIT 6. DEMAND

This chapter begins analysis of market as a form of economic cooperation between people, as a way of economic relations regulation.

Market relations are, first of all, relations of those, who need material benefits, demand them (such subjects can be called consumers or buyers) and those who are able and really offer such material benefits to buy (subjects of supply).

Economy will not exist without consumers, without subjects of supply. Activity connected with material benefits production has a sense only when there are people who need those benefits. That's why, consumers, undoubtedly, are the primary subjects of economy.

Consumers worry about many questions connected with material benefits purchase. Firstly, the necessary benefits must be really available, and must exist physically. Secondly, the cost of material benefits purchase and use for consumer is very significant. In other words, what price one should pay to purchase the goods and to get useful effect in the process of its use. And thirdly, the product quality and its functional abilities to meet certain needs are very important factors, too. These and some other motives are revealed in customer's market behavior as a subject of demand.

Main conformities to natural laws which reveal in customer's behavior as a subject of demand are considered in this chapter. We'll examine in details different aspects of demand as a basic concept of market system. It is not occasionally that one of the economists has written that you can make an educated economists even from a parrot, if you teach a parrot to say one short word. Did you guess what one?

6.1. Needs and demand

Demand

Main purpose for a customer to appear on the market is to purchase such benefit which would be able to meet his needs. Along with that each new portion of the purchased benefit in buyer's mind is less significant for him, has less utility than the previous one (*the law of diminishing utility*).

Purchasing is money exchange into some benefit. But both money and benefit have certain utility. They give the owner the opportunity to choose the benefit which he would like to exchange into his money. A choice is always sacrifice. Choice of one thing means rejection of another. That's why, money value for a customer is determined by alternative variants of its use. Purchasing one product for a certain sum, a customer rejects the other benefits. Purchase will take place only when the utility of the purchased product is balanced or exceeds the utility of money he has to reject.

If we assume that money utility is unchangeable, it is easy to notice connection between quantity of the purchased product and price a customer is ready to pay for its unit. As *marginal utility of benefit* (utility of its last unit) will reduce, then value of the benefit unit will reduce alongside with an increase of the volumes of its purchase. This interconnection related to each customer and each product is expressed in the form of the price ratio set and volume of purchases (table 6.1)

Table 6.1

Relation between volume of purchase and unit price

№	Price per 1 liter of water, money unit (P)	Quantity of purchased water, thousands of liters (Q)
1	100	10
2	75	20
3	50	30
4	25	50

To characterize the pointed out interconnection the notion “demand” is used. **Demand** is quantities of product which consumers are ready and able to buy at certain prices per unit during some period of time.

Needs are in the basis of demand. They just determine what customer wants to buy. Wishes are corrected by the available sum of money. That's why demand is the needs, which a customer is able to meet. Demand is “I want” and “I can”.

Relation between price and quantity of purchased product is stable, constantly repeated and has characteristic direction. That's why, it can be defined as law of demand: price reduction results in an increase of demand value, and its growth results in reduction under all other equal conditions. Such interconnection between price and demand is stipulated by **a range of circumstances**:

- effect of law of diminishing marginal utility;

– an increase of customers' purchasing capacity who have fixed sum of money at every given moment, as prices decrease and vice versa;

– strengthening of expediency of alternative use of money and implementing other purchases as prices for the given product increase.

Up to this point we had discussed *individual demand*, that is, demand of each individual buyer for a specific product. But the revealed conformities with the established laws keep their justice in the case when we summarize individual demands of all buyers for that product. Table 6.1 could be supplemented with a lot of new buyers, and each of them determines the quantity of product available to buy at this or that price. The difference in demand of individual buyers will be caused by their different estimation of the product utility and possible differences in money value which is at their disposal. Sum of the individual demands will give us an *overall* or *market demand* for the material value.

Table 6.2

Market demand

Price per 1 liter of water, money unit (P)	Quantity of purified water bought, thousands of liters			
	Buyer A	Buyer B	Buyer C	Buyer D
100	10	30	40	80
75	20	40	50	110
50	30	50	70	150
25	50	60	90	200

The presented interconnection can be shown graphically. Let's transfer data from the table 6.2 into figure 6.1. As we supposed, that the product can be divided into the endlessly little portions and prices can change into endlessly little values (this assumption is rather conditional), then there is continuous line *dd* in the graph, showing all possible variants of relation between prices and volumes of purchase.

Graph of demand shows dependence between price and quantity of the product bought at each given moment of time. It is supposed that all the rest conditions are unchangeable. If the price changes, then the value of demand changes too, that is, shifting along one and the same curve up or down takes place. Thus, price decrease from 75 down to 50 money units will cause a change of the value of demand from 100 up to 150 thousand liters of purified water.

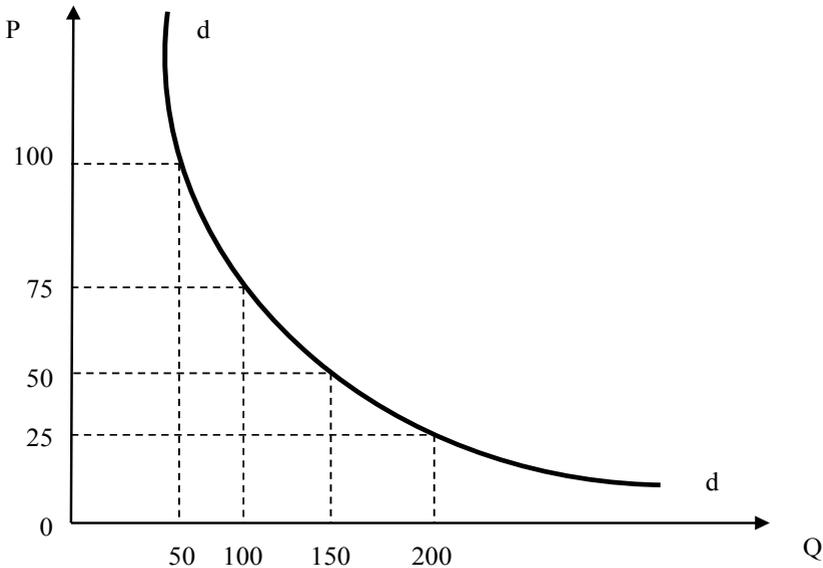


Fig. 6.1. Graph of demand

In fact “all other equal conditions” are subjected to dynamics. If they change, then a change in demand takes place and shifting of the demand curve itself in the graph takes place, too. Influence of such changes on the buyer’s behavior is so great that it deserves special investigation.

6.2. Factors of changes in demand

Influence of certain factors results in the fact that the buyers are ready to buy more or less products at the previous prices. If those factors positively influence the demand, the curve shifts to the right, if they influence negatively – to the left. In fig.6.2 the curve d_2d_2 means an increase of demand in comparison with the base position d_1d_1 , and the curve d_3d_3 means its decrease.

Consumer preferences

Let’s consider which factors and in what way can cause changes in demand. The buyer’s ideas about material value utility are not unchangeable. They change in favorable or unfavorable direction for the given product. And though consumers’ preferences are very difficult to measure quantitatively, every one had to observe their influence on demand.

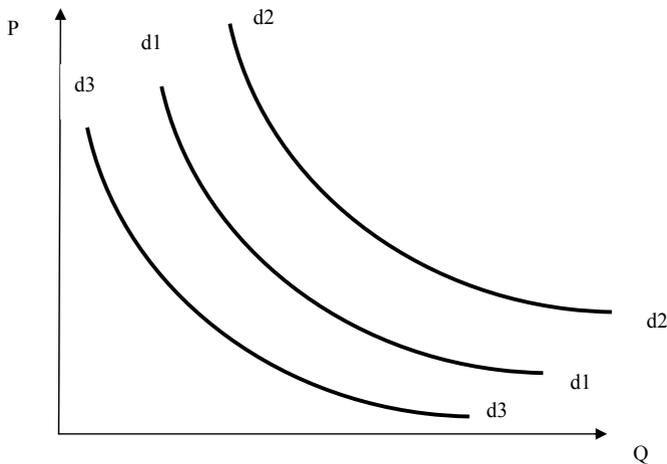


Fig. 6.2. Changes in demand

Among *factors changing the consumers' preferences* one should distinguish:

1. *Change of the needs.* Persons' needs are constantly changing. The production itself more often facilitates the appearance of the need and awareness of the need. Appearance of "flat" monitors, awareness of their abilities to meet the needs in a better way, caused a demand increase for them, and that shifted the demand curve to the right. At the same time, as to the "traditional monitors", negative change of consumers' preferences took place, and the demand curve for them shifted to the left. Change of the needs one should relate to the long-term factors of influence on consumers' preferences.

2. *Fashion.* If a product comes into fashion, the increased volumes of purchases will correspond to the previous set of prices. Alongside with that the demand curve will shift to the right. If the product is out of fashion, one can't expect that the volume of purchases at the previous prices will be kept: the prices will decrease if the volume of purchases is kept; the volume of purchases will decrease if the prices are kept. In other words, the demand curve will shift to the left.

3. *Advertisement.* It is a very powerful method of influence on the consumers' preferences. Advertisers spend huge resources for it and hope to influence the consumers' choice. Success of advertisement results in shifting of the demand curve to the right; failure of advertisement will result in shifting of the demand curve to the left.

Prices for other goods

As persons' needs are interconnected, then the material values meeting them are in certain interdependence. More often one and the same need can be met with different material values. For example, one can go to the neighboring city by train or by bus, to satisfy hunger with a sandwich or a glass of milk. That is why, one of the most important properties of material value is their interchangeability. Goods, able to meet one and the same need, are called *substitute goods*. There are practically no irreplaceable goods. A consumer always has an alternative. "Corridor of freedom" in the choice of material value can be wider or narrower, but it always exists.

At each given moment, proceeding from buyers' preferences, a certain demand for substitute goods is formed. Can the price change for some of them influence the demand for the others? How, for example, will the demand for railway transport service change, if the cost of tickets for inter-city bus transport increases? It is quite possible, that under the changed conditions, some part of potential passengers, while choosing a kind of transport for a journey, will prefer the cheaper one. That is why, the demand for the services will increase and the demand curve will shift to the right under the same prices for railway tickets. Consequently, the change of prices for substitute goods influences directly a demand for the given product.

But one more property is characteristic for the goods, they are mutually complementary (supplement each other). It means that effective use of one of them is possible only in combination with the other one. Such material values are called *mutually complementary*. For example, a microwave oven and electric power, a car and oil and so on. Will the sharp rise in prices for oil influence the demand for cars? Undoubtedly, it will. As maintenance of car is more expensive, some potential buyers will be forced to refuse its purchase, and that will reduce demand for uneconomic cars, that is, that will shift the demand curve to the left. Consequently, a price change for complementary material values has a reverse influence on demand for the given product.

Number of buyers

The most evident factor influencing a demand is the number of buyers. Its effect one could observe, considering some other factors. Here is the direct connection: an increase of the number of buyers increases a demand, a decrease – decreases it. A lower demand for food stuffs in a café during students' holidays or a sharp rise of demand for hotel services in Crimea during a health resort season can be an

example. One can observe even longer tendencies in changing the number of buyers, connected with the effect of demographic factors.

Price expectations of buyers

It is known that more often a man grasps the world not as it is in fact, but as it seems to him. A strong influence on the persons' behavior have their ideas about the events which can take place in future, what they are waiting for. Representatives of the theory of rational waiting argue that if a majority of economic entities are sure that some economic event will take place in future, it will really take place. Everyone knows that events are caused by a certain persons' behavior. Such statement can be true according to a demand, too. If, say, persons are waiting for further price rise for apartments then that can influence the increase of current demand. And, vice versa, being aware of forthcoming season sell-off some part of buyers will postpone a purchase today shifting the demand curve to the left due to that.

Price expectations of buyers are significantly influenced by mass media, rumors and so on. The interested persons strive to manipulate with a demand to reach their own purposes with its help. For example, to intensity currency transactions it is enough to convince population in the forthcoming slump of national currency. This, naturally, will cause a wish to get hard currency that will shift the demand curve for it to the right, and, under other equal conditions, will really decrease the rate of national currency.

Income

Income influences the changes in demand in a rather discrepant way, that is, real money opportunities of buyers to get some quantity of material values. Connection will be direct or reverse and it depends on what group of quality the product belongs to. If real income of buyers increases, the demand curve for goods of higher quality will shift to the right, and that means the increase of volume of purchases at previous prices. Some part of goods, as a rule, of lower quality is consumed by the buyers mainly because of low income and incapability to get some other material values of higher quality. That is why, with the growth of income a demand for the material values of the lower quality decreases, and consumers purchase goods of higher quality. The demand curve shifts to the left.

Discrepancy of effect of changes in income on demand is revealed in the fact that an increase in income for some subjects can take place simultaneously with a decrease in income for the other subjects. That's why, it is important to analyze not only the dynamics of the total income as a whole but in separate groups of population.

Of course, in real life no one of the listed factors doesn't exist in a pure form. They mix, forming complex and discrepant system, but understanding of mechanism of activity of each of them gives a key to analysis and understanding of many events in economic life.

6.3. Elasticity of demand

Up to this point we had investigated only directions of effect of this or that factor on demand. But practical use of obtained knowledge requires ability to measure a force with which a certain factor influences a demand. Especially as those factors influence a demand in diversified directions. Which side will demand curve shift to, if, for example, income increases and price decreases for substitute goods simultaneously? Will the demand change if prices for goods grow simultaneously with their coming into fashion?

To answer these and some other questions of the kind, it is necessary to know measure, or degree of demand response for a change of each factor or **demand elasticity** which shows how much a demand will change under a change of a factor value for the unit.

Price elasticity of demand

It is known that a price influences a value of demand. In fig.6.3 a graph of demand for some product is presented. It is clear that with the rise of price from P_1 up to P_2 the value of demand will decrease from Q_1 down to Q_2 .

To characterize the close connection between a price change and quantity change of the purchased goods, **rate of demand elasticity by price** (E_p) is used, the principle of comparison of growth rates of demand and growth rates of price is laid in the base of its calculation:

$$E_p = (Q_2 - Q_1) / Q_1 \cdot (P_2 - P_1) / P_1$$

The growth rates (decrease) of demand are shown in the numerator of the formula, and the decrease rates (growth) of prices are shown in the denominator of the formula. As the connection between a price and a value of demand is reverse, then the elasticity coefficient of demand by price will always be negative. Not to confuse it is always taken by module.

Let's suppose, that a price for a product rises by 10%, and that will cause a decrease of volume of purchases by 15%. Then the value of the elasticity coefficient will be 1.5. It is not difficult to notice that under such situation with the rise of prices the total proceeds of product sales decreases.

Elasticity coefficient of demand by price is applied under grounding of the companies' price policy. Even if a firm has an opportunity to rise prices, then, before doing that, it is necessary to weigh, will the price rise for a unit be able to compensate losses because of sales volumes reduction.

In dependence on close connection between a price change and a change of demand value one can distinguish:

– *absolutely inelastic demand*, when a demand value doesn't change under any values of price. For example, material values without substitute goods and meeting vitally important needs as, say, drugs determining whether a man will live or die (fig.6.4 a);

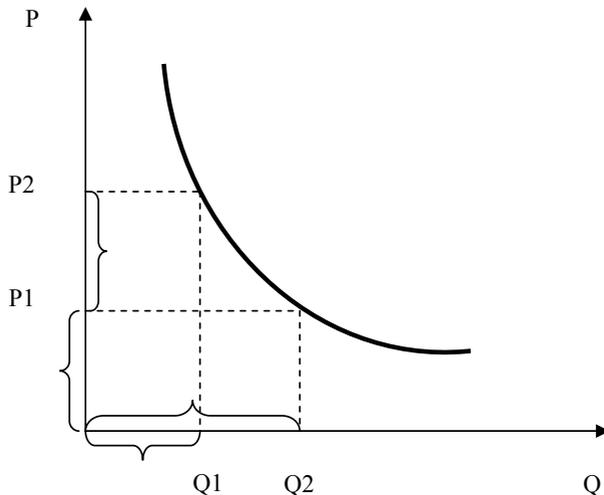


Fig. 6.3. Price elasticity of demand

– *weak elastic demand*. It is characteristic for material values, use of which is very significant for a man: some food stuffs, services of ritual offices and so on. (fig.6.4, b);

– *strong elastic demand* supposes active response of buyers for a price change. In our conditions such can be a demand for taxi, cinema service and so on.(fig 6.4, c);

– *absolutely elastic demand*. In that case a volume of purchases is constantly growing at unchangeable price. It is in this kind that a market demand acts according to an individual seller, whose share in the market is very insignificant (fig.6.4,a). For example, one can sell one, two or five baskets with strawberries brought from a suburb by a market gardener at one and the same price in the city market. Market

demand will be much larger in comparison with the opportunities to meet it by an individual market-gardener, and it can be considered as absolutely elastic one.

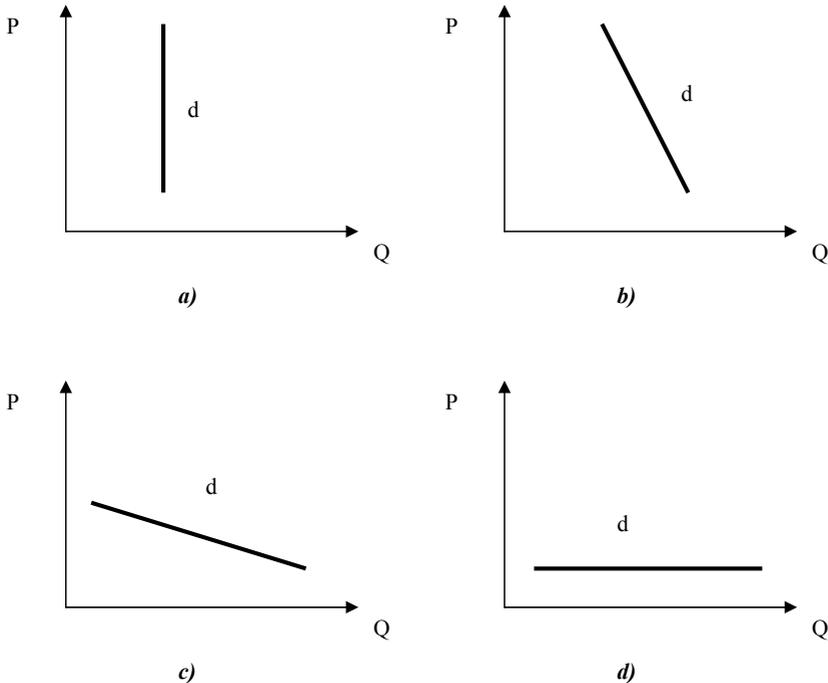


Fig. 6.4. Degree of demand elasticity

Closeness of connection between price and demand depends not only on the type of material value but on the area of the curve, too, that is, on the degree of availability of material value. As a rule, under slight volumes of demand the elasticity coefficient is not significant, and a buyer responds weakly to the price change. As far as needs are met it becomes more sensitive, and elasticity coefficient grows.

Elasticity of demand by other factors

Demand depends on a range of factors. With the help of elasticity coefficient one can measure closeness of connection between demand and those its factors which have quantities expression. Beside a price such factors may be income and prices for other goods.

Income. Demand elasticity in dependence on income can be defined as relation between comparative change of consumers' income

(R). In fig.6.5 an increase of demand is presented (shifting of the curve to the right) by $Q_2 - Q_1$, which is caused by an income increase by $R_2 - R_1$. Then the elasticity coefficient by income will be equal:

$$Er = (Q_2 - Q_1) / Q_1 : (R_2 - R_1) / R_1$$

Demand elasticity by income is usually positive, but if it goes about goods of lower quality – it may be negative. That's why, in contrast to elasticity coefficient by price here the mark (+ or -) is of great significance.

Prices for other goods (P_c) also influence a demand, and a degree of that influence is demonstrated with the corresponding elasticity coefficient:

$$Ep = (Q_2 - Q_1) / Q_1 : (P_{c2} - P_{c1}) / P_{c1}$$

If coefficient is positive that means that with the growth of prices for other goods a demand for those goods increases. Such connection is characteristic for substitute goods. The more a substitute fits to replace the given product the closer connection is between prices for it, and a demand for the considered product will take place. Say, interchangeability of two kinds of rye bread is very high. That's why, even a slight price rise for one of them will cause a sharp increase of demand for the other one.

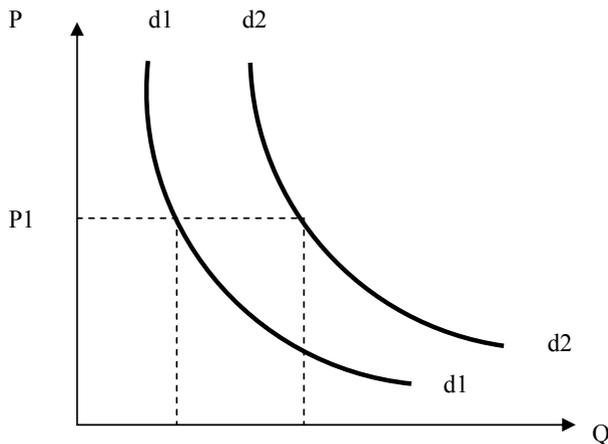


Fig. 6.5. Elasticity of demand by income

Negative coefficient of demand elasticity is characteristic for complementary goods. The more the degree to which the availability

of one good defines the sense of obtaining the other one, the more will be the value of elasticity coefficient by module. For example, a connection between prices for power cells and demand for electric torches, prices for refueling gas-cylinders with natural gas and demand for travelling gas cookers and so on.

CONCLUSIONS

1. Total value of a material value (benefit) for a buyer is defined by the marginal utility of the last one from the parts available at his disposal. That's why, while obtaining a product on the market, a buyer pays one and the same price for each unit.

2. Demand is a quantity of product the consumers are ready and able to buy at certain prices from available ones during some period of time. A law of demand shows the feedback between a price for the goods and a scale of their obtaining. Price change results in the change of demand value.

3. Factors of changes in demand are the following: buyers' preferences, prices for other goods, quantity of buyers, income and price expectancies. They shift the demand curve to the right or to the left in the demand graph.

4. The degree of the demand change under the influence of this or that factor characterizes coefficient of demand elasticity. It shows how much a demand will change under a change of a factor for the unit. Use of coefficient of demand elasticity gives an opportunity to calculate total effect of different factors on market demand practically.

The main terms and concepts

1. Total utility of material value (benefit)
2. Demand
3. Law of demand
4. Demand schedule (graph)
5. Value of demand
6. Factors of demand change
7. Substitute goods
8. Complementary goods
9. Price elasticity of demand
10. Coefficient of demand elasticity

UNIT 7. SUPPLY

To meet their needs people have to come into relations of exchange. A buyer has to find a seller on the market. The last one is the side which produces and offers goods for purchasing. He is a subject of supply. A seller has a lot of important questions as a buyer has. Firstly, what is expedient for him to produce and offer for selling – which goods, and which services. Secondly, a producer doesn't get goods free of charge, he spends resources for their production, marketing promotion, delivery, storing and so on. Thirdly, what volumes are expedient to produce and offer goods for consumers to provide maximum economic effect for himself. That is why, a behavior of a subject of supply on a market is characterized by a lot of elements and is influenced by a large group of factors.

In this chapter we will consider the most important aspects and regularities of the market behavior of the subjects of products supply. Ascertainment of them is not less important than investigation of consumer's behavior. Nevertheless, for our parrot to be able more thoroughly to claim for the role of an economist, it is necessary to teach him to speak one more word. A longer one.

7.1. Concept of supply

Essence of supply

Supply is quantities of product which a seller is ready to sell at certain prices for some period of time. Let's imagine some hypothetic situation. Let a man own natural mineral water spring which he gets without any costs. Capacity of this mineral spring is 10 liters a day. How many liters would he agree to sell? Let's look for an answer on the base of the economic regularities already well-known to us.

Offering for a sale a certain quantity of product, a seller means not to be down at least, that is, to get such quantity of money the utility of which will be at least no less then the utility of the product he sells. In table 7.1. data are presented related to marginal utility of each liter of mineral water which is at the disposal of a seller, and total utility of money obtained at different prices per 1 liter, if we suppose that the utility of one money unit (money unit) equals 10.

It is not difficult to notice that the tenth liter can be sold at any of the proposed prices because, having refused the utility of 10 standard units (marginal utility of the tenth liter of water), a seller can obtain correspondingly 50, 60 or 70 units of utility in return. The same arguments can be given concerning the 9th, 8th, 7th and 6th liter. Would

a seller wish to refuse consumption of the 5th liter when the volume of sale equals 6 liters? If he sells it at the price of 5 money units, then he will get 50 units of utility (300-250-50) extra, refusing 60 units of utility which the 5th liter of water had for him. Such barter, obviously, will be not in his favor. That is why, he will agree to sell no more than 5 liters of mineral water at the price of 50 money units.

Thus, we have found that a seller will agree to sell 6 units at the price of 6 money units, and 7 liters of mineral water at the price of 7 money units for a liter. This one example is enough to set dependence between quantity of goods offered for a sale and price for the unit.

Table 7.1

Marginal utility of a product and total utility of money obtained after its sale

Volume of personal consumption of a seller, liter	Marginal utility of 1 liter, standard unit	Volume of sales, liter	Utility of money obtained after water sale at a price for 1 liter, money units		
			5 money units	6 money units	7 money units
0	-	10	500	600	700
1	100	9	450	540	630
2	90	8	400	480	560
3	80	7	350	420	490
4	70	6	300	360	420
5	60	5	250	300	350
6	50	4	200	240	280
7	40	3	150	180	210
8	30	2	100	120	140
9	20	1	50	60	70
	10	0	-	-	-

Supply and production costs

Situation is somewhat complicated when material values arise as a result of production. And, besides, it is rather often for a producer that a manufactured product itself is not of any utility. Say, a producer of sulphuric acid will hardly have a direct consumer interest to his product. In what way are seller's needs realized in this case?

Absolute majority of material values arise as a result of production. Such resources are consumed during it: land, labour, capital, and

entrepreneurial abilities. That's why, a product can be considered as a function on resources(R):

$$Q=f(R_1...R_n).$$

In conditions of commodity form of economic activity a producer creates a product not for his own consumption but for exchange meaning to get money in return for a sold commodity, at least, recovering his costs for drawing necessary resources. In each given moment of time a producer is able to produce and offer for sale quantities of commodity. However, transition from one quantity to the other causes a change in costs of resources per unit of a product.

It is known that in a period of short duration an increase of production volume is accompanied with an increase of costs of resources per unit of a product. This is explained by the following reasons:

1. As resources are limited, then with production widening one is forced to draw more expensive or less suitable resources. An increase in mining of mineral resources can serve the most demonstrative example. Exhausting of deposits suitable for mining forces one to make mines deeper, open-pits-wider, and reconcile oneself to a less content of useful component in ore. The same regularity is characteristic for any other resource, too. A milk plant will be forced to take milk with less content of fat for processing which is brought from the remote districts; entrepreneurs will be forced to hire lower qualified labour forces as a whole and so on. All that reduces the total efficiency of the applied resources and increases costs per unit of a product.

2. There must be some quantitative correspondence between resources, creating an opportunity to obtain the greatest economic effect for the given period of time. That's why, if we consider a short period of time during which a producer is not able to change technical base of production facilities and can only increase the number of workers or the quantity of raw materials consumed, then, beginning from a certain moment, efficiency of such new portion of the involved resources will be decreased due to violation of optimal relation of production factors. Consequently, an increase of production volumes will be accompanied with an increase of costs of resources per unit of a product.

The noted interconnection can be presented graphically. Graph in fig 7.1 shows rather wide opportunities for a seller in the choice of production volumes. What way does he determine a real supply of his products in?

Law of supply

It is obvious, that a price at which a product will be sold, must recover producer's costs. As a price grows a producer is reimbursed

all great expenses per unit of a product, and, consequently, conditions are created to interest him in increasing volumes of production.

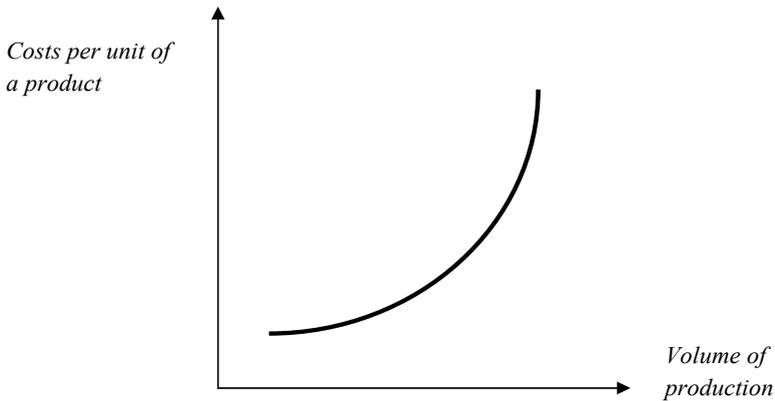


Fig. 7.1. Dependence of costs per unit of a product on production volumes

In table 7.2 conventional data concerning opportunities of purified water by “Source” company are presented. With that, it is supposed that only a price per 1 liter is changed, while all other conditions of a company’s operation are unchangeable. An increase of price from 25 up to 50 money units will result in growth of value of supply from 20 up to 45 thousands of liters. Such an increase is reached, for example, by introducing new cleaning capacities into operation. Growth of volumes of supply will cause additional costs but they will be compensated with the increased price.

Thus, independently of the fact whether a product was obtained by a seller free of charge or its obtaining was connected with special costs from his side, quantity of goods supplied for sale is in direct dependence on a price for its unit. This relation is called **law of supply**.

Table 7.2

Dependence of value of water supply on a price per 1 liter

№	Price of 1 liter of water, money units	Deliveries of water to the market by “Source” company, thousands of liters (Q)
1	25	20
2	50	45
3	75	60
4	100	65

Naturally, that other companies respond to the price changes analogically, too. Depending on the used technologies, level of labour productivity and other factors, the degree of an increase in a volume supply will be different in different companies, but orientation of changes for everybody will be general. In table 7.3 conventional data related to two more companies supplying purified water are presented. To determine the general market water supply, it is necessary to sum up supplies of each company at a certain price.

Table 7.3

Formation of market supply

Price for 1 liter of water, money units	Supply of purified water, thousand of liters			
	“Source” company	“Aqua” company	“Emerald” company	Market supply
25	20	10	30	60
50	45	30	75	150
75	60	50	90	200
100	65	55	100	220

Just as we constructed a demand schedule in chapter 6, we’ll construct a supply schedule, transferring data from table 7.3 into figure 7.2. A curve in a supply schedule is a set of points, and their coordinates correspond to a specific price and its characteristic value of supply.

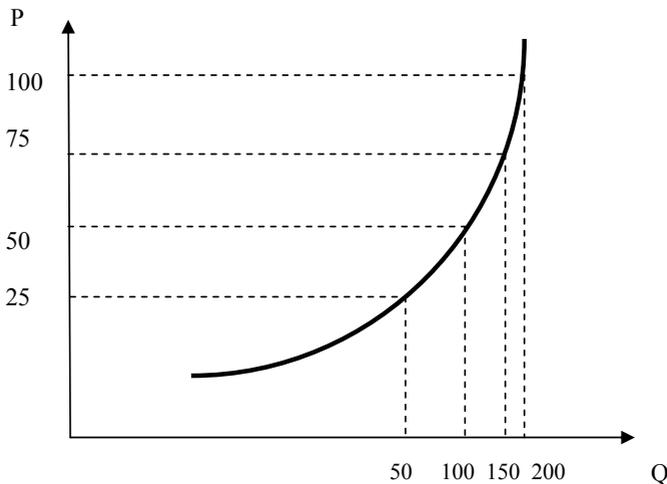


Fig. 7.2 Supply schedule

Price change under all other equal conditions shifts a point in the previous supply schedule, and increases or decreases a value of supply because of that.

However, some factors which are called other equal conditions influence supply. What will happen to the supply if those conditions are changing?

7.2. Factors of changes in supply

A price determines a point in the supply schedule corresponding its certain value. The position of a curve itself in the schedule depends on nonprice supply factors, among which we usually distinguish the following ones:

- prices for used resources;
- capital and technology of production;
- state economic policy;
- prices for other goods;
- price expectations of sellers;
- the number of sellers on the market.

Let's consider an influence of each of those factors separately.

Prices for used resources

How will price rise for oil be reflected in the supply schedule of purified water?

(figure 7.2) As oil is one of the resources used while water transporting, then we have the right to affirm that the price rise for it will result in an increase of production costs for 1 liter of water. If a price P_1 (fig. 7.3) recovered costs and made expedient a purified water supply which is equal to Q_1 , then under new condition costs for 1 liter of water can be compensated only with a higher price P_2 . While keeping the previous price, a supply will be decreased down to Q_2 level. That's why, the rise in prices for resources results in shifting of the supply curve to the left.

An increased volume of supply will now correspond to each previous price per unit of a product, that is, the supply curve will shift to the right (fig. 7.4). That's why, a price decrease for resources increases the supply.

Capital and technology of production

The value of costs for production depends not only on a price of used resources but on efficiency, and effectiveness of their application. If an increase of production capacities occurs intensively, then

this process results in an increase of return of used resources, and, consequently, decreases costs for production of a product unit.

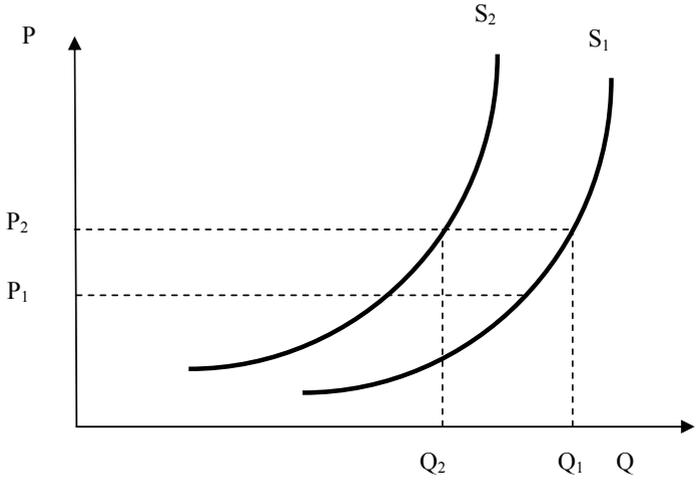


Fig. 7.3. Supply decrease

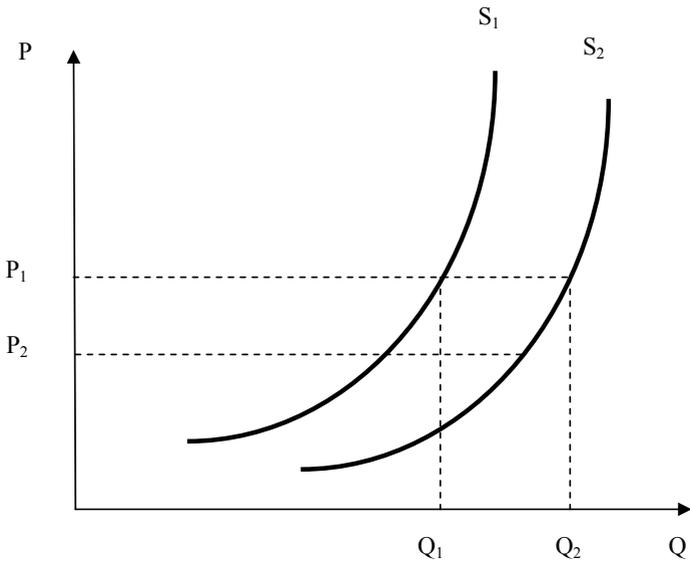


Fig. 7.4. Supply increase

Thus, if new equipment for water purification is introduced on a factory which increases workers' labour productivity and volume of product output at the same costs for equipment, then the supply curve will shift to the left. New larger supply volumes will correspond to previous prices for 1 liter of water.

As a rule, introduction of new equipment and technology results in an increase of supply. However, such traditional direction of relation can be violated when a social and ecological efficiency will serve a criterion of expediency for innovations and not a pure economic effectiveness. Then a positive effect from new technology will be expressed not in reduction of costs for production of a product unit but in an increase of ecological production or in creation of labour safety conditions. If new cleaning constructions are built at the metallurgical plants protecting Dnipro river from harmful discharges, that will hardly make the metal cheaper. The same results, as a rule, will take place while finding new technological solutions at those working places where harmful labour conditions resulted in diseases and traumatism. That's why, in the listed situations introduction of new equipment and technology, being socially necessary, can reduce a supply, shifting a supply curve to the left.

State economic policy

While selling goods, producer has not only to compensate costs at the expense of the obtained funds and get a profit, but to pay off taxes to a state. The last ones can influence the supply significantly. In the most clear way that can be watched in the case of a widely used value added tax. While selling a lot of products their prices include that tax subjected to a transfer to the budget of a state after products selling.

That's why, a real price of supply is always bigger by the quantity of value-added tax in comparison with the one enough to stimulate corresponding volume of supply.

In opinion of many economists the taxation rates can be considered as some "taxation wedge", which is forced between a supply curve built on the base of "a clear price" (got by a seller after payment to a state), and a curve built on the base of market, that is, actual price (fig.7.5). If a taxation rate rises, the "wedge" is forced deeper, moving the curves S_1 and S_2 apart. But as position of a curve is fixed by the set costs for production of a product unit, the shifting of a curve to the right takes place. That's why, an increase of taxation rates, under other equal conditions will influence market supply negatively and their decrease – positively.

State subsidies influence a supply in a contrast way. Use of subsidies, for example, in coal industry means that a state pays certain

sums of money to a producer in addition to market price from its budget. As a result, “a clear price” is higher than a price of a real selling. Subsidies are taxes of some kind with a negative sign. That’s why, an increase in subsidies shifts a supply curve to the right, and their decrease – to the left.

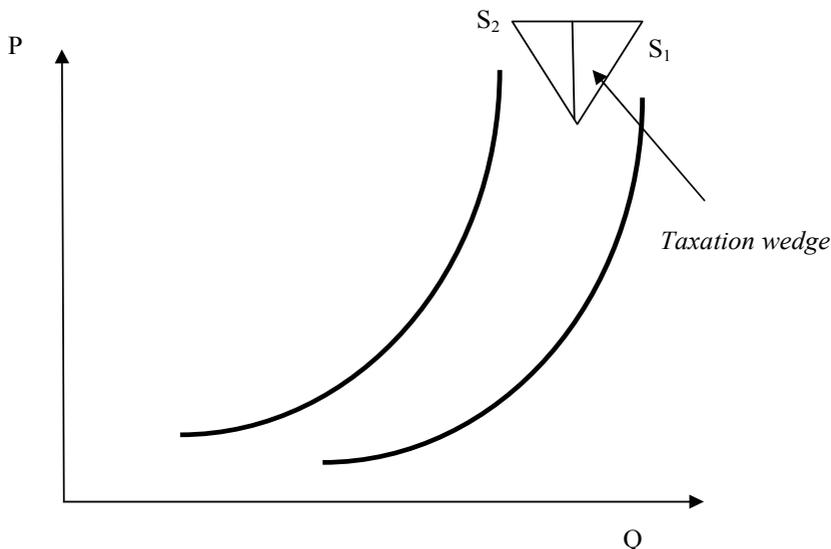


Fig. 7.5. Taxation wedge

Price for other goods

While choosing an area of application for resources, a potential opportunity of their alternative use has decisive meaning for a producer. The last one is determined by prices in many aspects. If prices for yoghurt raise then application of resources for milk production will become less attractive, and, perhaps, part of resources of milk plants will be reoriented from milk production to yoghurt production. This will lead to the shifting of the milk supply curve to the left in the schedule, testifying the producers’ refuse to offer the same volume of products at previous prices. If the price for yoghurt decreases, a milk supply curve will shift to the right.

In the long-term period there is relation between prices for very different goods and their supply. But sometimes a significant period of time is necessary to reorient resources for other goods output. This leads to the existence of time interval between a change of price relation for products and their supply. More close operative relation

is between prices and supply of those goods produced with one and the same equipment and with the use of similar raw materials. Say, it is easy for a producer of football balls to switch to volleyball ones. If prices for the first ones decrease, then, obviously, a supply of the last ones will increase.

Price expectations of sellers

Just as price expectation of buyers influence a demand significantly, price expectations of sellers determine the supply in many aspects. A supposed price rise, for example, in future can result in supply reduction, in shifting a supply curve to the left as sellers, keeping in mind future profit, will try “to hold back” manufactured goods or even reduce their production.

On the contrary, the expected price reduction forces sellers to maximize goods selling at the set prices to compensate future losses. That’s why, a supply curve will shift to the right for some time.

The number of sellers on the market

Considering table 7.3, one can notice that the number of sellers on the market influences a market supply. If they were not of three but of two in quantity, then a supply would reduce and the curve would shift to the left. If, a company from other city decided to supply purified water to our city’s markets because of some reasons, then a supply would increase, shifting a curve to the right.

Changing of the number of sellers can be caused both by the way of transferring resources from one area to the other and at the expense of the outside factor increasing general quantity of applied resources.

7.3. Supply elasticity

Elasticity of supply by price

Closeness of relation between supply and factors influencing it, is measured by elasticity coefficient of supply. It is calculated comparing a specific increase of supply to a specific increase of a factor causing it. Then elasticity of supply by price will be determined in the following way:

$$E_p = ((Q_2 - Q_1) / Q_1) : ((P_2 - P_1) / P_1).$$

Let us take the data of supply schedule as a base in fig. 7.2 and calculate elasticity coefficient by price for different areas of a curve. With a price rise from 25 up to 50 money units (double increase) a

supply will increase three times as much. Then elasticity coefficient will be 1.5.

For the area 50-75 money units it will decrease down to 0,67, and with a price rise from 75 up to 100 money units for 1 liter of water – down to 0,3. This testifies that in different areas the degree of relation between price and supply will be unequal. It will differ relatively to the supply schedules of different products, too. While characterizing closeness of relation we usually distinguish the following:

- *absolutely inelastic supply*, when supply is unchangeable in spite of the price rise or price reduction (fig. 7.6. a). This occurs when absolute involvement of some resource is reached with the substitute goods absence;

- *weak elastic supply*, under which a rather significant price rise is required even for a slight supply increase (fig. 7.6.b). Such situation arises each time when marginal productivity of additional resources is very low and a great price increase is necessary to compensate those additional costs.

- *strong elastic supply* reflects active sellers' response to even a slight price change (fig. 7.6. c). This is possible under condition of availability of significant quantity of inexpensive additional resources and low rates of reduction of their marginal productivity;

- *absolutely elastic supply* is achieved in the case when under unchangeable prices a supply increases (fig. 7.6. d). This situation can be found exceptionally seldom in reality but theoretical possibility of such interconnection exists.

Supply elasticity by other factors

Nonprice factors also influence a supply with different degree of effectiveness.

1. *Prices for resources.* Relation between prices for resources and product supply is reverse. That is why, an elasticity coefficient of supply by prices for resources will be always negative: if an increase is in denominator (t), then a decrease (+) will be in numerator, and vice versa:

$$Er = ((Q_2 - Q_1)/Q_1) : ((Pr_2 - Pr_1)/Pr_1),$$

where Er – is an elasticity coefficient by prices for resources; Pr – prices for resources.

Elasticity coefficients are expedient to calculate by each kind of resources. Relation between a price for resource and goods supply will be closer, and, consequently, the more specific gravity of the given resource in total costs of the firm is, the more elasticity coefficient by module will be.

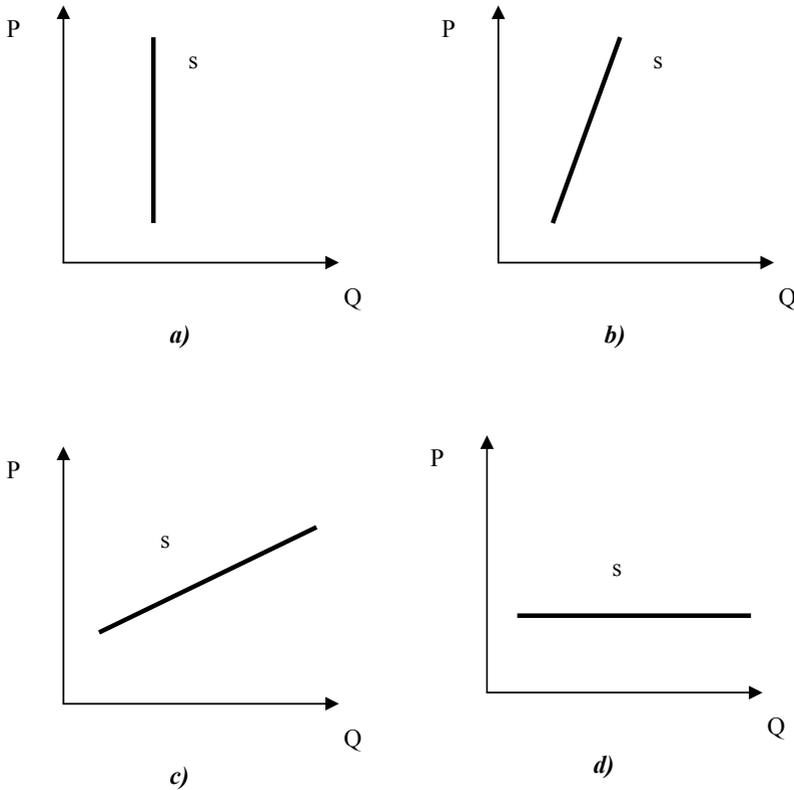


Fig. 7.6. Variants of supply elasticity by price

2. *Taxes and state subsidies.* The knowledge about the strength of supply respond to a change of that factor has a decisive significance in state policy of market regulation. Sometimes even a slight change of taxes can shift a supply curve very much. One can judge about such opportunity by the elasticity index of supply by taxes which is calculated from the formula

$$E_p = ((Q_2 - Q_1) : Q_1) / ((t_2 - t_1) / t_1),$$

where t – is a taxation rate.

This index will have a negative sign (-), because taxes decrease a supply, shifting a curve to the left in a schedule.

One can calculate the same index for state subsidies, too. It will be positive as its relation with supply is direct.

3. *Prices for other goods.* They have reverse influence on supply. That is why, elasticity coefficient calculated by the given factor will be negative. Its value by module fluctuates very much in dependence on the couples of considered goods. A supply will be strong elastic in dependence on prices for those goods switching to production of which can occur quickly and without significant costs. If such switching is complicated with some circumstances, closeness of relation will be insignificant.

CONCLUSIONS

1. Supply is a quantity of a product which a seller is ready to sell at certain prices for some period of time. Quantities of goods offered for a sale are in direct dependence on a price for their unit. Here is the essence of a supply.

2. In short period of time an increase of volume of production is accompanied with an increase of costs of resources and necessity to draw more and more expensive and less suitable resources, and from the other side – with reduction of productivity of each new portion of engaged labour and raw materials resources from a certain moment.

3. A change of price of goods influences a value of supply, shifting the corresponding point in a curve. Nonprice factors change a supply itself, shifting a curve to the right or to the left in a schedule. They include prices for applied resources, equipment and technology of production, state economic policy by taxes and subsidiaries, prices for other goods, price expectancies of sellers and their number on the market.

4. Closeness of relation between the supply and factors influencing it is measured with elasticity coefficient of supply. It is calculated by comparing a specific increase of the result to a specific increase of a factor causing it. One can calculate elasticity coefficients of supply by a price, prices for resources, taxes and subsidiaries of a state, prices for other goods.

The main terms and concepts

1. Supply
2. Law of supply
3. Supply schedule
4. Value of supply
5. Nonprice factors of supply
6. Changes in supply
7. Elasticity of supply

UNIT 8. MARKET AND MECHANISM TO ACHIEVE BALANCE

Characteristics for two main official persons in economics – producer and consumer- were given in previous chapter. Abilities, interests and regularities of behavior of exchange participant - separately for everyone – were explained. Now let's join them together and demonstrate the way they interact, what mechanism they use to achieve mutual agreement and make an exchange.

The role of such coordinating mechanism is played by a market. That's why in this chapter we are going to explain the way market coordination is carried out, what mechanism is played by a market. That's why in this chapter we are going to explain the way market coordination is carried out, what mechanism is used to achieve balance between demand and supply, what role is played by price, what conditions are necessary for normal market operation, and we are going to decide a range of other issues.

The nature of market self-regulation and its main functions are explained in the unit.

8.1. Nature and functions of market

Nature of market

A concept “market” is used in different meanings. Thus, there is a place practically in every populated area which is called a market: inhabitants know that regular meetings between sellers and buyers take place there. However, economists consider the term “market” as having some other content, they do not emphasize on geographic coordinates of exchange.

Market is, first of all, an exchange category, its characteristic. But it is not enough to determine nature of market. An exchange takes place in centrally planned economy too, but its content, forms, character, and order differ essentially. In centrally-planned economy the main parameters of exchange are regulated by a state. Such relation can't be called a market one. **Market is** a way of interaction of economic subject, based on price system and competition. This is a special mechanism of coordination for economic activities. Market relation set between a seller and a buyer has a range of *distinctive characteristics*:

– **position of participants is equal in their rights**. This means that both seller and buyer don't have abilities of noneconomic enforcement of partner to the entry into exchange relations. Of course, a barter can bring a large benefit for someone and less benefit or even losses for the other one, but the entry into it is voluntary and free;

– *application of principle of economic benefit as a main criterion of expedience for the entry into market relation.* One can distinguish three main rules for the participants of exchange to follow:

- 1) exchange must bring benefit;
- 2) everyone strives for making a barter with benefit for himself as much as possible;
- 3) it is better to make a barter with less benefit than to refuse it at all;

– *full economic responsibility of participants for their activities.* If freedom is one side of market position of a subject, then full self-responsibility is the other one. If economic subject chooses a partner of relations without enforcement, and according to his own will, then, naturally, he himself must be responsible for his choice correctness, for the whole complex of his activities;

– *legal guarantees and legal protection from the state.* A civilized society, as a rule, fixes main principles of its functioning in legal norms. A modern state sets legal norms of relations of economic subjects, and forms “rules of the games”. It provides real effectiveness of such norms, creating control authorities and judicial bodies.

Sphere of exchange can be presented as movement of two counter flows: commodities and money. Both final products and services and resources can serve as commodities. That is why, a market regulates movement of final products and services, their consumers are the householders, and their producers are businesses. A market regulates also movement of commodities-resources–labour, capital, land, entrepreneurial skills which are delivered by the households and by businesses to the market. It can be presented in the scheme of commodities and money circulation (Fig. 8.1).

Market functions

While considering commodities and money circulation, one can find those functions characteristic for a market:

1. Delivery of commodities to the final consumers. As modern production is based on labour division, then absolute majority of commodities is created not for someone’s own but for someone’s “strange” consumption. It is a market that serves the bridge through which a product comes from producer to its consumer.

2. Provision of production with resources. The households, being owners (individual or joint) of the greater part of labour resources, capital, land, and entrepreneurial skills implement their right on the market and that brings them corresponding profits. Businesses, while purchasing resources, bear expenses.

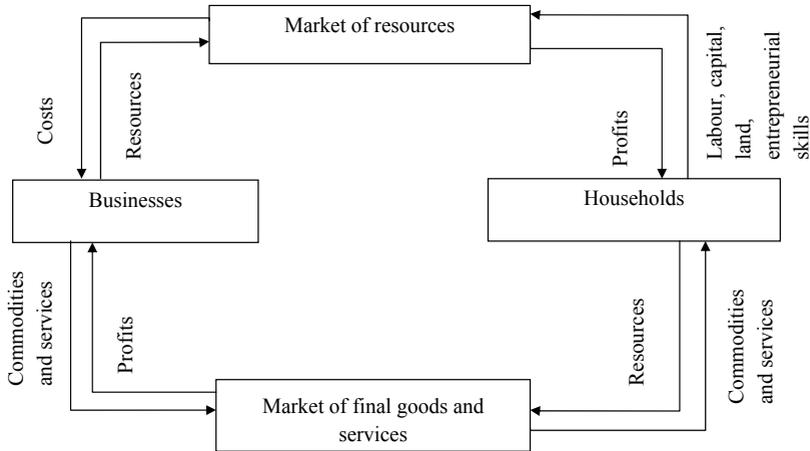


Fig. 8.1. Commodities and money circulation

3. Setting of correspondence between the produced product and expenses for it and the public needs. As producer, as a rule, is not oriented to the order but is oriented to his own ideas about what is necessary to produce and how much to produce, he always runs a risk.

Only after a product had been purchased by a buyer and a seller compensated his costs completely, he can surely say: “My choice was the right one”. If a mistake was made in assumptions, a market either doesn’t take such quantity of commodity, or doesn’t recover all costs to a producer. That’s why, a position of a commodity producer in a society is mainly defined by position of his commodity on the market.

4. Distribution of resources and final products. Unfavorable position of commodity on the market, reflecting its discrepancy to the public needs, forces a producer to reorient the use of resources to the other product development, the need in which is not met. That’s why, a market serves for redistribution of resources between producers with the purpose to bring the assortment of commodities nearer to the structure of public needs. Market is also a definite order of distribution of the final products.

5. Coordination of the interests of seller and buyer, coordination of their activities. All other functions are carried out through this one. That’s why, the next paragraph will be devoted to coordination of demand and supply.

8.2. Coordination of demand and supply

Market equilibrium

Buyers are ready to purchase and sellers are ready to sell the very different commodities. All depends on prices for them. In what way is that quantity of goods determined which will help to equilibrate present demand and supply?

To answer this question let's present the conventional data concerning demand and supply of purified water for city consumers given earlier, in one table (table 8.1) and analyze the way the relation between demand and supply under different variants of prices for 1 liter of purified water will be formed.

Table 8.1

Market demand and market supply of purified water in the city

Price for 1 liter of water, money units	Market demand for water, thousands of liters	Market supply of water, thousands of liters
25	200	60
50	150	150
75	110	200
100	80	220

Let's analyze from the highest price for 1 liter – 100 money units. If such price is really set on the market, then it will create conditions for companies to be interested to offer 220 thousand liters for selling.

But buyers are ready to buy only 30 thousand liters at such price. This creates an excess supply of 140 thousands of liters. A threat arises for producers not to sell a significant part of the proposed goods. Competitive struggle, between them forces to decrease prices. Consequently, the excess supply causes price decrease.

A price decrease for 1 liter down to 75 money units slightly improves market situation, but doesn't result in equilibrium of demand and supply. This price makes it unprofitable to produce previous volumes of purified water, and complete compensation of costs is possible under the value of supply of 200 thousand liters, at the same time the wishes and opportunities of buyer at such price, expressed in demand, will grow up to 11 thousand of liters. An excess of supply will be decreased down to 9 – thousand liters, but will be significant, nevertheless. This pushes up slightly to a new price decrease.

Perhaps, striving for goods selling, sellers will immediately agree to accept a very low price – 25 money units for 1 liter. But then a

contrary situation arises. Producers can offer only 60 thousand liters while buyers are ready to purchase 200 thousand liters. Situation known as scarcity of goods arises. Then competition between buyers comes into the foreground. Some of them agree to pay more to get necessary quantity of purified water. An excess demand for a product results in a price rise for its unit.

Price fluctuation results in setting of such price at which demand and supply coincide finally. For our example such price is 50 money units for 1 liter of water. Producers are able to produce and deliver to the market 150 thousand liters at this price. Just this quantity buyers would wish and are able to buy. Price for a product unit at which demand and supply coincide is called *equilibrium price*. Correspondingly, quantity of goods, balancing demand and supply, is called equilibrium quantity.

Equilibrium price is the only price of all possible ones at which both an excess supply and excess demand are absent. Any other price breaks correspondence, and, that's why, someone of participants of exchange (sellers or buyers) will strive for its change, directing it to equilibrium price gradually. Achievement of the last one will mean that all who would wish and are able to purchase products at such price will be able to meet their needs. All sellers who are satisfied with a set price, in the same way, will sell their goods.

The same conclusion we'll get with graphic representation. Equilibrium price and equilibrium volume are position of a point of intersection of the demand and supply curves (fig. 8.2).

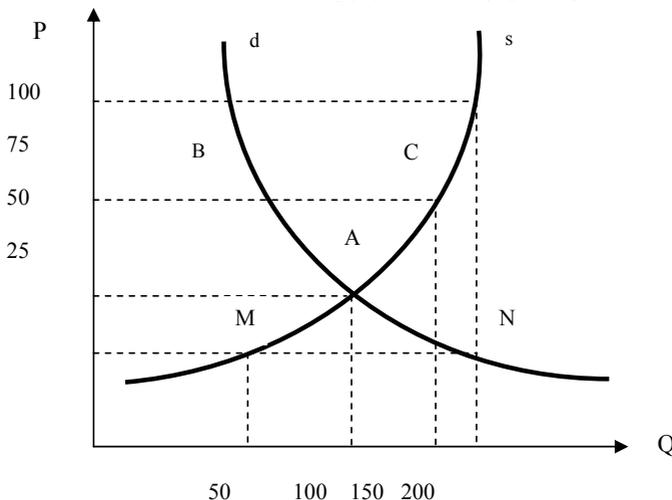


Fig. 8.2. Equilibrium of demand and supply

Taking into account character of the curves, such point can be only one. This testifies conclusion related to existing of one stable position on the market and striving for such situation in case of price deviation from equilibrium one.

Projection of BC segment onto Q axis shows an excess supply at the price 75 money units for 1 liter, and MN segment —excess demand at the price 25 money units for 1 liter.

Competitive struggle, changing prices, will promote achievement of market equilibrium.

Factors of the equilibrium price change

Equilibrium price is determined by position of the demand and supply curves. That's why, all *factors* which can shift those curves change an equilibrium price and equilibrium quantity of goods.

1. Shift of demand:

a) A demand increase. In unit 6 those factors which can result in a demand increase were rivaled. If, for example, a product comes into fashion, a demand curve shifts to the right (fig 8.3a). Then a point of intersection shifts upwards and to the right. This means that under a demand increase and unchangeability of other conditions equilibrium price and equilibrium quantity increase;

b) A demand decrease. Exactly the opposite situation takes place. Waiting for a price decrease cuts down demand, shifting a curve to the left. A point of intersection goes down and shifts to the left. That's why, an equilibrium price and equilibrium quantity decrease under a demand decrease (fig. 8.3, b).

2. Shift of supply:

a) A supply increase. Shifting of the supply curve to the right (that is the result of a supply increase) decreases a price of equilibrium but increases equilibrium quantity (fig. 8.3, c);

b) A supply decrease. While shifting a supply curve to the left a price of equilibrium increases and equilibrium volume decreases simultaneously (fig. 8.3, d).

3. Simultaneous shift of supply and demand. We can't answer in a single meaning what will happen in this case. All will depend on the elasticity of sellers' and buyers' respond to those factors.

Let's consider, for example, situation of a mass rise in wages. It is shown graphically in fig. 8.4.

From one side, a rise in wages means an increase in buyers' income. This will result in a demand increase for goods of higher category of quality and will shift a demand curve to the right. Due to that a price of equilibrium will increase from P_1 up to P_2 , and an equilibrium volume will increase from Q_1 up to Q_2 .

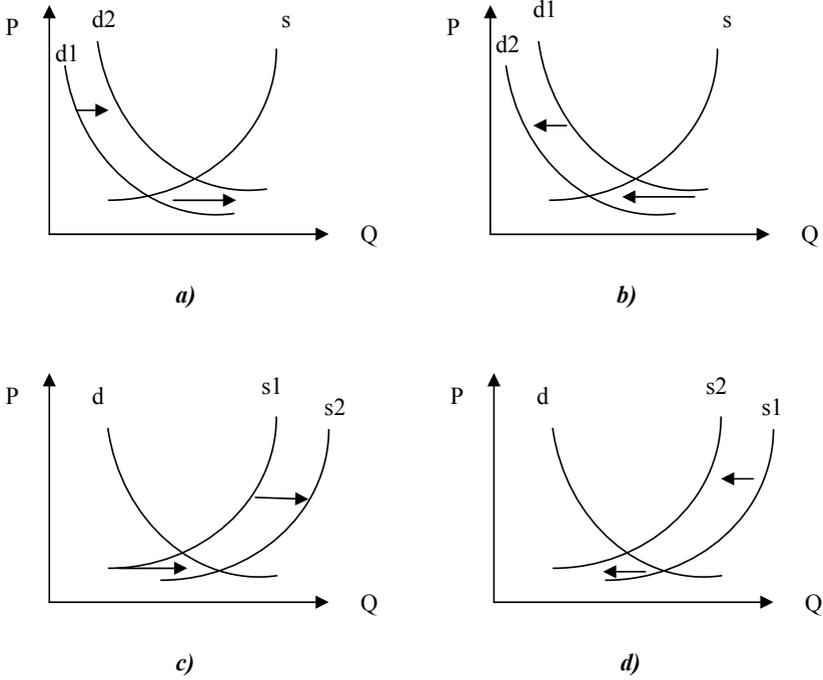


Fig. 8.3. Change of an equilibrium price and equilibrium quantity

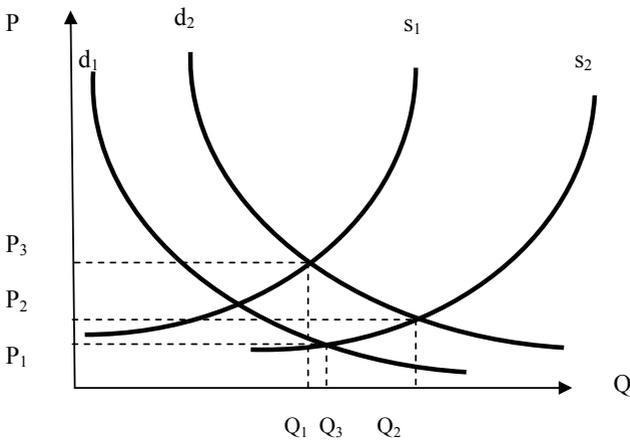


Fig. 8.4. Shift of an equilibrium price under a mass rise in wages

But from the other side, the wage is a price of labour resource. Rise in price for one of the resources will decrease a supply and will shift a supply curve to the left. A further increase of an equilibrium price up to P_3 level will take place, and an equilibrium volume will decrease from Q_2 down to Q_3 . It is difficult to forecast relation of the equilibrium volumes Q_1 and Q_3 . If coefficient of demand elasticity by profits is more than coefficient of supply elasticity by prices for labour resource, then $Q_1 > Q_3$, if relation of coefficient is reverse, then $Q_1 < Q_3$.

Thus, on the base of the stated ideas one can draw a conclusion that market forces are able to synchronize decision about purchasing and selling, excluding potential excesses and product scarcity doing that. However, for a price to carry out its characteristic balancing function, appropriate conditions have to be formed in economy.

8.3. Conditions of functioning and classification of markets

Conditions of market functioning

Operation of laws of supply and demand and other economic regularities takes place only in certain conditions. Their availability is precondition for the economic subjects to respond appropriately to corresponding factors.

The first condition of market functioning is *availability of free entrepreneurs*. For an economic subject to act on the market as a free entrepreneur, he must at least:

- a) manage conditions and results of production independently;
- b) be fully economically responsible for the results of his activities.

The second condition of market functioning is *availability of competition*. It is precondition of effective operation of a market price system. Absence or significant limitation of competition deforms market mechanism of interrelation –distorted signals begin to come to buyers and sellers. A violated order of exchange effects negatively functioning of the whole economic system. Historic experience has demonstrated that preconditions for limitation or even elimination of competition are formed inside of the market system itself. Market mechanism is not able to overcome this tendency. A state helps it in modern conditions.

Classification of markets

Classification of markets facilitates better understanding of nature of market relations. It can be defined by following main peculiarities (fig. 8.5):

- a) *by geographic factor*. One can speak about domestic market when relations of exchange are carried out by a partner on the territory

of his country, and about outside one when it operates on the territory of the other state. In its turn, a domestic market can be subdivided into a range of regional markets;

b) *by the objects of purchase and sale.* We have spoken about a market of resources and a market of final products. Including money into a market of resources requires some special explanation. Although money, as it was mentioned earlier, is not a special kind of resource, but due to its specification it is easy to transform into any of its kinds. Buying money (getting a credit), an economic subject widens its opportunities to obtain real resources. That is why here, from our point of view, some free definition of resources can be possible;

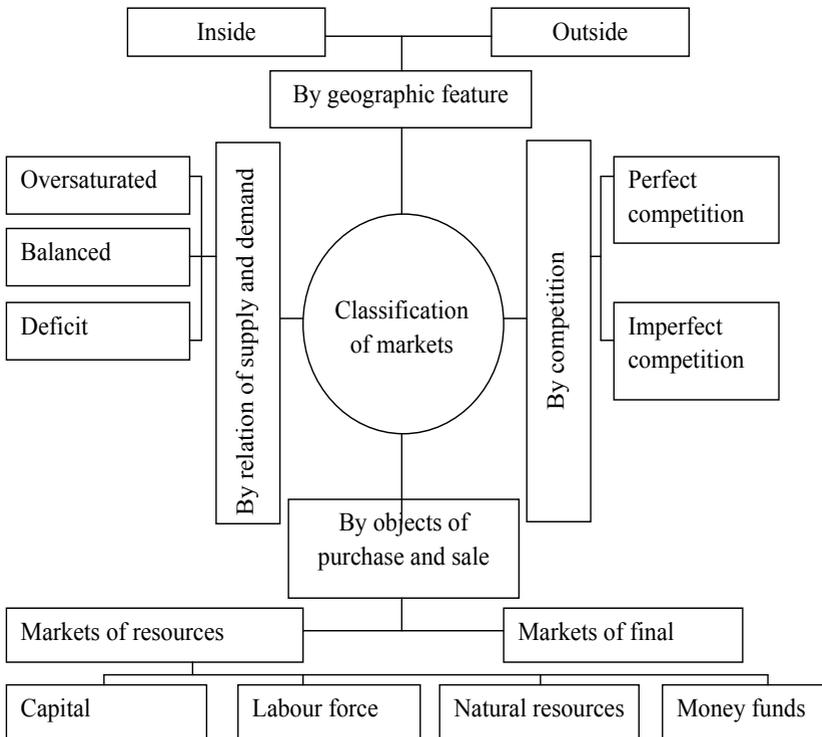


Fig. 8.5 Classification of markets

c) *by relation of demand and supply.* A market strives for achievement of equilibrium in demand and supply. When a market price is set at the level of an equilibrium price (point A in fig. 8.2) and

quantity of the demanded goods coincides with quantity of the offered goods, such situation can be called a balanced market.

However, it is not difficult to notice that such situation does not always exist. A market price doesn't correspond to the equilibrium price more often, though it strives for it, and then the values of demand and supply do not coincide. If a demand is less than a supply then we deal with a glutted market, when a demand is more than a supply then we deal with a deficit market.

d) by competitiveness. In dependence on condition of competition one can distinguish a market of perfect competition and a market of imperfect competition. We can speak about a market in which direct producer and final consumer of a product contact between themselves. But usually middlemen who specialize in bringing a product to final consumer are active in an exchange. Their activity must raise effectiveness of an exchange.

That is why, special institutes providing relation between mentioned partners are necessary for better operation of the market. In other words, infrastructure of market is necessary. It is usually formed by banks, broker's firms, investment companies, exchange, employment offices and so on.

In conclusion it is necessary to notice that a market can be presented in the form of some system (model) consisting of certain blocks and elements. Such system is presented in fig. 8.6. It, undoubtedly, has a simplified character in comparison with reality of economic life. But, at the same time, it helps for better idea about main components of the market system.

Market requirements to the economic subjects

A market makes certain demands to personal qualities and behavior of its participants. To be successful in market relation one has to understand those demands and strive to correspond them. That is why, it is important to consider this aspect of market, too.

In market economic environment the awareness of the following is formed:

- a man himself organizes his own life. Employment, income and other things are guaranteed for him not by a state, but by high competitiveness of his labour services, which he must take care of himself;

- a market gives wide opportunities in combination with absence of many guarantees.

A man can quickly clime the top of prosperity, but at the same short periods of time can find himself "at the bottom". A market doesn't guarantee but gives a chance to express economic initiative

and entrepreneurship in the form of freedom. It gives, may be, the best conditions for self-realization.

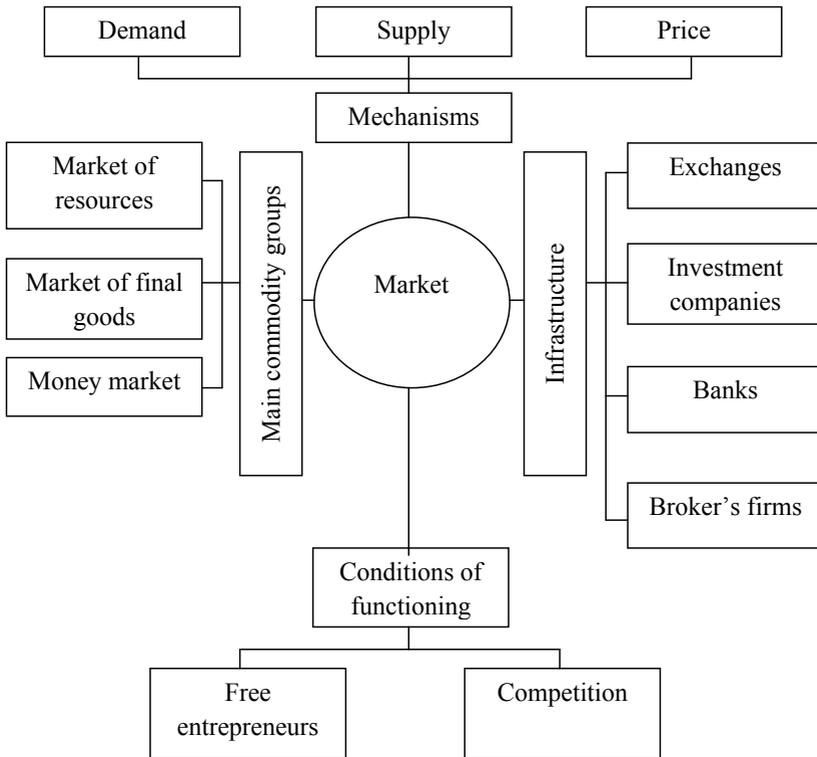


Fig. 8.6 Model of market

– a choice as an element of daily life is accompanied with a constant risk. Freedom of activities, provided by a market, calls people to analyze alternatives and choose the most effective of them constantly. But the variant preferred by someone, may turn out the worst. The element of risk is present in market environment constantly.

CONCLUSIONS

1. A market is a way to coordinate activities of the economic subjects, providing agreement of their economic interests on the base of a price system and competition. Equal position of participants, application of principle of economic benefit, and full economic responsibility of participants for their activities are characteristic for market relations.

2. A market provides a delivery of manufactured goods to a consumer, provision a production with resources, setting of correspondence between produced commodity and the expenses for it and public needs, distribution of resources and final products

3. Implementing coordination of supply and demand, market mechanism provides agreement of interests of seller and buyer by the way of achievement of an equilibrium price and equilibrium quantity. An equilibrium price can be changed due to the shift in demand and supply shifting the curves in the schedule and a point of their intersection.

4. Availability of free entrepreneurs and competition on the market are the main conditions to form market relations.

5. Markets can be classified by geographic factor, objects of purchase and sale, relation of demand and supply, and level of competition.

6. A market makes certain demands to personal qualities and behavior of the economic subjects: initiativeness, self-responsibility, ability to manage freedom, ability to risk and so on.

The main terms and concepts

1. Market
2. Peculiarities of market relations
3. Functions of market
4. Market equilibrium
5. Equilibrium quantity
6. Conditions of market operation
7. Classification of market

UNIT 9. ENTREPRENEURSHIP

Entrepreneurship is a free initiative of people in economic activity; it is a way to organize economic forces. In other words, it is an investigated way of effective organization of production in the world practice. Existence of entrepreneurship is an essential condition of market functioning. We have made such conclusion in the previous unit. That's why, the next stage of knowledge must be a deeper clearing up of the nature of entrepreneurship and its functions in modern economic system, conditions and types of entrepreneurship activity, processes of formation and development of the subjects of entrepreneurship in Ukraine.

9.1. Nature and functions of entrepreneurship

Nature of entrepreneurship

Entrepreneurship as a special kind of man's occupation was known long ago. It is considered that the basis of modern theory of entrepreneurship was laid by *I. Schumpeter* in the first half of the XXth century. In particular, his idea of "creative destruction" developed ideas about the nature and character of entrepreneurship activity. In contrast to an ordinary manager who controls the resources at his disposal, an entrepreneur behaves creatively in these or those conditions. If an entrepreneur draws a conclusion that some other structure of production or its organization must correspond to the established situation, he destroys old situation and creates a new one adequate to those conditions. "Creative destruction" is displayed in that way.

An entrepreneur, according to Schumpeter, is oriented not to the static efficiency connected with maintenance of the ability of the existing system to function, but to the dynamic one supposing a modern change and development of the controlled system.

Modern economic theory defines **entrepreneurship** as initiative, independent economic activity of people directed to obtaining profits through organization and use of resources in purposes of production and selling of goods.

It one supposes that organization of some business required an entrepreneur to spend M , then that activity will have a sense only when the gained result M^1 is bigger than M .

An excess of the gained profit over expenses is an income of an entrepreneur:

$$M^1 - M = \Delta M = P,$$

where M , P – income.

Entrepreneurship decisions come, first of all, from the business owners'. However, as the relations of ownership develop and its corporate forms extend, entrepreneurship authorities are delegated to the hired managers more often. One can't hold, say, a general meeting of shareholders on each problem. Situation often requires to make efficient and flexible decision. That's why, the owners delegate some part of entrepreneurship functions to the hired managers, taking into charge a control on strategic issues. Probably, one can talk about entrepreneurship management as a special form of entrepreneurship. Manager, carrying out entrepreneurship authorities, is looking for opportunities and taking aforethought risk, implementing changes and introducing improvements in his business.

Risk is an integral feature of entrepreneurship. Certainly, it is not only an entrepreneur who takes a risk. Thus, leaving home when the streets are sleepery with ice, we take a risk to injure ourselves because of falling; there is a threat that a tap, in the flat of your neighbor living upstairs will be broken down and your own flat will be flooded and so on.

However, those risks can be called spontaneous ones. An entrepreneur takes a risk consciously. He has not any guarantees that his merchandise will be bought, that the obtained return will cover the costs and will give him some profit. Of course, an ability to make exact calculations and foresee market situation decreases probability of failure, but it is impossible to eliminate the risk completely.

Functions of entrepreneurship

To understand a nature of entrepreneurship better let's clear up its functions and role in economic system.

1. Resource function. It is implemented in mobilization of capital, labour, material, information and other resources for their efficient use. An entrepreneur's purpose to reach a dynamic efficiency forces him to continuous search for additional resources. A lot of potential resources of society would be unrequired if entrepreneurs didn't mobilize them.

2. Organizational function. Mobilized resources can bring benefit to their owner, an entrepreneur and a society as a whole only in the case they are used properly. That's why, an entrepreneur takes a function of organization of production, distribution, market research, scientific developments and so on upon himself. Of course, hired managers can directly organize production operation in these or those directions, but the situation is in no way altered by that fact. An entrepreneur shows organizational skills when he finds necessary people able to manage businesses efficiently. Besides, an entrepreneur always reserves the right to make decisions of principle for himself.

3. **Creative function.** An entrepreneur constantly takes aim at a search of new decisions. Striving for maximization of profit or another result recognized by entrepreneur as a purpose of his activity, doesn't allow him to be satisfied with the established situation. He is constantly searching for the ways to improve his business. Mankind is obliged to creative function of entrepreneurship for emergence of many original scientific, technical, economic, and organizational decisions.

9.2. Conditions of entrepreneurship

Conditions of entrepreneurship (business) activity

Entrepreneurship has a centuries-old history. But it doesn't mean that automatic reproduction is guaranteed to it. For this phenomenon to appear, and especially to transform it into a basic organizational form of production, it is necessary to have certain conditions, among which the following ones are expedient to distinguish:

1. **Availability of corresponding property rights to conditions and results of production.** As one can see in picture 9.1., an entrepreneur must be the owner of the manufactured product and profit earned after its sale. Only under those conditions a proper interest appears to carry out entrepreneurship activity.

Different variants are possible concerning capital and land. Those economic resources can be a property of an entrepreneur or can be obtained by him for the use on the basis of agreements of different kinds: renting, leasing and so on. Today absolute majority of business organizations use combination both borrowed and their own funds (outside and internal).

2. **Availability of certain economic, legal and political environment.** Formal recognition of the property rights to conditions and results of production can get on with other legal norms regulating economic life of a society but not providing with the satisfactory degree of economic independence for business activity in practice. Of course, an owner never enjoys an absolute freedom to manage his property. But limitations of different kind forming economic environment must provide a satisfactory "corridor of freedom". For an entrepreneur it is expressed in obtaining satisfactory independence while:

- choosing a type of economic activity;
- choosing consumers of goods and suppliers of resources;
- determining prices;
- managing the earned profit.

If, for example, very high profit taxes are set or prices are strictly regulated, and it is ordered what to produce and who to deliver to, and if it is regulated what part of profit must be used for consumption and what part must be reinvested, that is, to be returned into production, then it is difficult to rely on high level of business activity in such economic environment.

Creation of environment favorable for entrepreneurship assumes availability of certain legal guarantees from the state. They may include the following:

- legal protection of the entrepreneur’s rights, compensation of losses caused by activities breaking those rights;
- state arbitration as a means to settle controversial economic situations;
- legislative support of free competition, consumers’ protection from unfair competition and monopoly, and provision of other necessary guarantees of business activity as well.

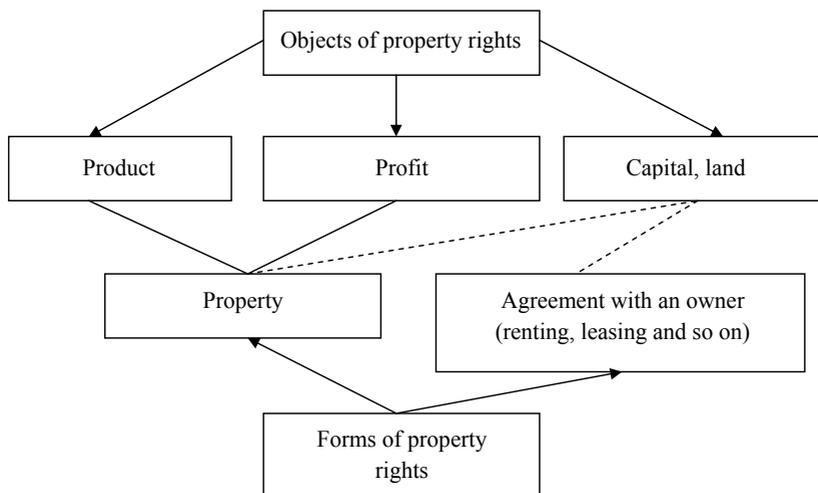


Fig. 9.1. Objects and forms of property rights

For normal development of entrepreneurship it is necessary to set a favorable political environment. Coming into power of political forces which are unfavorably set to entrepreneurship can change both legal and economic environment into negative direction for entrepreneurship.

3. Full economic responsibility for the results of activity. Negative results of business activity can be the following ones:

- unprofitableness, that is, budget deficit (excess of costs over profits);

- significant loss of property;

- bankruptcy (recognition of full insolvency).

They are caused by different reasons, including unpredictable ones (effect of natural forces, political and military conflicts and so on). But as, *Lee Iacocca*, one of the masters of American management thinks, there are only three reasons of company's bankruptcy: the first reason is a poor management; the second one is a poor management; the third one is a poor management (mismanagement).

An entrepreneur is just the specific person who takes a burden of reliability and risk, inevitable in business activity, upon himself. Such situation obliges to continuous self-control of economic activity, expects intensive searching for the ways of an increase of its efficiency, a display of inventiveness, flexibility and so on.

4. Ethics of entrepreneurship (business ethics). We'll consider only economic aspect of the issue here. We'll try to contend that ethics of entrepreneurship is one of the factors of its profitability or efficiency.

What moral and ethic norms are established in entrepreneur's environment on civilized markets and what is their influence on economic results of entrepreneurship? The answer is as follows:

- *obliginess*. It is originally formed by the strict economic responsibility for obligation, which is drawn up as a document. However, in time, the main guarantor to observe even oral agreements becomes striving for saving an image of an obliging partner. Loss of that image threatens to turn into breaking-off for the established relations, and that will negatively result in business activities and career of an entrepreneur. That's why, it is not surprising that, for example, in the majority of the exchanges, a broker, first of all, fulfils an oral order of a client (terms of tenders require immediate response to situation), which is drawn up as a document afterwards.

- *fair competition*. This is a deep moral and ethic issue. It is very important for a society and its future. It is important not only how many goods we produce. It is important what way we do it in. What our relations are, what moral and psychological satisfaction we get from those relations. Business can be rigid and "nervous" very often. But, in the end, unfair behavior, some time or other, turns into a loss of partners and clients, and that negatively results in financial and other results of a business;

- *general high level of culture and education*. More chances to prosper has a person who is able to think deeply and on a large scale, and it is necessary to be informed in a sufficiently wide field of knowledge for that. And what is more, an entrepreneur must be able

“to think ahead”, that is, to forecast development of situation, to make forestalling decisions;

– *communication skills, ability to communicate with people, to interest them, to mobilize for achievement of the set purposes.* An entrepreneur will not reach very much, if he loads himself with all the work. It is necessary to achieve the workers involved by him to contribute not only their labour but their creativity into the established business.

Ukraine experienced a difficult period of free entrepreneurship renewal in 1990s. Private entrepreneurship has got a right to life after approximately sixty years of contempt. This period has brought in many examples of “wild” entrepreneurship: dishonesty, avidity, collusions, easiness in giving out promises and the same easiness of their nonobservance, corruption and so on. A lot of people with not the highest level of moral, cultural and education qualities were found in the front lines of entrepreneurs. To some extent that reminded a period of entrepreneurship development in the XXth century, that was called “wild capitalism”. But further experience of economic development displayed that entry of a market into civilized limits, formation of a mixed economy of a modern type narrow sharply chances to serious success of entrepreneurs with a low level of moral, ethic, and education qualities.

Like in nature, there is a peculiar internal “natural selection” in market environment. There is also an influential “sanitary inspector” in modern economy who sweeps out unlucky entrepreneurs, - this is competition. Competition is an economic factor, but it is people who compete. Entrepreneurs, observing certain moral and ethic without speaking about legal norms of behavior, have more chances to survive and prosper.

Formation and development of the subjects of entrepreneurship

Formation of the subjects of entrepreneurship is possible in two ways in principle. The first of them is evolutionary way. It assumes gradual accumulation of monetary and other resources enough to launch and develop one’s own business. According to historic experience this process can be a rather long one. It is accelerated with application of a joint stock form of entrepreneurship which, like a magnet, is able to attract, to turn a lot of small funds into resources of effective power. Development of credit business facilitates that to a certain degree as well.

Opportunities for evolutionary way of formation of entrepreneurship participants had been rather limited by the beginning of reforms in Ukraine in 1990s. The reasons for such situation can be as follows:

– lack of enough savings that population has;

- population's distrust to securities – shares, bonds and so on;
- inadequate background of credit system;
- lack of enough psychological and social motives for entrepreneurship which people have.

The second way assumes acceleration in formation of the subjects of entrepreneurship. It, as a rule, is used in countries implementing transition from centrally planned to mixed economy. A state makes decision on:

- 1) privatization of businesses
- 2) change of conditions on the use of state capital by the way of commercialization and stimulation, in particular, and appearance of economic patterns of entrepreneurship type.

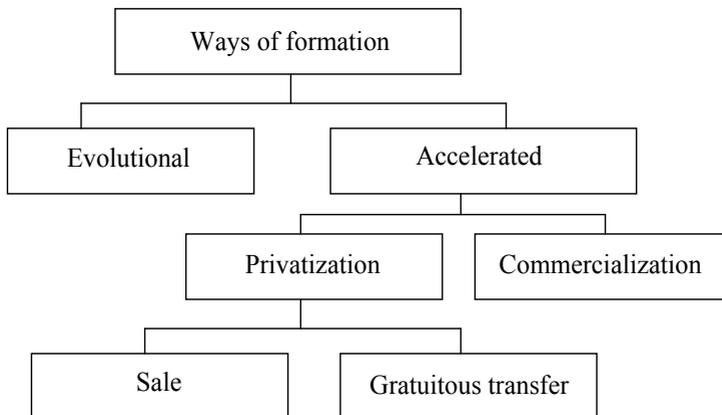


Fig. 9.2. Ways of formation of the subjects of entrepreneurship in Ukraine

Privatization process is proper to a lot of countries to this or that degree. For some countries it is a radical means to reform all economic system (under transition from centrally-planned to market economy), for others – it is opportunity to cheer up and modificate certain sectors of economy, and it is also a way to decide problems of the state budget. Application of the property sale procedure is a market way to carry out privatization. With that it is important for the state as a seller to create conditions of competition among buyers which will enable to carry out a sale in the actual market cost.

However, peculiarities of Ukraine's economy formation and some other countries specified the use of such way of privatization as gratuitous transfer of the part of state property to the whole population. The given way assumed to give out privatization property certificates

to the citizens and their further exchange into shares or some other corporate rights related to privatized businesses. Under such way, at first, appeared dissipation of the property rights, and then for a certain period of time through purchase and sale operations in the secondary share market processes of a decrease in quantity of shareholders and consolidation of blocks of shares took place.

Commercialization is the second direction of state property transformation. It is a wide concept which is specified by such forms as leasing, leasing with buyout of leased property and so on. Mode of state property functioning is changed. Use of property of state enterprises is carried out on the basis of commercial and market relations. Direct tutorship from the state's side is removed.

9.3. Main kinds of entrepreneurship

The objective basis to differentiate kinds of entrepreneurship

Like any other kind of activity there is some kind of labour division in entrepreneurship. Alongside with general characteristic features different kinds of entrepreneurship have specific characteristic features, too. The objective basis to differentiate different kinds of entrepreneurship is the process of entrepreneur's funds movement, which could be described as following. An entrepreneur, possessing some start monetary capital (M), obtains resources to launch his own business, first of all, capital (K) and labour services (L). In result of production process (P) some new product is created (C), selling the product, an entrepreneur gets more money than he had invested initially (M¹):



One of the decisive criteria, while choosing a field of activity for an entrepreneur, is a size of profit gained during some period of time when calculating for the unit of prepaid assets. This parameter is accepted to call as a rate of return: (P¹):

$$P^1 = \Delta M : M \cdot 100.$$

Rate of return to a significant extent depends on time during which monetary capital returns to an entrepreneur with growth. This is time of monetary capital turnover.

If, say, monetary capital of 1000 money units brings 200 money units of profit for one turnover and that turnover lasts for one year, then an annual rate of return will be 20%. If an entrepreneur manages to reduce time of turnover down to six months, then annual rate of return will be increased up to 40%.

Time of turnover of money capital includes the time to search for necessary resources on the market, production, delivery of manufactured goods to the market and organization of its sale. Sometime a significant part of time is spent on searching for necessary monetary means to organize production. It is obviously that entrepreneurs are interested to decrease the time of turnover. This can be facilitated by specialization among entrepreneurs, division of fields of their activity very much. Besides, a decrease in time of turnover, and differentiation of kinds of entrepreneurship results in general saving of resources to achieve the set goals.

Industrial entrepreneurship

Some part of entrepreneurs, as a sphere of application for their abilities, chooses creation of material product as a basis to satisfy society's needs. As industry is one of the fundamental branches to create a material product, then such kind of entrepreneurship is called an industrial one, though it encompasses some other branches as well (building, agriculture and so on).

Industrial entrepreneurship solves the following main tasks:

- creates a material product which is able to satisfy people's basic needs (items of consumption) and serves as a capital for all spheres of entrepreneurship (means of production);
- implements fundamental scientific and technical ideas, laying foundations of society's economic progress as a whole.

Specialization in that kind of entrepreneurship gives an opportunity to decrease that part of time of turnover which is connected with product creation, that is, time when the obtained means of production are in the form of production resources and creation of product itself, organizational and technological disruptions. A decrease of time of production itself and technological disruptions (drying of painted, getting cold of the warmed up, heating of the cold and so on) depends on the degree of introduction of new technical and technological solutions into production. Time of organizational breaks (lunch, absence of the third shift, failures in supply of raw materials and so on) is defined by the quality of implementation of organizational function of entrepreneurship. Attitude to organizational breaks is a control of an entrepreneur for ability to coordinate economic expediency and social acceptability. People are not robots, are not resources to get

profit for an entrepreneur, but not all the entrepreneurs, by the way, remember that. The way to profit can't only assume considering "pure" economic factors, and entrepreneurial skills are not the ability only to draw maximum from the hired workers.

It is necessary to consider especially the time when production means are in production resources. Ideal variant is a "work from wheels" when raw material even is not stored, but is immediately sent into production. But this impossible only under a high degree of suppliers' reliability, transport communications and so on. Even a little delay in supply can result in stoppage of production and can bring big losses. That's why, a decrease of time when the means of production are in production resources depends on the level of development of the other kind of entrepreneurship – trade one.

Trade entrepreneurship

This is a special kind of entrepreneurship, mainly connected with bringing a product from producer to consumer. Without creation of a new material product, a subject of trade entrepreneurship sales a special product – a service, accelerating and reducing in prices the process of a product movement.

This can be explained by the following reasons:

- specialization of an entrepreneur in trade activity enables him to research the state of market better, respond actively to the changes of its economic conditions;
- costs for maintenance the process of turnover are reduced (constant and complete use of warehouse spaces, reduce of transport costs, reduce of costs to promote products in the market).

Modern trade entrepreneurship is oriented not only to the philosophy of distribution, when ability to sale the greatest quantity of goods at the highest prices is considered a condition of a firm's success, but is oriented to the philosophy of marketing, assuming orientation to production and sale of the product necessary for a consumer, which is able to satisfy his needs in a better way. Such approach gives an opportunity to support competitiveness, to form loyal attitude of consumers to a company as a whole and to its trademarks.

The subjects of trade entrepreneurship carry out intermediary functions both on the market of resources and on the market of final products and services. Each of them has its own peculiarities. To specific features of market of material resources can be included the following ones:

- specific object of purchase and sale, not a final product, but a product coming back into production;
- limited number of buyers;

- larger volumes of procurements;
- ultimate buyer, as a rule, is a manufacturer.

Wholesale firms, commodity exchanges, trading houses and so on are the main institutions of trade entrepreneurship on the market of resources.

Trade entrepreneurs sell the products to the households on the markets of the final products. These markets are characterized by the following:

- significant quantity of buyers;
- significant differences of consumers from each other in age, level of income, education, points of view and so on;
- a great complexity in forecasting of buyer's behavior;
- buyer's unprofessionalism.

Two kinds of operations can be used in trade entrepreneurship:

- commission charge carried out on a client's assignment and at his expense. An income of a trade entrepreneur in the given case consists of commission, as a rule, in percentage on transaction value;
- commercial charge carried out by an entrepreneur on behalf of his own and at his own expense. His income consists of difference between price of sale and price of purchase.

Of course, producers could, in principle, manage without middlemen. But such system of distribution requires additional funds from them, time, distraction from basic activity. That's why, it turns out preferable to sale a product to a middlemen at a lower price than a market price of ultimate distribution, to receive less profit but to save time and additional costs.

Credit entrepreneurship

This is a kind of entrepreneurship related to accumulation of temporary free monetary means and their further use to credit extension on the principles of urgency, paid services and recovery. Both businesses and households, from one side, have temporary free monetary means (for example, accumulated funds to build a new work shop or saved money for a summer rest), and from the other side, there is a periodical necessity in additional financial means. A striving of a young family for getting a flat or a car with further payment of cost during some period of time can serve an example of the last one.

The main sphere of credit entrepreneurship is a bank credit. It is granted for a certain payment. It can be considered as a price of credit and is called a loan interest. Say, a borrower, using a credit of 1000 monetary units during a year, pays back to a creditor 1100 monetary units. 100 monetary units repaid in excess of the amount of credit is a *loan interest*.

Interest rate (norm of loan interest) displays a relative price of credit, that is, relation of payment for credit to its size. It will be 10% for the given example.

As market relations develop, the role of credit entrepreneurship is constantly increasing and today there is practically no a sphere of economic life which in this or that way wouldn't be connected with the activity of banks or other credit institutions.

But no matter what sphere an entrepreneur acted in, what specific market he maintained, he would be forced to do his business, as a rule, in conditions of competition.

CONCLUSIONS

1. Entrepreneurship is an initiative, independent economic activity of people, directed to the obtaining a profit through organization and the use of resources with the purpose to get and sale goods. An integral part of entrepreneurship is a risk which an entrepreneur takes on himself consciously. Entrepreneurship fulfils resource, organizational, and creative functions.

2. Entrepreneurship is possible under certain conditions, including corresponding property rights to conditions and results of production in a certain economic, legal, and political environment, under complete economic reliability of an entrepreneur for the results of an activity.

3. Successful entrepreneurship is achieved under observance of the moral and ethic norms by participants of the process, among which obligingness, fair rivalry, general high level of culture and education, communication, and ability to communicate with people are distinguished.

4. Formation and development of the subjects of entrepreneurship in Ukraine was carried out with the use of two ways – evolutional and accelerated. Accelerated way was used to carry out market transformation of economy. Instruments of its implementation are privatization (alienation of state property in favor of private persons) and commercialization of the process of the state property use.

5. The objective basis to differentiate different kinds of entrepreneurship is the process of movement of entrepreneur's funds. Specialization among entrepreneurs facilitates reduction of time in turnover of money capital, a decrease of general costs of resources, and, consequently, an increase of the generalizing parameter of efficiency of entrepreneurial activity, that is, rate of return.

6. Industrial entrepreneurship is related to creation of a material product satisfying basic people's needs or being a capital for all spheres of entrepreneurship. Trade entrepreneurship deals mainly with bringing a product from producer to consumer. The main function of credit

entrepreneurship is accumulation of temporary free monetary means and their further use to grant a credit.

The main terms and concepts

1. Entrepreneurship
2. Functions of entrepreneurship
3. Conditions of entrepreneurial activity
4. Rate of return
5. Turnover of capital
6. Industrial entrepreneurship
7. Trade entrepreneurship
8. Credit
9. Credit entrepreneurship
10. Loan interest
11. Interest rate

UNIT 10. CONDITIONS OF COMPETITION

A market presupposes interaction of producers and consumers of products. That cooperation is carried out on the basis of competition, economic rivalry of producers, consumers, producers and consumers. An issue of competition in economics is, first of all, about the quantity of different goods and services existing in the market, producers and consumers acting independently, and how free they are to come to those markets and to leave them. Private property, free price formation and competition are considered to be the “pillars” of market system.

Previously we examined a market in general, we didn't analyze a factor of competition, its influence on market interaction of sellers and buyers. Now it's time to examine competition as a factor defining market relations specifically. Many things would be changed in those relations in dependence on the type of competition characteristic for the market.

If a man decided to get a “four-footed friend” – a dog, he would usually read some special literature to study physiology, habits, and recommendations on looking after dogs. At the same time, there is no a dog at all, there are specific breeds of dogs – a sheep-dog, risenshnautser, St. Bernard dog, collie dog and so on. And who will argue against that there is difference between bulldog and poodle? That's why, it's very important for a perspective owner to get information not only about dogs at all but about peculiarities of a specific breed too.

It's necessary for a person striving for investigation of economics to understand organization of market relations in general and their specific conditions at different types of competition. Everyone of us can play a role of a buyer, a majority of persons able to work can play a role of a seller (for example, selling labour services), and some of us can play a role of an entrepreneur. Knowledge of conditions of competition will help estimate one's own abilities and chances better, forecast situation, try to prepare alternative types of behavior beforehand.

A market cannot function effectively without competition. At the same time it has no enough immunity against aspiration to limit or even eliminate competition. The last one means presence of only one subject on the market in the role, for example, of a seller, such phenomenon is called an absolute monopoly. A market itself can not protect itself. A state will give a hand of help, it pursues a policy of competition regulation.

This unit examines a nature and meaning of competition in economic system, its types (pure competition, monopolistic

competition, oligopoly, and absolute monopoly), forms, and activity of a state in competition regulation.

10.1. Competition in economics: nature, subjects, and meaning

Conception of competition

“To compete”, while translating from Latin, means “to clash” (with), to conflict with, to collide with. Clash of interests, their rivalry is one of the elements of our life. One can even say that it is filled with rivalry of interest.

Two fellows at the same time may cherish kindly feelings for one and the same girl, they will compete to win her favor; employees of one and the same institution can compete to earn a higher position; school-leavers compete to be admitted to the institute; political parties compete to get places in the government bodies.

With those examples we would like to demonstrate that competition is a rather wide conception, covering almost all spheres of a person’s activity. Competition is always a result of scarcity and scantiness of something.

Competition in economy is a rivalry of economic subjects for better realization of their economic interests. Sellers and buyers of goods are the competing economic subjects (fig. 10.1.). Better realization of economic interests for the first ones will mean earning greater money income in the result of selling goods, and for the second ones it will mean earning greater quantity of the necessary goods and services in the result of the less money costs. Competition among sellers is carried out for the money of buyers and among buyers is carried out for the goods of sellers.

Competition of buyers is pursued by the following methods:

a) *money voices*, that is, readiness to pay more money for the desirable goods. Auction of some kind turns out which is constantly operating, and having a great deal of “places” or “points” of carrying out. Those buyers become winners who have reached advantage in quantity of money supply for the goods. Such form of competition of buyers is the main one, absolutely prevailing. It “catches” economic interest of a seller, striving for maximization of money inflow.

b) *earning a special favor from those having material values at their disposal*. In the prevailing part of the competitive cases to get the desired goods, it is enough to have greater money power with the help of which one can win a victory over competitors. But that happens not always. Friendly, cogenetic and other privileged relations

of some buyers with sellers can increase competitiveness of those buyers and provide their better access to the material values. That can concern obtaining a credit, economic resources and consumer goods, conclusion of an agreement on a lease of premises, getting a job, a place for studying in a prestigious institute, privilege voucher in a local trade union committee and so on. Those examples illustrate reality, at the same time pointing out that forms of human cooperation are not perfect.

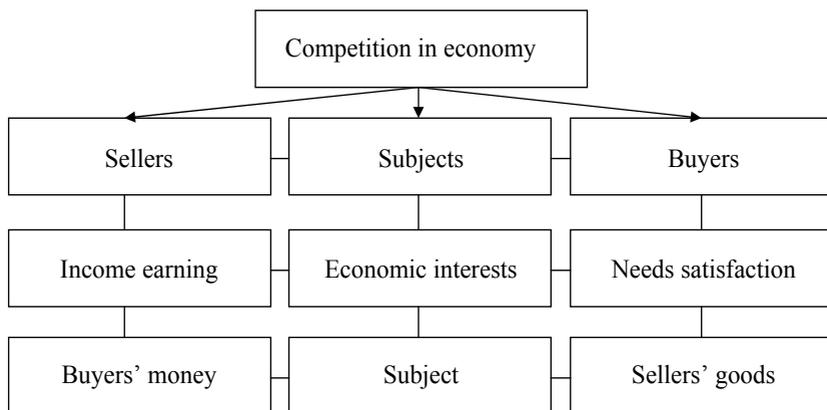


Fig. 10.1. Competition in economy

c) application of special personal qualities in obtaining a desired product or service. For example, if a price for some product is fixed by a state and a demand for it at the given price increases supply significantly, then money potentialities become a useless instrument in rivalry for obtaining the given product. It becomes a deficit one doesn't stay on the shop counter desks or in other places of selling. Then buyers use some other means: some of them try to foresee when and where it is more likely for deficit goods to appear; some other are ready to show their physical qualities (endurance, force), remain standing in many hours queues or squeezing themselves into overcrowded trolleybus or bus, achieving, in that way, a transport service. Such phenomena are more noticeable in conditions of centrally planned economy.

Competition of sellers can be pursued by (methods of competition):

a) use of pricing methods. A buyer's purpose is maximization of money inflow from realization of his goods. Money return depends on physical volume of production and a price for the unit of the sold product. It is possible to stand out among competitors by setting a lower price for a product. That will attract buyers' attention: under all

equal conditions that will increase purchases for the given seller, and by that, the outflow of money voices, and money inflows from other sellers will happen. In the basis of a lower price, in comparison with competitors, less costs for production and realization of goods or aspiration to increase its total mass for a certain period of time at the expense of reducing income for the unit of product may lay. Price competition can have rather sharp forms, often it is even called a “price war” and can be directed to full suppression of competitors.

b) use of nonpricing methods. In those cases buyers’ attention, their money are attracted by actions which are not related to manipulations with the prices for goods. A seller strives for carrying out active marketing activity – to study consumers’ needs, to reveal details, and tendencies to respond to them in a correspondent way, and, by that, to pass ahead competitors. Advertisement is actively used to inform perspective buyers about goods, to popularize their properties and distinctive characteristics.

Significance of competition

In the beginning of the unit the basic significance of competition in modern economic system was stressed. Now, it is necessary to detail the issue.

Firstly, competition provides equal position of the participants of economic relations – sellers and buyers. Equality of the rights is created and maintained by freedom of choice: a buyer has opportunity to choose a certain partner from several or many sellers of some products which are necessary for him; a seller has the same opportunity – to decide voluntarily an issue related to the geographical area, time, and conditions of his goods supply. Opportunity of choice is an opportunity to influence a partner if, for example, you are not satisfied with the quality of films show, repertoire in some cinema house, you can “punish” that business by refusing visiting it and becoming a regular client of the other cinema house, now giving your money voices exactly to it. If many of film lovers do as you do, then the cinema house failure will find itself in a rather difficult situation. Thus, competition turns out an influential instrument of influence of one party of exchange on the other party.

Secondly, competition creates one of the main conditions which are necessary for effective carrying out of coordinating functions by a price. Free price formation is a basic element of market mechanism, and one can contend that competition is condition of vital ability of the whole market system. Only in conditions of competition a market can effectively carry out functions of distribution of resources and

final goods. A market as a self-regulating system is effective only in presence of competition.

Thirdly, competition acts as a monitoring system of the efficiency of the private entrepreneurship. Competition examines business for the extent of its correspondence to the public interests. Not all businesses can pass that examination, there is a continuous rejection of inefficient structures in the result of competition, that is, a certain part of the economic subjects is forced to leave “a field of economic game”. In this case competition is like a football referee, showing a red card to the player who is guilty.

In the fourth, competition creates an interest in perfection of economic resources, their production combinations, scientific and technical renovation of production. For example, money incomes of many people are related to the supply of such economic resource as labour abilities. Attraction of this or that worker, a price of labour services – wages (salary) – in conditions of competition depend on the quality of labour abilities. As a rule, higher competitive positions of a worker give him a higher money income. So, a clear thinking person must take care of the quality of his labour resource.

Businesses pursue pricing and nonpricing competition. To win victory, that is, to win greater sum of money voices of buyers it is necessary to reduce costs, perfect quality of manufactured goods, think over their new models, technological changes, increase level of workers' education, actively cooperate with science, search out the latest scientific and technical developments.

Problems of competitive relations

Competition itself is not an ideal form of economic relations of people. Competitive character of relations in economy gives significant and unquestionable advantages in efficiency. At the same time, competition doesn't give satisfying decisions in some other questions in full.

So, resources and final goods are distributed according to the power of money voices in competitive system. That one who has more voices wins victory, as a rule. What should those consumers do who cannot get some acceptable sum of money income due to objective reasons? Some families can feed their favorite Labradorian with selected food, and others eat the simplest food and often of the low quality. Of course, laziness, inertness, irresponsibility can't be encouraged in no case, but at the same time, one can see problems of objective character in many cases. Critics of competitive system stress also its insufficient ability to respond to the requirements of

social justice and humanity in distribution of economic resources. In particular, resources can be directed to the construction of luxurious private residences, maintenance of expensive football clubs, creation refined products for rich men, and at the same time, there can be a scarcity of equipment for schools, hospitals, drugs for first medical necessity in society.

One more problem can't be passed over. Competitive system really creates an interest in reduction of production costs, its scientific and technical renovation. Motivation of such actions was previously explained. However, this question has the other side, too. Competition gives birth to an interest in a simple "buying-up" of scientific and technical innovations (for they not to be taken by the competitors), in localization of their application, in non-proliferation of new technical, information, and organization elements in economy. Moreover, competition creates an interest in buying-up of businesses for their further real liquidation. One should not, of course, exaggerate scales and abilities of such "selfish" activity but it is impossible not to take it into consideration at all, too.

That's why, competitive system needs certain correction from outside, and it can be carried out only by the state.

10.2. Types of competition

Perfect and imperfect competition

Different branches of economy have different conditions of competition. For example, a supply of potatoes, sugar, chewing gums, and chocolate bars comes from a lot of sellers, and provision of your apartment with water, electricity, gas and some other municipal services is possible, as a rule, only from the side of one subject. One may say that extremes are presented in those examples – a lot of sellers and the only one seller. They are not so characteristic. Competitive situations in the most cases don't fit such parameters. Between the poles of pure competition and an absolute monopoly such types of competition as monopolistic competition and oligopoly are situated (figure 10.2.).

It is accepted to call pure or free competition as perfect competition, and it is accepted to join three other types of competition under the name of imperfect competition. The last term belongs to *Joan Robinson* ("Economy of imperfect competition", 1933), and she is considered to be the creator of the theory of imperfect competition.

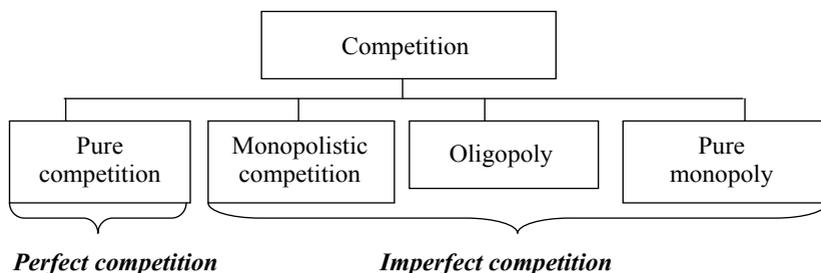


Fig. 10.2. Types of competition in economy

Pure competition

Pure competition is a market situation when a great deal of independent producers sell identical (standardized) product, and no one of them is able to control the market price.

For example, wheat, corn, sugar, shares and bonds of certain issuers can be such identical or standardized product. That means that all sellers of such products offer practically the same product; there is no difference in consumer properties. That's why, it is not worth for a buyer to find out differences in quality and properties, there are no of them, in fact. And it is practically senselessly for a seller to carry on nonprice competition. Each of the sellers is not able to influence the price of the product, which is formed on the market. It is connected with the fact that the share of any seller in the total volume of the product offered in the market is small. A seller on that market is a "recipient of the price".

Let's distinguish *the basic characteristic features of pure competition*:

- a) numerous participants of exchange – sellers and buyers;
- b) identical, standardized products. Only rather simple products the examples of which were abovementioned, can meet this requirement;
- c) free access of new sellers to the markets and an opportunity of the same free withdrawal out of them. If you look at the problem in a little wider way, you will notice that barriers for new subjects to enter any branch may be the following ones: technological, resource, financial, and legislative restrictions. For example, complexity of technology and necessity of the big launching capital are characteristic for many mechanical productions, metallurgy, oil-processing industry, and they sharply narrow the appearance of the number of potential pretenders in those branches. At the same time a majority of spheres, for example, in agricultural production have no such complex conditions for new producers' admittance;

d) availability of complete information for the subjects of a market. Buyers must have data about the available sellers, their product prices, and other conditions for products selling.

It is obvious, that today, it is impossible to reach the mentioned conditions in the most of the cases. That's why, pure or perfect, competition is a rare type of competition in modern economy. Forms of imperfect competition are prevailing today when sellers have a certain control on the market price.

Monopolistic competition

Origin of the name of this type of imperfect competition is related to that real circumstance that a great deal of sellers, offering the identical goods, aspire to give them unique, special ("monos" – one) properties at the same time. These differences can be both real and imaginary.

Monopolistic competition – is such market situation when numerous sellers sell identical goods, aspiring to give them real or imaginary unique qualities. Examples of such competition are the following: "chewing gum, cleaning teeth", "magazine for business women", "automobile for the tropics", "fresh bread", "shampoo, strengthening the roots of the hair", "wines from the best kinds of grapes", "ecological windows", "the most stylish mobile phone", "taxi of economical class", "reliable bank", "chocolate bar – paradise enjoyment" and so on.

The following characteristics can be attributed to *the main ones of monopolistic competition*:

- a) relatively a great number of not big producers;
- b) selling of the similar but not identical products. Different producers are engaged in creation of different kinds of products meeting one and the same requirement. But you can't name their products identical. Differentiation of the product is observed there;
- c) availability of the very limited control on the market price which an individual producer has; it is connected, firstly, with the fact that there is a great number of producers, and that means that the share of the offered product for one person is relatively small. Secondly, the demand for such product is characterized by a rather high degree of elasticity: buyers react to the price change sensitively, and in the case of its increase they may choose switching to buying similar products from the other sellers, ignoring some peculiarities in the properties of goods.

The competing subjects can use both price and nonprice methods of competition. Opportunity to use last ones in contrast to conditions of pure competition is related to differentiation of the product:

competitors offer product's versions, aspiring to convince a buyer in superiority of their specifications of a product. That's why, it is possible here to reach competitive advantages in result of improvement of product quality, terms of its sale, design, package, active advertisement and so on;

d) different agreements between competitors on restriction of competition; for example, agreements on carrying out of coordinated price policy, are almost unpracticable.

The point is that the competitors are numerous, and, in addition, the borders of the field of competition, and its participants are vague and uncertain;

e) opportunities kept for rather easy entering of new producers into a branch. In comparison with pure competition difficulties increase but not significantly. The scope of launching capital, and the level of technological complexity do not create insurmountable barriers for new competitors to enter a branch.

Oligopoly

There are markets where, as a rule, there is a relatively small number of big firms. Economists usually do not get down to quantity such subjects but one can meet, for example, such quantitative characteristic of oligopoly market where the number of competitors is from three to five. It is possible to accept it as some direction. Examples of such competitive situation in Ukraine can be the markets of operators' mobile communication service, domestic refrigerators, washing machines, computers, local markets of a range of goods and services in cities.

Oligopoly is domination of several firms, producing identical or similar goods in the market ("oligos" – a few).

The main characteristic features of oligopoly competition can be the following ones:

a) not numerous competitors. Each of them owns a rather big share of the market of some product or service;

b) supply of standardized or differentiated goods. A range of industrial goods such as, for example, steel, aluminum, and cement are standardized products and are usually supplied in conditions of oligopoly competition. Differentiated goods on the oligopoly markets can be, for example, automobiles, computers, refrigerators, vacuum cleaners, and telephone stuff. Oligopoly companies are usually significant in the sizes structures, carrying out a large scale production;

c) difficult entering of new businesses into a branch. There are very serious problems here which the potential competitors, possible candidates for entering the branch have to face with. They are the

following: formation of a big launching money capital, technological difficulties, access to the most important raw materials, wide opportunities of “veterans” in various ways to block beginner’s admission to the market and so on. It is very difficult for new companies to break through here;

d) availability of stimuli for meeting, agreements, directed to reduce or to eliminate competition. Competitors’ merging gives an opportunity to get a big share of market, and to a greater extent to use the effect of the scale: both “in the output” – while selling their own products (that can be done with the least specific expenses), and “in the entry” – while deciding problems of resource provision (purchase of the large lots of resources at the lowest prices). Agreements – on prices, places of distribution, and volumes of sales – are possible here because the number of competitors is limited and they all are in the public eye, and that creates favorable background for such aspirations. In conditions of oligopoly both price and nonprice competition are possible. But price methods of competition are usually less effective. There is close interdependence between businesses. If one of the competitors reduced prices, the others would be forced to respond adequately or too big loss of buyers and profits would be found. Having done the return step, they, simultaneously, would bring to nothing the efforts of a price leader. That’s why, the price methods here can give a short-term effect.

Pure monopoly

There is no competition under such monopoly. The level of competition is changing by a decrease – from pure competition to pure monopoly.

Pure, or absolute, monopoly – is such market situation under which there is only one seller of product having no close substitute. Absence of close substitutes means that a buyer has a choice not between goods but between problems of buying the given product or reducing to meet the requirements of it at all. A seller is only a single one, and in that case he is a king, and a buyer is a servant. Such seller has a great power.

Let’s distinguish ***the main characteristics of pure monopoly***:

- a) a single seller
- b) product differentiation is absent
- c) a seller practically carries out a complete control on prices
- d) very difficult conditions for new businesses to enter a branch.

The point is that the entrance is blocked by financial, technological, resource, and legislative conditions.

Absolute monopolist, of course, is not a “price recipient”, he is “a price setter”. He controls the goods supply completely and has an exclusive opportunity to choose any price among possible ones according to a certain demand curve at his discretion.

Here we should notice that the concept of “monopoly” is used not only in its narrow meaning as pure monopoly but it is often used in a wider interpretation. In the last case monopoly is usually interpreted somewhat vaguely, as dominating position of economic subject in the market, that is, one can suppose that the concept of “monopoly” in that variant includes both pure monopoly and oligopoly.

Problem of restriction or even elimination of competition is a reason for concern in many countries. A state plays the main role in its decision, the market itself, as previous and modern experience demonstrate, is not enough efficient to protect competition.

10.3 Regulation of competition by the state

Natural monopolies and control

Here we'll start with ascertaining of the universally recognized statement among economists that in some spheres of economy competition is undesirable, difficult or even unacceptable form of economic relations. Those are the fields of economic activity which can be classified as an exception to the rule maintaining the utility and necessity of competition in economy.

Natural (legal) monopoly is a pure monopoly, the existence of which is recognized by the society as an expedient one. A state must not pursue a policy directed to elimination of such monopoly. A state recognizes legitimacy or justification of the natural monopoly existence from the very beginning. That's why, an attitude to it is defined with the search of effective measures for regulation of activity conditions.

What are the subjects, the monopoly position of which causes such a loyalty of the state? Usually they are the enterprises providing power supply, gas, water and many other services of communication and transport. Can you imagine what problems could appear if in the area where you live several independent enterprises providing household heating operated, and each of them constructed its own lines of communication to clients' houses or apartments? It is more expedient and economically beneficial to refuse competition in such and the like cases.

Legal forms of pure monopoly are also patents, copyrights, and trademarks. Patents give the inventor of a new product or technology an exclusive right for power of supervision for their production during

a certain period of time. The state ensures protection of inventor's ideas, labour, money, time spent by him, and protection from seizure and unpaid misappropriation. Copyrights give the authors of artistic work or work of literature the exclusive rights to sell or edit their works. A trademark is a certain symbol used by companies for promoter of their goods on the market. A trademark registered by the state acquires the status of intellectual property; it can't be used legally without its owner's sanction. In many cases trademarks have a great market value, and they are an important element of the company's assets.

Public regulation of natural monopolies' activity can be carried out on the basis of the different forms use. A state often uses a price control, establishing both special values of prices and their marginal levels for monopolistic enterprises. A state can specify a territory of operation for such subjects, it can control the order of agreement conclusion by them for products supply or services rendering. The extent of restrictions depends on the structure of the natural monopolist whether private or state one.

Regulation of enterprises' growth

What is a large firm? Is it an engine of progress or its brake? It is an ancient controversy among economists.

Arguments "pro" and "contra" are adduced. This question has possibly a certain strategic meaning. What must be an attitude of the state to the concentration processes in economy, what must be its corresponding policy? Growth of economic structures can be carried out according to *the following directions*:

1. *Horizontal growth*. It is expansion of the volume of company's production within the branch. A merge of two steel mills may be an example of horizontal growth.

2. *Vertical growth*. It is expansion of company's economic turnover at the expense of penetration into the adjacent branches. Acquisition of the controlling block of shares of engineering company by a steel company, for example, has vertical form of growth.

3. *Conglomerate (diversified) growth*. It is expansion of the company at the expense of penetration into branches which are not technologically connected. That happens, for example, when steel mill acquires capital in oil-processing branch, and a bank purchases a ferroalloy plant or a tourist's complex.

What must be state's attitude to the directions of companies' growth and to merger then? Of course, a state must carry out control over the mergers. The mergers, reorganizations, obviously, can influence the competition level. Let's suppose that two milk factories operate in some city. If they join, it is not difficult to imagine, that

will negatively influence competition and interrelations between sellers and buyers. A state must control such activities and even prevent them in case of considerable threat to competition.

Drop or elimination of competition can have place not only when merging. Control over incorporated enterprise is carried out by the persons owning shares. The more shares one person has the stronger his influence on the enterprise's operation. Shares change their owners periodically, they are the subjects of purchasing and selling. Thus, if a large block of shares, for example, of the tube-rolling mill will be passed to a competitor to another tube-rolling mill, that can significantly undetermine competition in the tubes market. That's why, a state must carry out a control over the large selling and purchasing of shares, carry out an expertise of such transactions as to their influence on competition, make corresponding decisions on them, right up to cancellation. At the same time, this state's activity must not be straightforward and extremely tough, a lot of other issues must be taken into consideration here, because very often there are cases when losses caused by decline in competition can be more than just compensated by the advantageous position in other cases (for example, an increase in production, retention of jobs, improvement in quality).

Estimation of the markets' condition from the point of view of the competition level is one of the important elements of state's economic activity in that sphere. Criteria, on the basis of which one can make corresponding estimations, are necessary. Index of *Herfindahl-Hirschman* is used as one of such criteria, according to it a market, safe from the point of view of monopolization, presupposes availability of ten and more competing firms, and a share of the largest of them must not exceed 31 percent from all sales of a certain product in the market, a share of two largest firms must not exceed 44 percent, a share of three largest firms must not exceed 54 percent, and a share of four largest firms must not exceed 64 percent.

CONCLUSIONS

1. One of the basic factors of the economic system efficiency is availability of competition. Competition in economy is a rivalry of the economic subjects for better realization of their economic interests. Sellers compete for buyers' money, buyers compete for the sellers' goods. Competition can be a price competition or nonprice one.

2. Competition is not an ideal form of economic relations but it gives an opportunity: a) to reach equal position of buyers and sellers; b) to use effectively a price coordinative potential; c) to subordinate private entrepreneurship activity to the public interests; d) to form stimuli for improvement of resources, production, and final goods.

3. Pure competition, monopolistic competition, oligopoly, and pure monopoly are considered to be the main types of competition. Pure competition comes into existence when numerous producers create identical products, and no one of them is able to control the market price. Numerous sellers sell similar goods under monopolistic competition, aspiring to give them real or imaginary unique qualities. Oligopoly is a domination of several firms producing identical or similar goods in the market. There is only one seller of a product which has not close substitutes under a pure monopoly.

4. Natural monopoly is a pure monopoly the existence of which is recognized expedient by a society. A state regulates activity of natural monopolies through the prices and other parameters.

5. A large enterprise has both its own pluses and minuses. A state must control growth of enterprises, and their mergers. The directions of enterprises' expansion can be horizontal, vertical, and conglomerate (diversified).

6. A state develops criteria for market condition estimation from the point of view of competition level, and carries out measures to suppress unfair competition in entrepreneurship activity.

The main terms and concepts

1. Competition
2. Methods of competition
3. Significance of competition
4. Pure competition
5. Monopolistic competition
6. Oligopoly
7. Pure monopoly
8. Perfect competition
9. Imperfect competition
10. Natural competition
11. Horizontal growth
12. Vertical growth
13. Conglomerate growth

UNIT 11. INCOMES

Goods are exchanged into money in modern economy. It means that one must have money to get desirable material values. Incomes are money earnings got by people. The existence of a source or sources of money earnings is precondition for needs satisfaction in conditions of the economic world which we live in. Such dependence, of course, is not absolute. Fortunately, satisfaction of far not all needs is connected with this or that volume of money earnings. A statement is well-known, for example, that love can't be bought for money. But we, nevertheless, must agree with the fact that our life depends on the incomes got very much.

The main information about persons' incomes formation in modern society is stated in this unit. We examine, in particular, the essence, origin, forms, and factors of profits. Economic activity of a state in the sphere of incomes: regulation of wage, provision of certain population classes with money earnings is touched upon here.

11.1. The essence and significance of incomes

Income and its application

Income is a volume of money earnings for a certain period of time. *The recipients of income* are the following:

1) individuals, and families (these recipients are named "households")

2) enterprises, organizations, and institutions.

Incomes of households are often defined as personal incomes. Analysis of personal incomes is emphasized in this unit.

Incomes are necessary to use them. Money earnings of people have the following *application*: 1) a certain part of them is paid to the state's budget in the form of taxes; 2) the main part of them, as a rule, is used for consumption, that is, for obtaining consumer goods and services ; 3) some part of them is converted into savings which can take different forms (opening and replenishment of an account in a bank, obtaining shares, cash keeping in money-box and so on). It is necessary to emphasize that one of the problems of saving is choosing its most effective form. Finding out the appropriate proportion between consumed and saved parts of their incomes is important for people, too.

Saving usually pursues the following purposes: a) formation of the reserve for the cases of extraordinary expenses; b) accumulation of money for future, as a rule, big money purchase; c) investment of money into production with the purpose of new money incomes.

Income significance

Income has a very great significance for a person's living, for a family, and is an important element of peoples' economic cooperation:

1. *Factor of material well-being.* Income forms a purchasing power of a household and any other subject of economic life. The level of peoples' economic potentialities is mainly defied by three factors: quantity of income; level of prices, and level of taxes. These are the three "whales" on which the economic subjects' purchasing power is based.

2. *Precondition for reproduction of economic resources.* A supply of economic resources – labour, land, and capital – gives money incomes. An interest in creation, improvements, and saving economic resources is formed with that. The thing which produces an income, in the form of money earnings in the given case, always, calls an interest and aspiration for resources' saving and improvement under certain conditions.

3. *Factor of spiritual development.* Influence of incomes on spiritual state is a rather difficult problem. One should not insist on the fact that an increase of incomes is always accompanied with an increase of the level of a person's spiritual level. You can actually prove that on the examples of persons you are acquainted with.

Money gives an opportunity to buy books, be occupied with music, collect things or travel. An increase in income is a widening of potentialities for spiritual development. The way this or that man uses them forms his spiritual changes. One point is books as food for one's mind, the other point is books as an interior element.

4. *Factor of life duration.* A person's life duration depends on many circumstances. An income quantity significantly defines a structure and volumes of consumed food stuffs and services (conditions of having a rest, medicine service), quality of living conditions, and that in its turn results in a person's life duration.

5. *Influence on character, manners, psychology, and world outlook.* One can notice, for example, that people's behavior often changes especially behavior of young people who managed to increase their level of money incomes significantly during relatively small period of time. They behave themselves more confidently, their posture is better, they are more relaxed in relations with other people, some can even be imposing and rather cool in their attitude to former friends.

Differentiation of incomes

People can't have the same incomes. Idea of an absolute equality in incomes can't be recognized as realistic one. Moreover, equality in incomes can be considered, with good reason, as a negative factor

of economic efficiency. At the same time, as historical experience demonstrates, the other extreme situation can't be permitted such as uncontrolled differentiation of incomes, too big gap in the levels of incomes earned. The last circumstance has negative economic, social, and political after-effects. Economic costs of a society will be unable to replenish economy with enough number of qualified workers, but scientific and technical progress requires much more higher quality of general and special education, and level of intellect. Social costs of society will be in decreasing of moral norms of people's relations and worsening of social contradictions. Political costs are dealt with impossibility to reach a politically stable society under too big gap in the life levels of different classes of population. That's why, a society in the person of a state has to control differentiation of incomes, and to provide its socially safe level.

11.2. Origin and forms of incomes

Supply of economic resources

Production, as you know, requires certain economic resources. They include: labour, land and natural raw materials, capital, and entrepreneurship skills. Resources are limited, scarce, they can be sold. Selling of resources means the earning money incomes for their owners.

Tens of millions of people in Ukraine and other countries sell their labour services. They get salary or wage in exchange for labour resource. Thus, **salary (wage)** is an income got by a person as a result of selling his physical and intellectual potentialities to create material values. It is the main income for the majority of population. In total incomes of a society, incomes in the form of salary (wage) are dominating. Taking into consideration this and some other circumstances, the problem of salary (wage) will be examined in a separate section.

Land and natural raw materials are one more component of production, its resource. Supply of this resource is accompanied with earning money income in the form of rent by his owners. **Rent** is a price paid for the use of land and other natural resources, quantity of which is clearly defined (limited). Quantity of land and natural raw materials can't be widened, it is such as it is, whatever a society could do. Supply of this resource can't overcome a natural limit of its reserve. Whatever way the price for land and some kinds of natural raw materials could rise, the supply will never overcome that natural limit all the same. Growth of prices can play a limited stimulating role here, the nature of which can be only in structural changes in the use of land (for example, one rooted out forest and allotted this land

for production of some agricultural crops). A supply behaves rather passively, and quantity of rent is mainly defined with the conditions of demand.

Quantity of rent depends, on demand in that way and is defined by the following main factors:

a) *a change of price for products grown on this land.* For example, an increase of prices for grain, meat, milk will make their manufacture more profitable. The level of profitability is the compass according to which directions of entrepreneurship efforts are defined. An increased interest to the given productions will call an increase in demand for land which is their necessary component;

b) *a level of productivity, which can be reached on this or that land plot.* A demand will be higher, for example, for more fertile land, and consequently, quantity of rent will be higher on the lands of the middle and higher level of fertility. One should notice, that a number of economists define rent as a surplus, that is, it is not a condition of resource reproduction, it will be available all the same, and it doesn't depend on whether the payment is collected for it or not.

Interpretation of rent as a surplus widens a sphere of application of the term "rent": it is often used not only relatively to land and natural raw materials but relatively to other profits earned for goods and services, the availability of which can be ensured even under the lower price for them (for example, profits of some professional sportsmen, singers, and musicians).

A necessary element of any production is capital as it is well-known: equipment, buildings, means of transport and so on. Its owners earn income for capital. The forms of such income can have different names: interest, rent payment, leasing payment (for lease of equipment, means of transport, etc.) and so on. In economic literature one can find a statement that suppliers of capital (as suppliers of land and natural resources) get a rent income. However, whatever the name could be, it is necessary to emphasize an important significance of the existence of the income on capital: firstly, an interest in capital ownership, and its reproduction is created, people limit their potentialities on current consumption because of that; secondly, an interest in effective application of capital is created. Payment for the use of capital forces to search for the ways of its the most effective use.

An entrepreneur takes organization of economic forces upon himself. Naturally, he will not do that free of charge. He expects to get money reward for his entrepreneurship skills and efforts. An entrepreneur pretends to get entrepreneurial income in the form of ***profit***.

Money supply

Money is not a direct economic resource. But production requires money, too. Money gives an opportunity to attract, to purchase necessary resources. Transfer of money into temporary possession gives a creditor (who gives money) an income in the form of *loan interest*. Thus, a loan interest is a price paid for the use of money.

It was noted, that a price of loan is usually expressed not in the absolute values in practice (that is, in money units) but in an interest ratio from the value of loan itself. Such form of a loan price is called an interest rate.

Many factors influence *the value of an interest rate*, and consequently, the volume of money earnings of a creditor. The main factors are the following ones:

a) ratio of demand and supply of money;

b) level of inflation. For example, the higher the level of inflation, the higher an interest which will be charged for money supplied. A creditor, naturally, wants to save purchasing capacity of his money, and he strives to eliminate situation when after paying off a loan and getting an interest he will find himself with money for which he can buy less goods and services in comparison with that he could have at the moment of lending money. Effect of inflation, as a factor depreciating money, results in appearance of such concepts as nominal and real interest rate. *Nominal interest rate* is a common interest rate, showing ratio of a loan price to its value. *Real interest rate* is a nominal interest rate which is corrected to the level of inflation. If, for example, a nominal interest rate is 20% and the inflation level is 10% for the period for which a loan was given, then a real interest rate will be 10% (20 – 10). For a creditor, of course, it is just a real interest rate that is important;

c) price expectations. Lending money into temporary use, setting a certain interest rate for it, a creditor evaluates not only the established level of inflation, but the one which, from his point of view, could be expected in future, in a forthcoming period. A forthcoming period is that temporal space of time for which a loan is given. That's why, not the level of inflation is important which existed in the preceding period but that one which will be established in the forthcoming period. It is difficult to forecast situation, and there are often mistakes resulting in the money loss of the economic subjects;

d) regulating norms, set by Central bank. Banking system of two levels is established in Ukraine: Central bank (National Bank of Ukraine) and commercial banks. Central bank carries out macroeconomic credit and money policy, establishes some norms of activity of commercial banks. Its policy can influence significantly the levels of the interest rates of commercial banks.

Special social status

In many countries, including Ukraine, there are people who get incomes which are not connected neither with supply of economic resources nor with money lending to the temporary use. Those are pensioners, invalids, children, the major part of students, and unemployed. They have a special status giving them a right to get certain incomes in the form of pensions, doles, benefits, payouts, grants, scholarships and so on. They receive their incomes from a state, which carries out the so called *transfer payments* – a special kind of the state costs related to the direct income redistribution of the society's members. A state collects taxes from businesses, individual citizens, and a certain part of those earnings is passed to the mentioned categories of population. The value of transfer is defined mainly by economic potentialities of the state and its social and economic policy as well.

Thus, we have defined three main sources of income and their corresponding forms of income. Beside them, accidental, occasional circumstances can appear which result in getting money profits by people. That can be a lottery prize, coming into an inheritance, a find and so on. In the whole, all sources and forms of incomes are presented in table 11.1.

Table 11.1

Origin and forms of incomes

№	Source of income	Form of income
1	Supply of economic resources	Wage (salary) Rent Lease payment Profit
2	Supply of money	Loan interest
3	Availability of a special social status	Pension Grant Scholarship Payouts
4	Accidental occasional circumstances	Prize Heritage Find Other

11.3. Wage (salary)

Wage (salary) is the main form of income for millions of people in our country. A supply of labour services is a critical source of income for the major part of the population capable for work.

It was emphasized earlier, that wage (salary) is an income earned by a person in result of application of his physical and intellectual potentialities to create the material values. A certain wage (salary) rate is determined by the conditions of the labour agreement between a worker (employee) and an employer. However, a range of the subjects, related to formation of the terms for labour payment, is not limited with those persons. We have presented all potential participants of that process in figure 11.1: a worker, an employer, a state, trade unions, and the unions of entrepreneurs. Let's examine some specific factors determining the wage (salary) rate.

Demand of labour

A wish to get a certain quantity of workers of various types of professions comes from employers. What is their behavior determined by in the labour market?

Firstly, it is determined by the objective conditions of the business operation. Entrepreneurs strive for maximization of their income which is the margin between earnings from products selling and costs for their production. That's why, they are interested to select workers able to work more efficiently. Willingness to attract a certain number of workers is related to the process of products selling of the business, and demand for them. Employers, while selecting workers, take into account technological peculiarities of their production (physical load of labour, complexity, the shift system and so on).

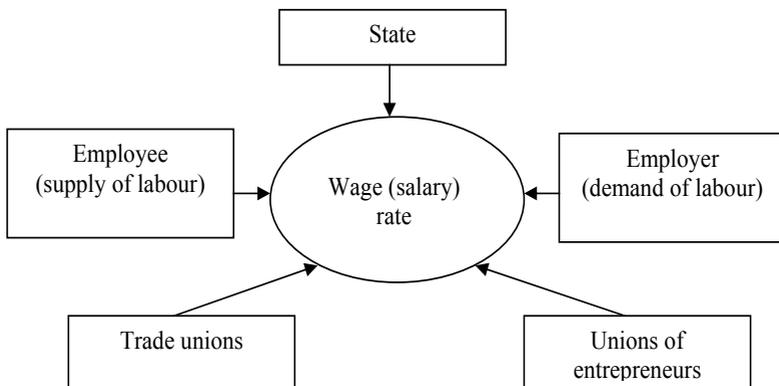


Fig. 11.1. Whom the wage (salary) rate depends on

Secondly, an employer, while hiring workers, has his own subjective preferences. Such factors can appear here as personal devotion, loyalty, gender, political points of view, nationality and so on.

It is necessary to emphasize that such situation can be established in some markets, when a side of demand is presented only by one big employer. For example, in a range of settlements in Western Donbas the role of an employer is played by one mine. Such situation is characterized as monopoly by economists, that is, the availability of the only one big employer in the labour market. In those conditions the workers of some professions within the frameworks of a certain geographical area have practically eligible alternative for their labour use.

Labour supply

Labour supply comes from a person who has special labour skills. What is worker's behavior determined by on the labour market?

Firstly, it is determined by his economic interests. Naturally, he would like to get the greatest personal economic benefit from his labour selling. It is measured by a worker, as a rule, by the value of the obtained money income. He strives to sell his labour skills as expensively as possible. Low wage (salary) can attract less quantity of workers; high wage can attract more workers.

Secondly, worker's activities in the labour market can be determined by the noneconomic interests. For example, a supply of labour forces can be influenced by the following circumstances as a remote place of living from a place of work, family status, an extent of responsibility and independence, prestigious work, working conditions, devotion to profession, ecological conditions of production, psychological atmosphere and so on.

State policy

First of all, it is necessary to notice that a state plays the role of an immediate employer for many people: for teachers, doctors, drivers of the city transport, military men, workers of the state industrial enterprises and so on. That's why, representatives of the state act as employers in the state sector of economy. Influence of the state on the terms of labour payment in that sector, of course, is significantly stronger than in a private sector.

At the same time, a regulating role of the state in the field of wage (salary) and formation of profits in general becomes apparent in a private sector of economy, too. For example, a state extends application of officially established norms of minimum wage (salary),

allocations for social needs for employers and workers into the pension fund, employment fund, carries out taxation of personal profits, and so on in this sector of economy, as well. Besides, a state regulates the other sides of working agreements, as well. For example, it determines the maximum duration of the working week, minimum duration of a paid holiday, conditions for retirement, an order for workers firing, an order of the obligatory hiring for some categories of citizens and so on.

Policy of trade unions

Hired workers are united into professional organizations (unions) to influence collectively the conditions of labour supply and conditions of working agreements. The main issue of their activity is an issue of wage (salary).

Trade unions can influence the rates of wage (salary) directly and indirectly. A direct influence usually results in those papers which are adopted with trade unions and employers jointly. We can differentiate several levels of such agreements: 1) a level of a business – collective agreement between trade unions committee and administration; 2) a level of branch – tariff agreement between a branch trade union and government or association of entrepreneurs; 3) an interbranch level – tariff agreement between federation of trade unions and government or entrepreneurs' union. These agreements are adopted, as a rule, for a period of one year. Conditions of labour payment, social and technical conditions of production, etc. are specified in them.

Besides, trade unions can influence indirectly the rates of wage (salary) through the impact on demand conditions or the labour force supply. They can try to increase a demand for goods of businesses (through ads, lobbying in government and parliament) that can lead to an increase of demand for the labour force if successful. This is a difficult thing so trade unions try not to permit a decrease in demand for labour more often. They can actively protest against intentions to close down, for example, uneconomic, and ineffective mines.

They rather often use a restriction tactics of a labour supply, actively supporting projects and government decisions on access restriction of foreign workers to the labour markets, on reduction of working week duration, etc.

In their branches, according to world experience, trade unions can pursue different policies: 1) introduce restrictions on admittance of new trade union members to achieve privileges for trade union members from employers; 2) strive for maximum involvement of the branch workers into trade union to get stronger opportunities of influence on employers.

11.4. Profit

Entrepreneurial skills are applied with the aim to get income. Business is not a hobby but hard and risky job. Entrepreneur, organizing economic forces, accounts for getting income in the form of profit. **Profit** is the money earning got after goods selling and costs deduction. At first sight, everything looks rather clear in profit understanding. However, the things are not as that. Profit is a controversial conception in modern economics.

Costs

Definition of **production costs** as payments which are necessary to make to get the volumes of resources necessary for production at one's disposal is the most widespread in modern economic science. Some part of those costs requires direct money expenses from an entrepreneur but some part doesn't. That's why, costs are subdivided into external and internal ones.

External costs are money payments to the resources suppliers which do not belong to the number of business owners. This is a sum of all money expenses of an entrepreneur on attraction of necessary economic resources. Such costs include wage (salary) for the use of labour resource, loan interest – for the use of loan money resources, rent – for the use of land, leasing payment – for the use of premises, and some other elements.

Internal costs are money payments which could be got by the owners of the given business for their resources under some other way of their application. An entrepreneur carries out specific management functions at his business. Salary is not charged to him for that. He himself cannot buy a labour resource from himself. At the same time, he could offer his managerial labour skills to some other entrepreneur and earn a corresponding income from that. Further on, an entrepreneur uses his own money. If he invested his money into commercial bank, he could get an income from that in the form of the loan interest. If he owns land on which he has his business, then, leasing out that land to other persons, he could get an income in the form of rent. Thus, it turns out that, using his own resources in his business, an entrepreneur loses money benefits which he could get under the alternative variant of their use.

Profit

Payment for performance of entrepreneurial functions refers to the costs. **Normal profit** is payment for performance of entrepreneurial functions which corresponds to some average public value under

the established conditions. Its value is determined by the level of profitability, which is normal or average in a special branch, that is, the level which keeps an entrepreneur in that branch.

The second form of profit is ***economic (net) profit***, which is an additional profit of an entrepreneur in the result of his more efficient activity in a special branch – better anticipation, better organization, introduction of large-scale innovations (technological, selling, decorative design) and so on. This form of profit is obtained by not all entrepreneurs. It doesn't refer to the costs. It is clear, what difficulties of quantitative differentiation of profit (normal and economic) one can face with in practice, taking into account the results of economic activity. That's why, both Ukrainian and foreign practical activity, bookkeeping, in particular, just ignore that division of profit which is offered by economists and recognize profit in the only one form: receipts and deduction of paid, that is external costs (figure 11.2). In other words, the costs are not divided into internal and external ones here, only paid costs are taken into consideration, the difference between receipts and those costs is determined as profit.

Factors of the value of book profit are the following ones:

a) volume of the sold products. It is important to emphasize here that just the sold products but not manufactured ones, as it is believed sometimes, because only the sold products bring money income;

b) a price for the unit of the sold products. A direct dependence is here – with price growth for the unit of a product the volume of the obtained profit increases, and vice versa;

c) the value of the paid costs for the unit of the products. Its decrease leads, under all other equal conditions, to an increase of profit and its increase leads to a decrease.

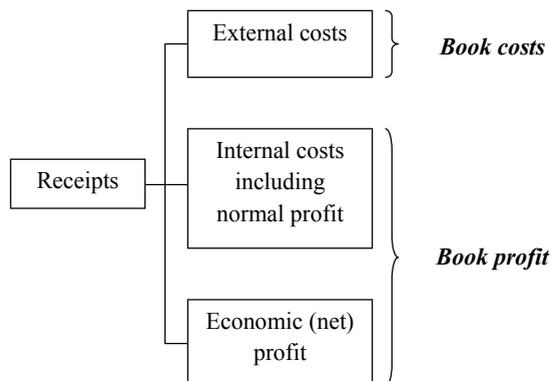


Fig. 11.2. Determination of the costs and profits

CONCLUSIONS

1. Income is a volume of money earnings for a certain period of time. Income is used for: a) payment of taxes; b) obtaining consumer goods and services; c) savings, including investments.

2. Income has the following importance: a) it is a factor of material well-being; b) it influences the opportunities for spiritual development; c) it is a precondition for reproduction of economic resources; d) it is a factor of life duration; e) it influences the character, manners, psychology, and people's world outlook.

3. Differentiation is established in a society, that is, inequality in the earned income. Its existence is inevitable and positive for economic progress but, at the same time, a rather big gap in income can cause a range of serious problems in a society, that's why differentiation must be under control

4. The sources of income are the following: a) supply of labour, capital, land, and entrepreneurial skills; b) money supply; c) availability of a special social status for people; d) accidental, occasional circumstances. The main forms of income are wage (salary), rent (interest), loan interest, and income.

5. Wage (salary) is an income earned by an individual after selling his physical and intellectual abilities to create material values. The factors of wage are the following: labour demand, labour supply, policy of the state in the sphere of labour payment, and trade unions' activity.

6. Transfer payments are a special kind of the state expenditures related to the direct redistribution of the income of society's members. Income in the form of pensions, allowances, scholarships and so on is formed according to social status.

7. Rent is a price paid for the use of land and other natural resources, quantity of which is strictly limited. Rent depends on demand, supply plays a passive role.

8. Loan interest is a price paid for the use of money. Ratio of demand and supply of money, level of inflation, price expectations, and policy of central bank influence the value of the interest rate.

9. Income is payment for entrepreneurial functions. As a whole it is determined as the earning left after goods selling and deduction of costs. External costs are money payments to the suppliers of resources who do not belong to the number of the owners of the given business. Internal costs are money payments which the owners of the given business could get under the other way of their use. Normal profit in that case is referred to the internal costs. Economic (net) profit is a profit earned additionally by the most efficient entrepreneurs; it is not referred to the costs. In practical activity, in bookkeeping,

in particular, the concept of profit is used as difference between the receipts and the paid (external) costs.

The main terms and concepts

1. Income
2. Significance of income
3. Sources of income
4. Wage (salary)
5. Factors of wage (salary)
6. Rent
7. Nominal interest rate
8. Real interest rate
9. Transfer payments
10. Profit
11. Costs
12. External costs
13. Internal costs
14. Normal profit
15. Economic (net) profit
16. Factors of book profit

UNIT 12. ENTERPRISES

Production of goods and services requires incorporation of the production factors or, in other words, economic resources. This incorporation takes place within an enterprise. Thus, an enterprise is a special institute where, entrepreneurs, managers, and workers interact through a special organizational and legal forms, a production process is organized on a permanent basis – transformation of economic resources and selling manufactured goods and services, as well.

An enterprise is often called the main link of the economic system (households and institutes of government management of economy can be considered the other links). This statement is based on the fact that just enterprises create the overwhelming part of national production of goods and services. And from the other side, an enterprise is just that main arena where economic cooperation of people is carried out.

In this unit we'll consider the nature, main characteristic features of an enterprise, analyze the main ways of classification of enterprises – according to the field of the primary activity, sizes, organizational and legal form. Great attention will be given to the last classification, and to the description of different kinds of enterprises, in particular.

12.1. Nature and the main features of an enterprise

Nature and purposes of an enterprise

An enterprise is a separate economic structure dealing with production and selling of special goods and services. An enterprise can be established, set up both by private entrepreneurs and a state. In the countries with market economy, in majority of cases, private persons initiate establishment of an enterprise.

Private entrepreneurs establish enterprises, as a rule, with the purpose to get money income in the form of profit. A state, while establishing enterprises, pursues usually more versatile purposes: that can be striving for an increase in the level of national security or for solution of some ecological problems, necessity to create new working places in labour redundant regions, necessity to organize production of some goods and services which are not enough economically advantageous for enterprises and so on.

The main characteristic features of an enterprise

The main characteristics of an enterprise include the following:

1. Economic isolation. It becomes apparent, *firstly*, in property separation. An enterprise has at its disposal its own property, is a subject of property, and can lease or, according to some other agreement initiatives, use different resource elements – land, capital, etc. *Secondly*, an enterprise has a completed reproduction cycle: it mobilizes resources, transforms them and gets a finished product, sells it and uses the earned receipts again to get resources. An enterprise, in majority of cases, is a self-reproducing institution. *Thirdly*, an enterprise has independent economic interests. Of course, interests of hired workers and entrepreneurs can't coincide in all aspects. But, at the same time, all members of an enterprise are usually united by availability of the weighty general interest – to manufacture products, sell them, and earn money income.

2. Technological isolation. An enterprise has a completed technological cycle of production. It means that its technical or technological “stuffing” is rated for carrying out technologically completed production process. It can result in final product or intermediate product which is intended for the production use. Garment factory, for example, has all necessary technological set of equipment for production of shirts without a resort to the other enterprises, for example, for the help to sew on buttons on those shirts. A milk factory has at its disposal a complete technological system as well, and it has no necessity to entrust the other enterprise, for example, with pouring out milk into paper bags.

3. Juridical execution of isolation. It is expressed in: availability of the enterprises' statute (for some kinds of enterprises only articles of association), account in the commercial bank, producing balance sheet, availability of the contrast law and the right for hiring workers, and certain property responsibility in relations with other enterprises and individual citizens. A lot of enterprises strive to develop and register their own trademark.

4. Participation in public division of labour. Position of an enterprise is characterized by availability of close economic relations with other economic structures. An enterprise acts as a specialized commodity producer and, that's why, it experiences a great dependence on the activities of the other economic subjects. Sale of products and resources provision are those fields of an enterprises' operation where it feels its greatest economic dependence on the others.

Conditions of enterprises' activity

Enterprises may have different standards or conditions of operation. This difference mainly refers to conditions of private

and government enterprises operation. Typical conditions of *private enterprise* operation in market environment are the following:

a) an independent carrying out of reproduction process. In other words, an enterprise has to provide its reproduction and vital capacity with its own forces and resources. An enterprise can use money resources of the other subjects, as well – to get a credit, attract money funds by the way of selling its own binds but all that takes place on the loan basis, those resources must be returned with a certain payment for the service;

b) complete economic responsibility for the results of operation. Finally, this responsibility is a duty of the enterprise owners. Distribution of that responsibility between them is determined by the form of organizational and legal structure of an enterprise;

c) profit which acts as the main source of money for the enterprises' development. Striving for development is natural for an enterprise. Broadening of an enterprise brings, as a rule, great money profits to its owners. Profit is a critical source of money provision for such development of many enterprises;

d) competition with other enterprises. Competition influences a behavior of an enterprise and its internal organization significantly;

e) economic assistance of the state which has exceptional and selective character. This assistance directed to maintain reproduction of an enterprise must consider, first of all, interests of national economy as a whole. A state can't and mustn't be a generous sponsor. It must be rather "stingy" in those issues but, at the same time, calculating and far-sighted when determining possible macroeconomic consequences under "failures" in operation of certain private enterprises.

Some *government enterprises* approximately can operate under the same conditions, too. Differentiation of the operation modes of government enterprises is naturally a prerogative of the state itself. In the result, nevertheless, a major part of government enterprises has got some other noncommercial or not entirely commercial mode – operation mode. Its main distinctive peculiarity is less strict people's economic responsibility, and first of all managers, for the results of enterprises' operation, less tough financial conditions, greater quantity of limitations set by the government structures.

A lot of government enterprises, for example, water-supply, electric power supply and gas supply, communication, transport function under absence of competition, and act as absolute (pure) monopolies.

12.2. Classification of enterprises

Nature and main ways of classification

Classification of enterprises is their grouping according to certain features. Classification features can be: a level of profitability, sphere

of activity, size, organizational and legal structure, market price, margin of profit, etc.

Classification of enterprises gives an opportunity to examine enterprises more regularly and systemically. An acquaintance with the main ways of classification gives an opportunity to analyze different aspects and sides of an enterprise operation consistently and comprehensively.

In table 12.1 some ways of enterprises classification are shown, they are used more often than others and they are worth to acquaint with primarily: by the main sphere of operation; by the size of enterprises; by organization and legal structure.

Classification of enterprises by the main sphere of operation

In table 12.1, in particular, the main kinds of enterprises are listed, which are determined by the sphere of their main operation. Sphere of enterprise operation is far not always limited by the frameworks of one branch of industry. For example, transportation enterprise (the main sphere of operation is providing with services in transportation of passengers or cargoes) can be dealt with intermediate trade activity, too, say marketing, gasoline. However, as a rule, an enterprise has got one main sphere of operation, that is, that one which gives it the greatest share of money earnings. Considering that circumstance, an enterprise is included into this or that classification group.

Table 12.1

The main kinds of enterprises classification

By the main sphere of operation	By size	By organizational and legal type
1. Industrial 2. Agricultural 3. Building 4. Transport 5. Finance-credit 6. Trade 7. other	1. Small 2. Middle-sized 3. Large	1. An individual (sole) 2. Economic union: – Joint stock company – Unlimited company – Company with Limited liability – Mixed company – Company with additional liability 3. Cooperative society 4. Government enterprise

Classification of enterprises by the kinds of operation allows to determine their economic direction, technological and economic peculiarities of reproduction. Say, for agricultural enterprise seasonality

is rather characteristic feature which influences movement of financial resources, purchasing of capital, attraction of work force, necessity in credits, etc. One can judge about the level of competition and set preferences in specialization by quantity of enterprises operating in this or that brunch of industry.

Classification of enterprises by size

First of all, it is necessary to explain what can be accepted as a criterion to determine the size of an enterprise and attribute it to this or that classification group. Such *critierion* can be the following:

- a) the number of workers engaged at the enterprise;
- b) volume of economic turnover of an enterprise, that is, the value of its money earnings (receipts) for a certain period of time;
- c) cost of capital of an enterprise.

Criteria of enterprise classification by size are determined by the state, it sets their specific quantity values, too. Very often this is not limited only by the choice of one criterion. It is connected with the fact that the use of only one factor, for example, the number of workers, not always can show real potentialities of an enterprise. An enterprise with a small number of workers can be equipped with the latest automated technical systems, that is, to have a significant capacity at its disposal.

The number of qualifying groups by the size feature of an enterprise is different in different countries. In table 12.1 the most typical example of enterprise qualification by size is given: three groups – small, middle size, and large enterprises.

What is *the aim* of a state while developing enterprise qualification by size? This is rendering different forms of assistance for small enterprises from the side of the state. Necessity of such assistance is dictated because of the following circumstances:

1. *Necessity to maintain and develop competitive environment, a system of free entrepreneurship.* New entrepreneurial structure is a new competitor. We have already emphasized the exclusively important significance of competition for economic efficiency. But new subjects of entrepreneurship are not usually born as rather large enterprises. People, as a rule, begin from a small enterprise. But small enterprises are “sickly children” (those children are named in that way by their parents and doctors who are very sensitive to the slightest changes of temperature, draughts, etc.). Vulnerable places of such enterprises can be the following: higher costs; worse conditions of crediting; high sensitivity to the slightest fluctuations of market situation, discrepancy in supply of resources, delay in

payment of accounts; worse access to resources. That's why, a state, as a rule, strives for an increase in competitive opportunities of small enterprises, strives for creation of additional chances for them.

2. Utility of combination of small, middle-sized and large enterprises in national economy. Such combination positively results in efficiency of economic system. The whole system becomes more flexible, mobile, and crisis resistible. Small enterprises are able to respond more quickly to the changes of the needs than other ones. They actively launch a new business. This new thing (product, technology) gives them a chance to break through into a lot of markets. The conditions themselves for small enterprise operation force it to be flexible, maneuverable and search for new goods and services actively. Combination of different sizes of enterprises in economy allows to use a principle of labour division and its advantages more completely. Small structures are able to reach high degree of perfection in production, for example, of different machine parts and equipment. Large enterprises get more opportunities to focus on the scale structural maneuvers, to concentrate their forces and resources on large scientific and technical designs.

3. Use of small enterprises' potentialities to solve regional problems. New enterprises give the new working places. The problem of employment in modern economy is the most urgent economic issue. A small enterprise gives up to 70-80% growth of working places in some countries. Maintenance of the new structures can positively result in financial opportunities of the local authorities – to expand their budget, to facilitate solutions of certain social and economic issues.

The main forms of maintenance of a small enterprise from the side of a state are the following:

- a) establishment of privileges in the field of taxation;
- b) rendering financial assistance in different forms;
- c) creation of "business-incubators" supposing training, consulting, lease of capital to the newcomers, etc.
- d) rendering promotion in obtaining credits.

Of course, promotion of a small enterprise from the side of a state is an important moment. But it is obvious that one should not overestimate its role. A critical significance in success or failure of entrepreneurial initiatives, as experience testifies, belongs, first of all, to the personal qualities of an entrepreneur such as: talent, intellect, education, organizational skills, ability to work much and intensively, persistence, purposefulness, ability to analyze situation, and run a risk.

12.3. Organizational and legal types of enterprises

An individual (sole) proprietorship

This business is established and controlled by one entrepreneur. As a rule, it is not big in size. **The main characteristic features of a sole proprietorship** can be the following:

- a) availability of the only one owner of a business;
- b) an individual control of a business operation.

Entrepreneurial efforts of one person are realized in such business. It often doesn't attract hired labour; "personnel" of a business can consist only of the members of an entrepreneur's family. The main spheres where businesses of such type operate are the following: agriculture (farming businesses), trade consumer service, public catering, agency business, and repair services.

A sole proprietorship has both its advantages and disadvantages. Advantages are the following: firstly, owner's significant freedom of activities. He has no partners with whom he has to agree different issues of entrepreneurial activity. Secondly, there is availability of strong stimuli to manage effectively: both profits and losses are not subject for distribution – they completely belong to one person. Disadvantages of a sole proprietorship are considered as the following: firstly, scarcity of money resources. One entrepreneur, as a rule, is not able to provide his business with significant financial resources, turnover of his business is usually rather small, and development of business is connected with serious difficulties. Secondly, it is complete property responsibility of an owner: he runs a risk not only with his own capital invested in that business but other personal property including a house, a car and other property in the form of shares, bonds, etc. belonging to him. Thirdly, a sole business loses potential benefits from specialization in management. As a rule, one person is dealt both with technical, resource, distribution, and financial issues. One should agree whatever talented an individual entrepreneur could be, he wouldn't be able to complete all entrepreneurial functions equally and successfully. There is a specially hired personnel of managers in other businesses.

Economic unions

Economic union is an enterprise where two or more persons agree on its ownership and management with the purpose to carry out joint entrepreneurial activity.

Existence of economic unions is a natural respond of entrepreneurs to the disadvantages of a sole business, a striving for overcoming restrictions of the last one. Economic union can be considered as

logical development of a sole business, here entrepreneurial efforts of several persons are joint.

The main distinctive features of an economic union are the following:

a) multiplicity of owners. Partners invest the shares (stocks) in different forms. Money, physical capital, land, ideas, etc. can be a share. Each share is correspondingly estimated in money, each participant has its share in the assessed cost of a business;

b) a joint control of business operation. Owners carry out joint management by the union. They have to agree between them and demonstrate that agreement in the corresponding papers of a business about forms of control and an order of business management;

c) distribution of profit and losses between partners. A certain order is set with constituent documentation of a union. A business is created for the sake of earning profit, partners strive for realization of their personal interests and earning profit during joint activity to the greatest extent. Usually profit and losses are distributed in proportion to the invested shares.

The main types of economic units are following:

1. Joint stock company. This is a business with restricted liability of its members, its capital is divided into the shares in the forms of corporation stocks between the owners. Stockholders are not responsible for the union's debts. This is widely spread type of a business which has significant importance in modern economy. That's why, we'll pay special attention to the joint stock companies.

2. A limited company. Its distinctive feature is the fact that all partners are responsible for the business operation only within the values of their investments. It is like a joint stock company as to this point. A loss of investment is a maximum loss of a limited company's member. This is an attractive feature of such type of a business. A significant popularity of a limited company among entrepreneurs is evidently explained with that fact.

3. Unlimited company. Partners are fully responsible for the business operation and for its debts. This is a form of property responsibility which is characteristic for a sole business. Such union of entrepreneurs, at the same time, gives each of them the greatest freedom of activity but requires setting of special confidential relations between partners.

4. Mixed company. Its main distinctive feature is union of partners having different rights and liabilities:

– real (full) members, their position differs in nothing from the role and liability of partners in the unlimited company;

– members-investors having limited liability for the business operation within the frameworks of their investment.

5. Company with additional liability. Partners are liable for the debts of the company within the limits of their investment into the authorized fund of a business, and additionally in the size corresponding to each partner's investment. They are the suppliers of capital and expect to get an interest on it. This type of company allows to join entrepreneurs' efforts having different extent of interest in joint activity.

Now let us dwell on the advantages and disadvantages of the economic unions of the non-joint stock company type.

Their advantages are the following: firstly, growth of financial potentialities of a business, as the number of suppliers of capital increases and economic turnover expands; secondly, creation of the greater opportunities for business development, as a union gives greater profit and opportunities to get a credit are improved, too; thirdly, an opportunity to carry out specialization in business management appears. Managers, having corresponding managerial specialization, begin to work in a union and that allows to promote efficiency of management by a business, as a whole.

Disadvantages of the economic unions are the following: firstly, joint money and other resources of partners are rather limited. It is connected with comparative scantiness of the number of capital suppliers and their individual potentialities as suppliers; secondly, there is always a danger of serious disagreements between partners in their points of view on business operation in the economic unions, and that can significantly decrease efficiency of entrepreneurial structure functioning; thirdly, withdrawal of one or several partners from the union structure can undermine the business existence at all and cause its liquidation.

Joint stock company

Joint stock company is one of the types of economic unions. At the same time, joint stock companies exactly create the main part of the national product. Joint stock companies possess the greatest organizational and legal potential in the problem of investment resources mobilization. That's why, the importance and peculiarities of the joint stock company require to examine them in details.

To have better idea about operation of joint stock company it is necessary, firstly, to dwell on the characteristic features of the stocks themselves, their issue and circulation ensure the existence of a business itself:

A share is a security without a fixed turnover period, it certifies a deposit of money with the purpose to create or develop a business and gives its owner the right to:

- participate in business management;

- get a part of business profit in the form of dividend;
- participate in property distribution in the case of business liquidation.

A subject, issuing shares, is called an *emitter*. Emitters carry out subscription for the shares with the purpose to attract money and other types of resources to create or expand a business. The one who buys shares becomes an *investor*. The buyers of the shares can be households and businesses. Authorities of government management can act as shareholders.

Investors buy the shares and are oriented to achieve *the following purposes*:

1. Obtaining an immediate financial income. This income can be in two main forms. The first is obtaining a dividend. *Dividend* is a part of business profit charged for one share. One must not believe that the share possession automatically ensures obtaining a dividend. Obtaining shares is a venturesome capital investment, there are no guarantees to get income here.

What does dividend depend on? Firstly, it depends on the total volume of profit obtained by a business. Secondly, it depends on the order of profit distribution and investment policy of joint stock company. Necessity to return back some part of profit into production is an ABC truth of economics. Profit is the main source for expansion and development of a business and an efficient entrepreneur always strives for that. In joint stock company, as in any other business, the decisions are made on profit distribution. If the part which returns back into production increases, then, consequently, the fund of dividends payment decreases and vice versa. These are two main factors determining the value of dividend.

The second form of shareholder's income can be obtaining income after an increase in rate (market) value of a share. Nominal value of a share is that part of the authorized fund which is presented by this share. It is also called a face value, because if a value of the share is marked on the share it is just a nominal value. Selling and buying of a share, as a rule, is not carried out on its nominal value. A share is sold on its *rate value* which is its market value. If investor had bought a share at one price, and after some time he sold it at the other price, a higher price, then the obtained positive difference would be his income from an increase in a rate value of a share. The main factor, determining a change of a rate value of a share, is an extent of operation efficiency of a joint stock company.

2. Acquisition or enlargement of the right to control a joint stock company operation. This is one more purpose which can be set by an investor while buying shares. To understand the order of its

achievement it is necessary to make acquaintance with the order of management of the joint stock company. Management structure of the joint stock company is the following:

a) *shareholders' general meeting* is the highest authority of management. Its competence usually includes determination of the main directions of business activity, approval and amendment of its statute, approval of annual results of activity, election and recall of the authority members, and some other issues, too. Making decisions is carried out by voting. The number of voices which a shareholder has at his disposal depends on the quantity of the shares he owns. Obviously, the more the quantity of the shares the shareholder has at his disposal the more his influence is on the business operation. Quantity of shares, the possession of which allows to carry out a control for the joint stock company operation, is called **controlling block of shares**. Its specific value depends on many circumstances: quantity and distribution of the issued shares; statute requirements; an issue, a decision on which is made on the meeting, etc. Obtaining big blocks of the shares is accompanied by getting significant opportunities to influence the joint stock company operation;

b) council (supervisory council) of the joint stock company is elected by the general meeting from the number of its shareholders. Its competence includes such issues as a control of the activity of the executive bodies of the joint stock company, approval of the budgets and plans for business development, design of business strategy, etc;

c) board of directors of the joint stock company is an executive body which is formed from managers hired to work in a company. The whole current and operative management by a business is concentrated here.

A business which possesses a controlling block of shares of other joint stock companies is called a holding or holding company. And "the other joint stock companies" themselves become affiliated businesses in that case. A holding structure has an opportunity to respond the changes in market situations operatively and flexibly, mobilize financial resources for big building, scientific, research, and other projects, develop specialization, and maintain industrial cooperation relations within the frameworks of a group of businesses.

Now it is expedient to make acquaintance with the main types of the shares. The shares are classified in that way:

1. The shares are divided into the nominal and bearer shares by the extent of control for their circulation. Circulation of the nominal shares is constantly registered, information about a special owner of the share is shown in the register book of shareholders. The bearer

shares have freedom of circulation, passing of property doesn't require, as a rule, special registration.

2. There are the common and preference (preferred) shares by the extent of dependability in obtaining dividend. The common shares don't give any guarantees to their owners for obtaining dividends. The preference shares give certain advantages to their owners in obtaining dividends. Privileges themselves can be different in their specific filling. That can be, for example, establishment of fixed dividends (in percents to their nominal price), concession of the high priority right for obtaining dividends to the holders of such shares.

3. There are one voting shares, nonvoting shares, and multiple shares by potentialities to take part in management by the joint stock company. The voting shares give one voice to their owners in the general meetings of shareholders. The nonvoting shares don't give the right to vote to their owners while making decisions on the shareholders' meetings. Often the preferred shares are the nonvoting shares at the same time. The multiple shares ensure more than one voice for their holders in the general meeting of the shareholders.

4. One can divide shares issued in a documentary form and without documents (electronic form) by the form of the issue. In the first case an owner has opportunity to get a special document – certificate of shares. In the second case it is not provided: an extract from the register of the company's shareholders can be confirmation which certifies availability of the shares at the disposal of one special person – a natural person or a legal person.

In conclusion we'll emphasize the main advantages and disadvantages of the joint stock company. The advantages of the joint stock companies are the following:

- a) availability of a rather powerful mechanism for attraction of money resources;
- b) limited liability of the business owners, and an entrepreneurial risk spread among a great number of shareholders;
- c) opportunity to achieve economic advantages carrying out large scale production;
- d) organizational stability of a business.

The disadvantages are the following:

- a) a rather long period of a business creation;
- b) a significant remoteness of a number of joint owners from the real business management. It is possible that a joint stock company is subject to the virus of bureaucratization in management activity to the greatest extent among all entrepreneurial businesses. There is a threat that managers will not always follow the interests of business owners in a proper way.

Cooperative society

Cooperative is a business in which resources and efforts of partners are united with the purpose to fulfill special economic functions.

Cooperative is one of the forms of economic partnership. Cooperative societies have some common features with economic units in the sphere of organizational and legal structure (“body”) and rather distinctive differences in the purpose of their establishment, character, and direction of operation (“soul”). **The main types of cooperative societies** are the following:

1. **Consumer cooperative societies.** The subject and purpose of people’s cooperation are a common supply, provision of the cooperative’s members with special goods and services in such businesses. Perhaps, you know horticultural, country-cottage, housing and other cooperatives of that type. Farming consumer cooperatives are very popular in some countries, they promote provision of farmers with oil products, fertilizers, means for plants protection, etc.

2. **Credit cooperatives.** The subject for cooperation is formation of money fund, from which participants can take low interest credits. Such cooperatives are often called “credit unions”, “people’s banks”, etc.

3. **Marketing cooperatives.** The subject for cooperation is a common selling or recycling and selling or storing products manufactured by the members of a cooperative society. Producers of the agricultural products use the opportunities of such cooperation to a greater extent.

4. **Labour cooperative societies.** Here, the subject of cooperation is the labour process itself, consolidation of labour efforts of the members of cooperative society takes place. Participants of such business possess the means of production and manufactured goods jointly, they take part in a production process together. A fishing artel can be one of the examples of such business.

Acquaintance with the main types of cooperative societies could help better understanding of the purposes and some sides of activities of those businesses. Now let’s determine their **main distinctive features**:

a) profit orientation is not so dominating purpose as in the economic unions. Cost reduction of the cooperative’s members for obtaining certain goods, broadening access to some goods and services, increasing incomes of the cooperative’s members after selling their goods or labour services are the main purposes of a cooperative business;

b) cooperative acts like an organization of mutual assistance and self-sufficiency according to the character of its operation. A special spirit of cooperation is characteristic for it;

c) the carried out operations are usually oriented on immediate service or participation of cooperative’s members in those operations.

Government enterprise

Those are enterprises owned by government and controlled by government.

In any modern economic system the role of such enterprises is rather significant, government sector of economy is presented by a significant quantity of enterprises operating in many fields. As experience testifies, government uses differentiated approach to its enterprises management, uses different forms and degrees of control. Generalizing the used profits, one can, perhaps, differentiate two regimes of control for government enterprises operation: tough one, when government determines the main parameters of business operation and practically withdraws it from the sphere of market (commercial) relations – for example, a post office, municipal services, power supply and other enterprises operate in that way; liberal one, when government determines the enough degree of freedom for business managers to work in a commercial regime and more strict conditions of economic liability for business operation, for example, a business producing cars, building organization, etc. can operate in that way.

12.4. Reproduction of a business

Reproduction process and its guarantee

A business, as a rule, guarantees its reproduction process independently, that is, continuous reproduction of its economic vital capacity. It means that a business can guarantee continuous recurrence of production cycles in a self-sufficient way. The main links of reproduction process of a business are shown in fig.12.1: resource provision, goods production, obtaining income after goods selling.

Reproduction process is provided with the funds of a business. All material, technical, and money resources the business owns are called *funds of an enterprise*. Funds of an enterprise are in different forms in reproduction process: one part of them is presented in physical capital of a business, material reserves – that is a *productive form* (P), and the second one is presented in a produced but not sold products – *commodity form* (C), the third one is presented in the form of money funds which a business has at its disposal – monetary form (M).

Funds structure

First of all funds of a business are divided into *production assets* and *nonproduction* ones. *Production assets* directly provide production operation of a business, and *nonproduction assets* are not directly related to it.

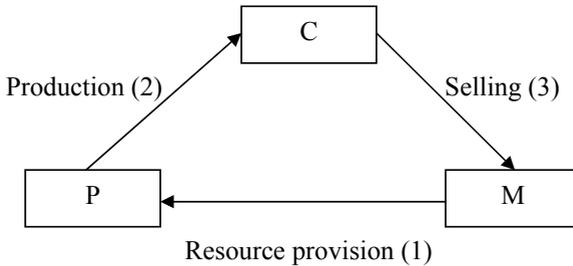


Fig. 12.1. Stages of business reproduction and forms of funds

The last ones include funds, for example, polyclinics, sports, cultural and other nonproduction facilities owned by a business. They, undoubtedly, influence the position of personnel involved into business.

Structure of production assets is presented in table 12.2. The critical meaning belongs to the *capital assets*, and, first of all, to their active part – machines and equipment. Technical and technological opportunities of a business determine the qualitative level of produced goods, assortment, specific costs, etc. in many aspects. In that way the state of capital assets, and their structure influence market positions of a business significantly.

Table 12.2

Structure of production funds of a business

Production funds		<i>Floating funds in circulation</i>
<i>Capital assets</i>	<i>Floating funds</i>	
Machines, Equipment, Buildings, Premises	Objects of labour, Incomplete production, Wages fund	Finished goods at warehouse, Goods in transit, Currency deposited in the bank account
Fixed assets	Circulation assets	

Production assets make a circle floating from one functional form into the other (fig.12.1). **Circulation of production assets** is a process of the forms changing, successive forms transformation from one functional form into the other. A business is interested in returning money advanced into production more quickly, and with a rise in the form of profit. Minimum requirement to a business reproduction is a return of invested money funds through the earnings after products selling. *Funds turnover* is fund movement from the moment of the

money means advancing to their complete return. The process of advanced money return itself is different for the capital assets and circulating assets. In reproduction process of a business they behave differently, and that must be considered in organization of economic operation. That's why, we'll examine the peculiarities of capital and circulating assets participation in a business reproduction.

Capital assets

In general the peculiarities of capital assets participation in reproduction process of a business are shown in table 13.4. Let's try to explain them using an example.

Table 12.3

Peculiarities of capital and circulating assets participation in business reproduction

<i>Assets</i>	<i>Used in production</i>	<i>Transfer cost on a new product</i>	<i>Perform circulation</i>	<i>Compensate cost in monetary form</i>
Capital assets	Long period of time	Gradually, in parts	During a range of circulations	Through amortization charges
Circulating assets	Completely in each production cycle	Completely in each production cycle	During one circulation	Through allowances for compensation of the corresponding costs

Let's assume that you have become a founder of a small business producing jeans. First of all, you have to supply it with resources. To produce jeans you'll need corresponding fabric, threads, zippers, buttons, press-buttons, and, of course, sewing-machine. Naturally, if you are not going to produce jeans by yourself directly, then you have to hire workers of the sewing industry.

From all mentioned resources of production a sewing-machine is included into capital assets. It is expected for a long period of operation.

It can't be "absorbed" (transformed), like fabric or threads in each production cycle. The second circumstance is that a sewing-machine is expensive, money spent for its purchase can't be returned after selling one or several jeans produced. In a competitive market such jeans will be too expensive and their selling will become a rather problematic issue.

That's why, money costs for a sewing-machine purchase will be returned to the owners of a business gradually, in certain portions, in the result of some number of circulations. Such portions or parts are called amortization charges.

Amortization – is a cost value of capital assets corresponding to their wear and tear, which is transferred into the cost of manufactured goods and accumulated in a special amortization fund. A state determines terms of amortization of different elements of capital assets. Let's assume, that a five-year period of amortization is fixed for sewing-machines and a price a sewing-machine producing jeans was purchased is 100 000 money units. Then amortization process can be presented in that way (table 12.4).

Table 12.4

Process of amortization

<i>Jeans</i>	<i>Residual value of the sewing-machine</i>	<i>Amortization fund</i>
1	80000	20000
2	60000	40000
3	40000	60000
4	20000	80000
5		100000

In the end of the fifth year all money means spent for a sewing-machine purchase will be compensated. All its original cost will be transferred into amortization fund which equals 100000 money units. The residual cost of machine will be equal zero.

Now, let's specify the above mentioned concepts. *Original cost of funds* is cost of funds in the moment of their entry into production sphere. This is a sum of money which was paid for obtaining funds. *Residual cost of funds* is an original cost of funds after deduction of amortization charges. In our example the residual cost of sewing-machine will be 40000 money units at the end of the third year of operation. An original cost, amortization, and residual cost of funds are shown in balance-sheet of a business.

The purpose of amortization charges is reproduction of capital assets. Means of amortization fund are necessary for restoration of the removing equipment, buildings, and facilities. At the same time, there is a constant threat of depreciation of amortization fund in the result of inflation. In five years after amortization period had been completed, you will not be able to buy the same sewing-machine for 100000 money units because of the price growth for that product.

Taking into consideration that circumstance, economists introduce a concept of the *replacement value of funds* as cost of funds determined by the conditions of their reproduction in the given moment.

Inflation is able to depreciate the amortization charges but not real cost of funds. The last one can rise in a period of inflation under all other equal conditions.

That's why, if you, for example, decide to sell a sewing-machine after the third year of operation, then, perhaps, you'll be able to do that at the price significantly exceeding the residual cost. An actual cost of funds can be reduced with appearance of a new, more effective or with the same degree of productivity but cheaper equipment. In that case moral ageing of the current funds takes place. That's why, there can be a variant when, in three years, with the necessity to sell a sewing-machine one will be forced to do that at the price even lower than residual cost, if new and more efficient sewing-machines appear during that period. Appearance of new, more effective equipment can reduce competitive positions of those using old equipment, because they will have higher costs. Products become more expensive in comparison with the similar, produced with the new funds. Obsolete funds can not have time to be amortized during a fixed period of time. That's why, a right determination of the optimal terms for operation of equipment and means of transport has great significance.

Circulating assets

Circulating assets of a business consist of floating funds and floating funds in circulation (table 12.2).

Floating funds include the subjects of labour (raw materials), incomplete production, and payment of hired personnel labour.

Floating funds in circulation include finished products at a warehouse, goods in transit, money on the bank account. In that way one can notice that circulating assets of a business are formed from commodity-material elements and monetary means. Their availability is one of the conditions of a business reproduction.

Floating funds have a range of peculiarities according to their participation in reproduction process in comparison with capital assets. Firstly, elements of floating funds are completely used in each production cycle. Coming back to our example with jeans production, it is easy to find out that one and the same pattern of fabric can't be used for production of several pairs of jeans, it can be used only once.

Secondly, cost of floating funds is included into the cost of the product sold not by parts as in the case with capital assets, but completely in each production cycle. Cost of jeans will include overall cost of the fabric used, threads, payment of workers' labour, etc.

Thirdly, floating funds make a circle during one circulation, a return of the monetary means advanced into those elements must be carried out after each circulation. The fourth point is that compensation of the cost of floating funds is carried out in the form of direction of the corresponding parts of the obtained earnings for full compensation of the expenses.

CONCLUSIONS

1. A business is a sole economic structure which is in production and selling of certain goods and services. It can be established both by private entrepreneurs and a state. The main features of a business are the following: a) economic isolation; b) technological isolation; c) juridical registration of isolation; d) participation in public labour division.

2. There are different ways of business classification. Classification of businesses by the main type of activity allows to determine their economic direction, technological and economic peculiarities of reproduction

3. Classification of businesses by size supposes, as a rule, division into small, medium-sized, and large businesses. The criteria for determination of the sizes of a business are the following: a) the number of employed; b) volume of economic turnover; c) cost of capital. A state gives different forms of assistance for small businesses; combination of different sizes of businesses in economy increases its efficiency in the whole.

4. Classification of businesses by organizational and legal structure allows, in particular, to distinguish the following: sole enterprise which is established and controlled by one entrepreneur; economic union (joint stock company with limited liabilities; joint stock company with unlimited liabilities; and mixed company with additional liability) – two or more persons agree on its possession and management with the purpose to fulfill certain economic functions; joint stock company is an enterprise with limited liability of its members, its capital is divided between the owners in the form of shares; government enterprise belongs to a state and is controlled by it.

5. Joint stock companies, as world experience testifies, account for the main part of the national production. A share is stockholders' securities having no fixed period of circulation, it certifies contribution of recourses for the purpose of creation or development of a business and it gives the right to its owner to participate in a business management, the right to get profit in the form of dividend, the right to take part in property distribution while liquidating a business.

6. All material, technical, and monetary resources owned by a business, are called funds of an enterprise. They provide a business reproduction.

7. Production funds of a business are divided into capital assets, floating funds, and floating funds in circulation. Circulation of production funds is a process of the form changing, transformation of funds from one functional form into the other (monetary productive, and commodity form). Circulation of funds is a movement of funds from the moment of monetary means advancing up to their full return.

8. The basic production assets serve for a long period of time, they make a circulation during a range of circulations, the costs for them are returned gradually, by certain portions which are called amortization charges. The cost of capital assets can be expressed through the parameters of their original, residual, and replacement cost.

9. Floating funds are completely used in each circulation, they are included in the cost of produced goods in the full volume and are compensated during a period of one circulation.

The main terms and concepts

1. Enterprise (business)
2. The main features of a business
3. Classification of businesses
4. Classification of businesses by size
5. Sole proprietorship (enterprise, business)
6. Economic union
7. Joint stock company with unlimited liability
8. Joint stock company with limited liability
9. Mixed company
10. Cooperative society
11. Holding
12. A share
13. A dividend
14. Controlling block of shares
15. Nominal value of shares
16. Market value of shares
17. Types of shares
18. Funds of an enterprise
19. Capital assets and floating funds
20. Amortization
21. Circulation and turnover of funds
22. Original, residual, and replacement cost of funds

Part 3.

GOVERNMENT REGULATION OF THE ECONOMY. GLOBAL ECONOMY

UNIT 13. A STATE IN THE SYSTEM OF MIXED ECONOMY

Perhaps, everybody of us feels an influence of a state to some extent. Thus, for example, enterprises, workers and we all pay taxes as buyers of goods. Incomes of millions of people in Ukraine depend on the budget which a state has at its disposal, and the way it is distributed by the articles of expenditures. What prices enterprises and households will pay gas deliveries depends on the activities of the corresponding government institutions to a great extent. Obtaining a land plot in the city by a business for construction of trade centre requires an appropriate decision of the local authorities. That list can be continued. The role of government in modern economy can't be called secondary one on no account, it is essential. System of mixed economy supposes roughly the same regulating role of a market and a state. A state acts not only as a regulator of society's economic life. A state can be considered as a subject of economic activity, too: a state acts like a founder of many enterprises which are managed by corresponding state authorities.

In this unit we'll consider the reasons stipulating necessity of state participation in society's economic life, basic economic functions of a modern state, methods and instruments of government regulation, and such an important issue as reflection of public preferences in economic policy of a state.

13.1. Basis of government regulation of the economy

Necessity of government regulation of the economy

Necessity of state intervention into economic life is caused, first of all, by the following:

1. Requirement to maintain conditions of self-regulation of economy, effective functioning of a market. A state defends a market from its "enemies", and monopoly is the most dangerous among them, and the economic subjects' aspiration to limit or even eliminate competition. When competition is failing, efficiency of entrepreneurial activity, as a rule, is decreasing. Defending competition, a state defends efficiency;

2. *Disadvantages of self-regulation and necessity to overcome them.* Firstly, production of not all the goods and services turns out to be profitable for entrepreneurial sector, that's why, a state organizes rendering educational services, carries out building of roads and bridges, finances fundamental and other scientific development, carries out municipal service of houses, sanitary control, lightening of streets, establishes and maintains organizations which guarantee safety of country's citizens, etc. Secondly, market self-regulation doesn't ensure the complete use of the available resources in a state. First of all, this problem is related to the labour resources. A state can't ensure full employment but it can and must influence situation on the labour market as to its stabilization. Thirdly, market relations themselves don't ensure effective cooperation between economy and ecology.

3. *Necessity of a certain redistribution of profits, an increase of access to some goods and services.* Mechanism of profits distribution supposes payments from a state budget and off-budget such as pensions, scholarships, and different grants. As to the creation of the more favorable conditions for obtaining some goods and services for population, as examples here – education, medical service, work of libraries, museums, and so on can be taken. Financing educational programs in particular, a state creates preconditions for great masses of population to master general and special education which increases a society's potential. Budget system of financing for creation of the mentioned goods and services has economic and social grounding, and that, however, doesn't exclude parallel use of direct or market mechanism of their payment. That can be observed in Ukraine and many countries all over the world.

Circulations in economy with participation of a state

Economy is, first of all, interaction of business and households. This interaction supposes movement of goods (services) and money. At the same time, a state takes part in circulations – commodity and monetary ones (fig.13.1). That's why, let's consider in what way business and households interact with a state.

Households – a state. Part of resources which is supplied by households into corresponding markets is purchased by a state. For example, a state purchases services of teachers, military men, doctors, managers, miners, drivers and so on. All of them get a job in state structures. Those structures produce goods and services which are purchased or got by households. The first circle is closed in that way. Let's analyze the second circle: a state collects taxes from the households, then a part of those money means is used for payment of resources purchase which is one of the sources of households'

profits. Households can get money means from a state according to the programs of social security (for example, pensions) and services (for example, education) which are not directly paid by them.

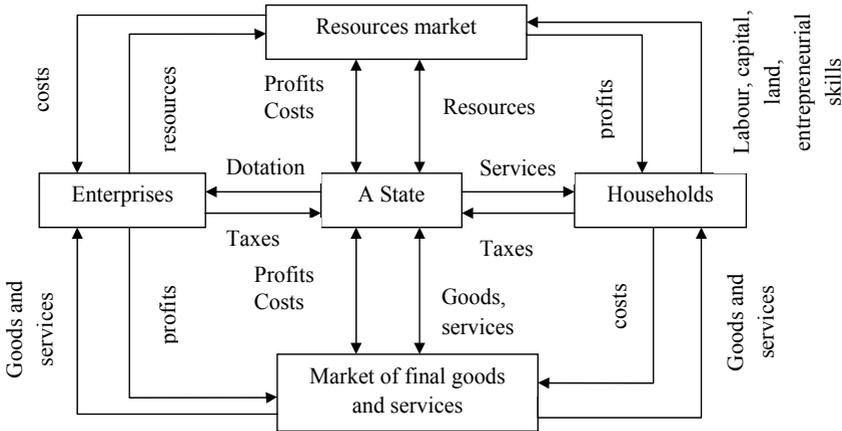


Fig. 13.1 Commodity and money circulations in economy

Businesses – a state. A state may act a buyer of goods and services produced by businesses. A Ukraine’s government, for example, annually purchases grain into public funds from agricultural producers. A state also purchases all necessary things to maintain army, police, schools, hospitals and so on. From the other side, a state provides a range of goods and services: grants land plots, provides water and various services, for example, judicial protection and so on. To purchase necessary goods and services and to organize production of some kinds of them a state needs the monetary means which it obtains using taxation system.

13.2. Economic functions of a state

Formation of the rules of the game

Formation and development of legal foundation for economic activity can be considered as one of a state’s key functions. With the help of laws and other normative acts a state establishes how economic entity “can or can’t” act. A state determines and defends the property rights, the rights of producers and consumers, payment procedure, the rules of products selling, conditions of conducting export and import

operations, foreign investments placing and so on. It is important not only to adopt proper legal norms but provide their effectiveness, too. That's why, a state should organize a control for observation of the "rules of the game" by the participants of economic life, it should perform functions of a supreme judge, and punish violators. Violations of economic legislation can be connected with nonobservance of the terms of goods delivery, restriction in competition, unfair advertisement, dissemination of false information concerning origin, properties of a product and some other circumstances.

A state's activity in the sphere of economic legislation creates one of the important preconditions of standard operation of the individual economic subjects and economy as a whole. Of course, this system can cause inconvenience and economic losses of the individual subjects but it is undoubtedly beneficial for a society in the whole. It is a barrier for spontaneity and a sign of people's civilized cooperation.

Maintenance of competition

Availability of competition is one of the basic conditions for effective market functioning. Potential of a free entrepreneurship is realized in the best way in the consumers' interests only in presence of competitive struggle. A factor of producers' competition creates opportunity for consumers' free choice, and it provides their influence on goods sellers. At the same time, the wishes and actions appear among participants of market relations which are directed on restriction and even elimination of economic rivalry. Any economic agent is both a seller and a buyer at the same time. An enterprise, for example, acts like a buyer of resources which are necessary to produce goods and services.

As a buyer an economic agent is interested in economic competition on those markets where he buys necessary goods. He can get benefit in price, quality, conditions of aftersales service and so on from that competition. But, as a seller, an economic agent is not interested in competition on those markets, where he sells his goods. He "suffers" from competition – it can negatively influence his income, future opportunities and so on. That's why, there is always an interest to decrease and even to eliminate competition on the market. With that, it is not difficult to notice that capturing monopoly position on the market by any seller changes distribution of forces in "seller-buyer" relations: a seller gets opportunity to dictate his conditions, his interest to costs reduction, to scientific and technical updating of production, to investigation of consumers is decreased. That's why, a degree of the effective use of economic resources is decreased in economy. A market itself has no proper immunity against monopoly,

it needs the external help. Such help is rendered by a state carrying out events to defend and develop competition which are often called antimonopoly policy.

Production of commodities

Organization of certain commodities and services production is one more economic function of a state. An entrepreneurial sector shows no interest to produce certain goods and services necessary for a society. Entrepreneurs either do not produce some goods (services) at all or do not provide their enough supply. One can add fundamental scientific research, production of commodities with a long period of recoupment of expenses and some others to the above mentioned examples. Such benefits are often called “public” goods and services: a state is dealt with their production as they are not produced or produced in not sufficient quantities within the market system. Besides, a state purposefully “takes away” production of a range of goods and services from the market (for example, education, medical service, and culture partially), supposing that a state has to be dealt with them from the point of view of national interests. Reasons for a market “to deny attention” to some goods and services are connected with the following:

a) Impossibility to take payment for goods and services from those using them. It is preferable to be in the streets in the dark period of the day when they are lightened. It is known that a state takes a concern upon itself, local bodies indeed. Can you say, if that was done by a private company, could it be able to get payment from all gaining benefit from the street lightening? Obviously, not;

b) Long period of recoupment of expenses. The monetary means are allocated to struggle with such extremely dangerous disease as AIDS practically in any country today. Doctors and scientists are searching, in particular, for the ways of its treatment. Nobody can say even roughly today when they will be discovered. Who will try to determine possible terms of invested capital recoupment more or less exactly? Private investments take part in carrying-out of the programs alongside with state ones but, as a rule, they are rather limited. Private capital is invested in rather small portion into economic projects with the remote period of recoupment.

Redistribution of income

Nature of this economic function of a state is in the fact that a state with the help of taxation system “takes away” part of income from population and enterprises and transfers them to certain categories of people. This transfer can be carried out

in different ways. One of them is the *transfer payments* which directly form money income of pensioners, invalids, unemployed, temporarily unemployed because of disease and so on. The other one is reduction in prices of some goods and services at the expense of state additional payment (dotations) to their producers. This means that consumers, obtaining some goods and services, do not pay their full cost. A state pays some part for them in addition. For example, in Ukraine it can be a travel by public transport, providing population with municipal services, selling of some types of medicines and so on.

A state can completely exempt certain categories of population (for example, pensioners, invalids) from payment of some goods and services.

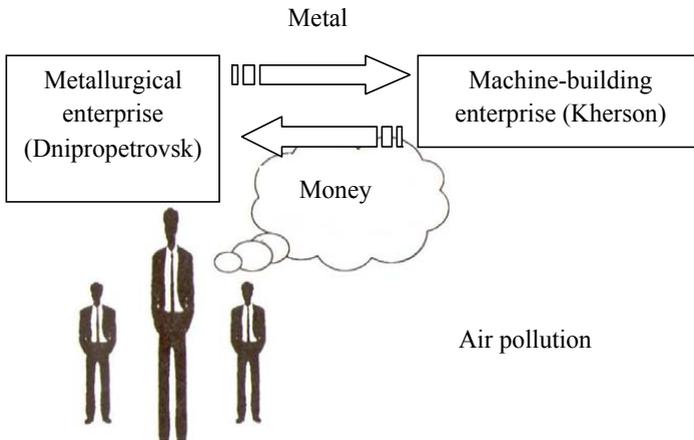
Receiving goods and services with partial personal payment or without it, those people increase their real income, that is, that quantity of goods and services which they can use.

Accounting external effects

Producer and consumer are the two sides in any economic transformation. They must also pay costs and they will have benefits dealt with establishment and consumption of the object of their relations – goods and services. However, those costs and benefits are often distributed not only between direct participants but “fall” to the third side – the by-side (external) effect appears, as a result.

External (by-side) effect is some costs or benefits movement which are connected with production or consumption of certain goods to the subjects which are not their direct sellers or buyers.

By-side effect can be both negative and positive for the third side. Negative costs movement can be more clearly demonstrated on the examples dealt with environment pollution. Let's assume that a metallurgical plant in Dnipropetrovsk (fig.13.2) sells metal to a machine-building enterprise in Kirovograd and earns certain income. With that, the metallurgical plant doesn't provide complete utilization of the emissions into the atmosphere: as a result, inhabitants of Dnipropetrovsk suffer costs dealt with the fact they breathe the polluted air and that negatively results on their health. Nobody will compensate them those bound costs, if effective state's intervention doesn't take place, which can with the help of legal and economic instruments, force a metallurgical enterprise to bear costs for application of the more effective systems for environmental protection, technological improvement and to take all expense dealt with a given product manufacturing on itself.



Inhabitants of Dnipropetrovsk

Fig. 13.2 External (by-side) effect

An external effect can have positive effect, as well. For example, having built a cultural centre, having laid out public garden with a fountain, benches, and children swing, a metallurgical enterprise will give excellent opportunities for having a rest not only for the workers of the enterprise, workers of other enterprises, other inhabitants of the city will come here and have favorable external effect as well.

Macroeconomic stabilization

No one economic system has an absolute stability. Fluctuations in the volumes of national production, prices, and employment are characteristics for the economies. Government economic policy is called to smooth economic fluctuations and facilitate economic growth, achievement of the stable price level, and an increase in the employment level.

13.3. Methods of government regulation. Economic policy

What way can a state influence the enterprises' and households' behavior in? The answer is: using rather famous methods in management practice at any level, including family, such as: enforcement (direct regulation) and motive (indirect regulation).

Direct regulation

Direct regulation of economic relations by a state (enforcement) supposes direct establishment of the certain obligatory norms in relations of the economic subjects. The forms of such regulation can include determination of minimum wage, the order of introduction of these or those expenses into bookkeeping expenses, insurance allotments, minimum sizes of authorized funds of different enterprises, direct determination of prices and so on. Enforcement limits freedom of the economic subjects' actions, it is not popular, it often causes unhealthy respond from business and households. But objective and realistic point of view on the things requires acknowledgement of unavailability of the enforcement use. It is impossible to organize economic cooperation in a normal way without it. Problem is not in enforcement itself but in the scales of its application. It is important to find out a sound dose. Doctors know that a difference between a drug and poison is just determined with a dose.

Indirect regulation

Indirect regulation of economic relations by government (motive) supposes the influence on the economic subjects' activity through the change of conditions under which it is carried out. It is indirect influence, it is not built according to the factor of "threats", punishment, and fear. Here the motive of benefit, rationality of this or that step is used. A tiger in a circus jumps through a burning ring not because it is afraid of a trainer but because it expects to get a reward just for this activity. A state doesn't limit freedom of the economic subjects' choice but it strives to persuade, interest it to make certain decisions. It uses such instruments as taxes, budget expenses, credit and money regulation, foreign economic policy and so on for that.

Economic policy of a state. Public choice

Economic policy of a state is those measures taken by a state directed to the decisions of a society's economic problems. How can those measures be determined? Whose interests do they express? What is the influence of country's citizens on the state's economic policy? How can they declare about their preferences? These and other detailed issues can attract attention to themselves from the economists' side.

Economic policy of a state must express a public choice which is a preference of country's citizens. Since all people can't have the same points of view on the organization of society's economic life, economic policy of a state has to express interests of the majority.

The way of formation and expression of a public choice is rather difficult. It is necessary:

- to create conditions for identifications of public preferences
- to organize practical realization of public preferences

Let's start from the first issue. How can each of us declare of his preferences? In democratic country one can determine the following ways: firstly, while electing persons for government positions. Usually applicants advance their political programs where economy takes the most important place, electorate makes acquaintance with them and supports or doesn't support them, voting "for" or "against"; secondly, through the political parties' activity. The last ones strive to develop program principles of activity and advance economic purposes and projects of their solutions. Taking part in the activity of this or that party, voting for some party, a man demonstrates his attitude to certain economic problems; thirdly, through the activity of trade unions. Coverage of economic problems which trade unions are dealt with is rather wide. Position of trade unions can express economic atmosphere among very large groups of people; in the fourth, through referendums on the most important issues; in the fifth, through participation in fairly organized sociological surveys.

Identification of public preferences is necessary to respond them somehow, to take into consideration in a state's economic policy. The extent of consideration depends on a lot of circumstances: for example, on organization of the government power in a country, how much being at the political place depends on the extent of correspondence of a politician's activity to the electorate's interests and preferences. It also depends on politicians' morality, their political culture and political traditions existing in a society, availability and character of opposition's activity. Political practice gives examples of situations when on the stage of pre-election campaign some promises are given and after victory the real actions have different character.

As a whole, there are more chances for realization of political decisions in democratic state, including economic character and public preferences. However, one should not idealize politicians and assume that they are always guided only by public interests. Theory of "public choice" advises to analyze their activities as well as economic decisions of households and enterprises. And the last ones, as it is known, are guided, first of all, by their own interests. If this regularity is really demonstrated on the political level, as well, then country's political system must express a key principle of the market: personal well-being of a certain subject depends decisively on how he meets requirements of other people through his activities and results. Creation of such system and its maintenance in effective condition is not a simple task.

CONCLUSIONS

1. The role of national economy regulators is carried out by the market and government management under mixed economic system. Necessity of a state's active participation in a society's economic life is caused by: a) necessity to maintain conditions of economic self-regulation and market effective functioning; b) disadvantages of self-regulation and necessity to overcome them; c) necessity of a certain redistribution of income, an increase of access to some goods and services.

2. A state fulfils the following basic functions in modern economy: a) formation of legal basis of economic activity ("rules of the game"); b) defense and development of competition; c) organization of certain goods and services production; d) redistribution of income; e) accounts of by-side (external) effects; e) implementation of macroeconomic stabilization.

3. A state uses methods of direct (enforcement) and indirect (motive) regulation of economic relations. The first one supposes direct establishment of the certain obligatory norms in relations of the economic subjects through a change of conditions under which it is carried out.

4. A state's economic policy is the measures taken by a state which are directed to make decisions on a society's economic problems. This policy has to express social preferences. Theory of "public choice" is a branch of economic science examining process of making decisions by a state. A problem of public choice includes two the most important moments: a) creation of opportunities to identify public preferences; b) organization of practical realization of public preferences.

The main terms and concepts

1. Necessity of government regulation of economy
2. Circulations in economy with participation of a state
3. Economic functions of a state
4. Goods and services of public use
5. Transfer payments
6. External (by-side) effect
7. Direct government regulation
8. Indirect government regulation
9. Economic policy of a state

UNIT 14. THE MAIN DIRECTIONS AND INSTRUMENTS OF THE GOVERNMENT REGULATION OF ECONOMY

A state, fulfilling economic functions, uses different instruments of regulation. Taxation-budgeting (financial) and money-credit (monetary) instruments are considered the most important among them by economists.

Financial instruments have a versatile character of influence on economic relations in a society. A society is able to: influence the volumes and structure of national production, investment activity of the economic subjects; regulate inflation, employment; influence condition of competitive environment; carry out redistribution of income and so on with their help.

Taxes and distribution of the budget means – are always “hot” issues. Practically permanent decisions are held on how to make taxation system more effective. It is clear that one can’t do without taxes but at the same time, their use can bring different effect, including negative one as well. Taxes can be compared with a medicine, the curative properties of which are demonstrated only when it is used in sound doses. And taxation practice, in particular in Ukraine, demonstrates how difficult to determine those “sound doses”.

One more important element of macroeconomic regulation is money-credit (monetary) instruments. While regulating money supply and influencing the processes taking place on the money market, a state is able to influence the extent of business activity of economic subjects, the general level of prices, and condition of employment in national economy. In this chapter we’ll examine a structure of Ukraine’s taxation system, we’ll analyze the basic types of taxes, we’ll demonstrate directions of the taxation and budget expenses influence on the progress of economic processes and on economic subjects’ behavior. After that we’ll analyze monetary system of a country, activity of financial and credit institutions, directions and monetary-credit instruments of government influence on economy.

14.1. Financial (taxation-budgetary) regulation of economy

Taxes

Taxes are obligatory payments of households and enterprises into a state’s budget.

Sources of taxes can be the different forms of income: wage (salary), profit, dividends, interest, pension, scholarship, material aid and so on.

The object of taxation is what is subject to taxation. That can be income, cost (its part) of certain goods and services, property of enterprises and households, transfer of property, use of natural resources and so on. In some cases the source and the object of taxation can coincide: income tax collection, company income tax collection can be considered as examples.

Depending on the fact who is a *subject of taxation* the following are distinguished in Ukraine:

– *national taxes* are set by the Verkhovna Rada and are collected all over the whole country. They, in particular, include the following: profits tax, excise tax, value-added tax, income tax on individuals, payment for land, collection for obligatory state retirement annuity, income insurance, obligatory state social insurance and so on. These taxes are set by the Verkhovna Rada of Ukraine;

– *local taxes* are set by the country's laws and are put into operation by the local bodies on certain territories. Advertisement tax, hotel tax, tax for transit transport and so on can be noted among them in Ukraine. The list of those taxes and their marginal rates are set by the Verkhovna Rada. It is within competence of local bodies to determine which of the set local taxes will be really used on their territory.

Tax rate is a value of tax for the unit of the taxation object. It can be given as interest (for example, a rate of income tax) or in the money sums from a physical unit of taxation (for example, payment for land).

Depending on proportion set between *the rate of tax and income*, taxation can be subdivided into the following:

– *proportional taxation* – a taxation rate is constant, it is connected with the size of income and its change. If a uniform rate of income tax on individuals (independently of the income amount) is set in a country, this is just an example of such taxation;

– *progressive taxation* – a taxation rate is increased according to the growth of the income size. In that case a tax burden is not distributed evenly among taxpayers as under proportional taxation;

– *regressive taxation* – a taxation rate is decreased while income grows up. A tax burden is greater for subjects with less income under regressive taxation. That's why, this order of taxation is not widely spread.

Depending on the *object of taxation*, taxes are divided into the following:

– *direct taxes* – those are such taxes the object of which is an income or property of tax payer (income tax, company income tax, land tax, personal tax, real-estate tax and so on);

– *indirect taxes* – are those taxes the object of which is circulation and consumption of certain goods and services (for example, value-added tax and excise tax). Those taxes are not so obvious for households, not everyone even is aware of their existence. They are included in the price of goods selling and are paid by their buyers.

The main types of taxes

Those taxes which influence households and enterprises in the most powerful way are the following:

– *income tax* – the object of taxation here is an individual income (a proportional order of calculation is used in Ukraine, the rate has been 15% since 2007);

– *company income tax* – income which is subject to taxation, it is formed as margin between earnings and costs of an enterprise (a rate of tax is 25% in Ukraine);

– *individual excise taxes* which are collected from some goods on the flat rates. They are used, in particular, for alcoholic drinks, tobacco products and some other goods;

– *value-added tax*. The last one is determined as margin between the earnings of an enterprise and value of its costs for raw materials, semi products and services received from suppliers. In other words, this is the value added by an enterprise to the value of the original materials in the result of their special recycling, finishing off or some other economic use. Taxpayer is a buyer of goods, and a seller of goods is a tax collector – an agent between a payer and a state;

– *special taxes (fees):*

a) payments of enterprises and citizens into Pension fund and Social Insurance fund. Temporary disability allowances, connected, for example, with a disease are paid off at the expense of the last one, in particular. In 2007 working citizens deposited 1 – 5% from their income into Pension fund, 0,5 – 1% into Social Insurance fund, and enterprises deposited approximately 35% of their expenses for labour payment in the above mentioned funds taken together;

b) payments of enterprises and citizens into the Fund for support of population employment. Unemployment compensations are paid off, expenses for staff training and retraining and some other measures connected with the solution of employment problem are financed at the expense of that Fund. In 2007 the rate of payment for employed citizens was 0.5% from income, and for enterprises it was 1.3% from total costs of enterprises for work force attraction;

– *other taxes*, in particular: payment for land; personal taxes and real-estate taxes; inheritance tax and gift tax; export taxes (under exportation of certain goods into other countries) and import taxes (under importation).

“Tax moderation”

The main condition of the tax system efficiency is *moderation of tax levies* introduced by a state. The high tax rates can cause a range of problems.

Firstly, they are able to undermine stimuli and interest of households and enterprises in an increase of their economic activity. The used tax rates must not be an anti-stimulus for them.

Secondly, it can happen that a state, having used the heavier tax rates, will get less income from tax revenues. The dependence which exists between the values of the tax rates and volume of budget earnings is shown in figure 14.1. In the picture one can see that only up to a certain value (point A) the tax rates growth can bring large income for a state. After going through that level, the tax revenues can only decrease (a decrease in economic activity of the economic subjects as a respond to the excessive tax claims of a state arises).

Thirdly, taxes can form an interest to concealment of income by payers. Concealment of income is one of the elements of a shadow economy. Shadow economy is an economic activity dealt with production and exchange of commodities and services which do not have legal registration or accounting. Money earned in shadow economy, is not shown in corresponding documents and is not taxed.

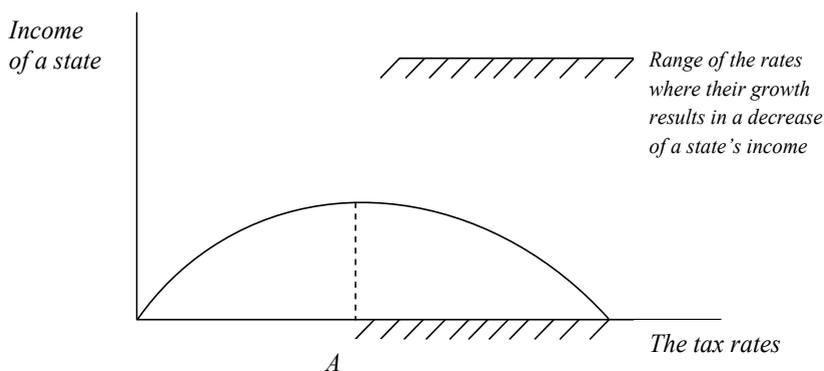


Fig. 14.1. Dependence between income of a state and the values of the tax rates (Laffer curve)

Functions of tax and budget system

Tax and budget system carries out the following functions:

1. Formation of budgets for purchase of goods and services. A state experiences expenses to maintain institutions of education, science, medicine, culture, army, law-enforcement bodies, national TV and

radio, building of houses, roads, enterprises and so on. The main source to cover those expenses is tax earnings. A state can have other sources of income as well (selling of state property, receiving an income from capital, dividends from shares, placement of government bonds and so on) but their significance turns out to be much less in comparison with tax sources in the total earnings of a state.

2. Regulation of production and investment activity of enterprises.

Using tax privileges, and, perhaps (to some extent), differentiation of the tax rates, a state can make more economically attractive production of certain goods and services for enterprises, or vice versa, - more difficult. Thus, for example, in Ukraine, a state with the help of liberal tax conditions usually tries to stimulate growth of agricultural products manufacturing.

A state can't direct a private enterprise how it should use the received profit but, at the same time, a society is interested in enterprises to use a significant part of profit for investment purposes, that is, to return it back into production for expansion of goods production, renewal of assortment, an increase of qualitative characteristics of goods, and technological improvement. That's why, a state can set tax privileges for taxation of that part of profit which is returned back into production to stimulate its development.

Acting like a customer for certain goods, paying them, a state influences volumes and structure of the manufactured goods in that way.

Tax system is often used to regulate competition. If a state sets tax privileges for new small enterprises it promotes formation of new competitors to some extent.

3. Regulation of inflation. Instability of prices is one of the basic macroeconomic problems. A state must be able to control inflation, it must strive to guarantee the low level of inflation. Tax and budget system is an important factor to achieve price stability. From one side, budget problems can cause inflation, and from the other side, tax instruments are applicable for government regulation of inflation. One of the reasons of inflation is growth of the total costs which is not supported with the corresponding changes in public labour effectiveness. Through financial system a state can, in particular, influence aggregate demand through changing the volume of the budget expenses and the tax rates. A struggle with inflation requires to take measures to limit the total costs, and that can be achieved through tightening of the system of tax exemptions and pursuing more curbing policy of the budget costs.

4. Redistribution of income. Monetary earnings received by households originate from different resources. Income, in particular, can be brought by a supply of labour, land, capital, and money. At

the same time, there are always people receiving income according to a special social position in a society: pensioners, invalids, unemployed, students and so on. They receive cash income from a state which, in its turn, forms its budget at the expense of taxpayers' money. Those payments are transfer payments. Households, while using economic resources on different markets, receive different income. Tax system corrects distribution of income in a society. Under progressive structure of the tax rates, those who are rich through taxes give up larger part of their income than those who are poor. Besides, in the result of a certain budget policy, those who are rich can receive less "free of charge" ("public") benefit.

Problems of a state budget

1. Problem of balance. A state budget includes the budget revenues and budget expenditures. There must be correspondence between them in ideal. But often expenditures exceed revenues, and government budget deficit arises as an excess of a state's expenditures over received revenues. The danger for economy is not from deficit itself but from its certain level. **Level of budget deficit** is determined as relation of the deficit volume to the gross national product expressed in percents. An admissible level of budget deficit is recognized its value within 3%.

The main danger for economy coming from deficit of government budget, is dealt with the problem of inflation. The point is, that the cover of budget deficit can be carried out both at the expense of inflation sources and by attracting inflation sources of financing. One of the variants of uninflation financing of deficit can be an issue of government bonds. Buyers of those bonds act like creditors of a state. The other way to cover the lack of money resources for government is the use of credit issue which results in growth of the means of payment, and money supply which results in acceleration of inflation under given conditions.

The availability of budget deficit usually means that a state must borrow, or, as they sometimes say, get into debts. National debt is formed in that way, that is, money supply borrowed by a state. That debt can be domestic (home) if it concerns borrowings contracted by government within a country, and foreign (external) debt in those cases when a state borrows money from foreign borrowers.

A state is obliged to return the borrowed money supply. That means that if one borrows today then government expenditures for repaying debts, including some other things tomorrow must be foreseen in government budget. Moreover, money is usually lent as interest-bearing debt, and that means a state must not only repay a debt, but it must meet obligations on interests payments. The more

the amount of the debt the larger debt burden is on the shoulders of future generation of taxpayers.

2. *Problem of money distribution by the levels of budget system.* Budget programs are realized in Ukraine at the national (government budget) and local (local budget) levels. The sum of government and local budgets is called consolidated budget. Distribution of budget money must be based on the functions entrusted to the corresponding structures of authority and management.

3. *Problem of money distribution by the budget items.* Distribution of budget money by the items of expenditures can tell much about a state's policy and its priorities: what specific costs are for education, culture, medicine, science, army, economy, social security, ecology, and so on. The Verkhovna Rada and government have to divide national budget "pie" and the local one has to be divided by the local bodies.

14.2. Monetary (money and credit) regulation of economy

Structure of money supply

Money supply is a sum of universally recognized instruments of payment in country's economy.

Credit money is payment obligations of the certain subjects of economy. Such financial and credit institutions as banks should be considered, first of all, as the subjects of economy. Enterprises, for example, settle accounts with each other not with the help of cash. Each enterprise has an account (accounts) in a commercial bank where a sum of money funds is shown which is at the disposal of the given enterprise and settlement with other enterprises is carried out by the way of this sum reduction or its replenishment.

In general a structure of the money supply is presented in the form of the following *money aggregates*: M0, M1, M2, and M3. Their filling can have the following form (table 14.1):

Table 14.1

Money aggregates

<i>Symbol of aggregate</i>	<i>Aggregate composition</i>
M0	Cash in circulation
M1	M0+current account
M2	M1+fixed deposits, savings deposits
M3	M2+certificates of deposit and some other obligations

Formation of money aggregates is carried out *by the degree of the payment means liquidity*. Degree of the payment means liquidity is determined by how quickly and with what costs those means can be exchanged for goods and services.

Cash is the most liquid means. Current accounts can be considered as the highly liquid payment means as banks are obliged to carry out payments to other persons on the clients' first requirement. Less degree of liquidity, in comparison with cash and current accounts, is characteristic for the fixed deposits and savings deposits. Fixed deposits are the deposits which are placed for a fixed period of time. The early call of the placed means by the owners is usually dealt with certain costs expressed in some money and time losses. Certificates of deposit – are bank certificates on depositing of the fixed money means by their owners in banking institution. Government bonds can be included into M3 as well.

Banking system

Modern banking system has a two-level structure. Its basement – the low level – consists of commercial banks and a top-high-level – consists of central bank.

Commercial bank is a financial institution which accepts the deposits and gives the commercial loans. As one can see in figure 1.4, money mobilization for bank is dealt with expenditures (%) and distribution of the loans gives income (%''). Bank manages to reach its commercial purpose only in the case if margin – difference between %'' and %' is positive.

The reserves of commercial banks are the bank assets which can be used for immediate satisfaction of depositors' requirements. The *reserves rate* is relation of the reserves sum to the sum of the accepted deposits.

Application of the *system of the fractional reserves* in banking business means that commercial banks, at each given moment of time, have at their disposal only a part of the money means necessary to cover all obligations given by them. Banks retain (reserve) only a part of the money received from depositors, and the rest of money are given on credit.

The order of fractional reservation applied by banks gives the banking system a range of important properties: firstly, there appears opportunity for banks to increase a money supply, and, secondly, there appears a potential threat for stability of the monetary system in the case of simultaneous massive presentation of clients' requirements to banks to return money.

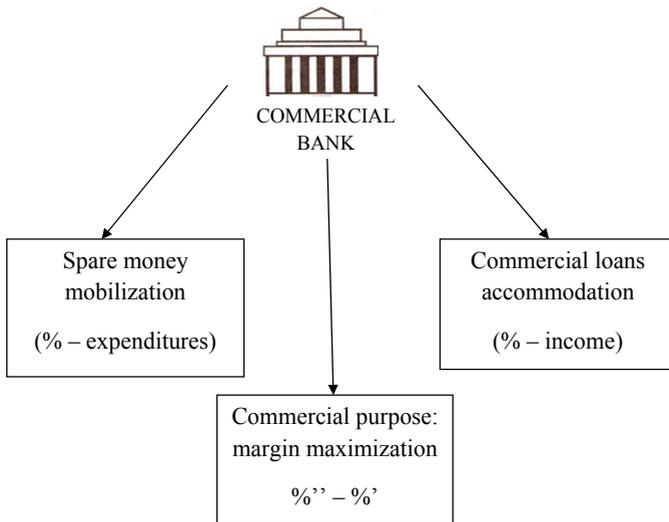


Fig. 14.2. The main functions and purpose of commercial bank activity

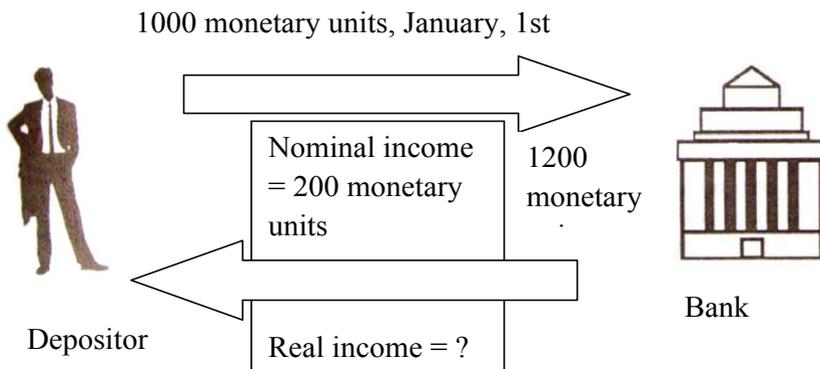
Deposits can be placed into bank on different terms and can perform different functions. The main purposes of depositors are the following:

- *carrying-out of payment operations*. They can be carried out both by enterprises and natural persons;

- *receiving of income*. Transfer of money to a bank for the temporary use gives a depositor an income in the form of interest. An interest is an income received after transfer of money into temporary use. As any other income, an interest can be divided into nominal and explicit interest. *Nominal interest* is a sum of money received as payment for the given opportunity of the temporary use of the money means. Thus, a depositor places one sum of money into bank (for example, 1000 hryvnas) and takes away the other sum which is larger (1200 hryvnas). An increase of money (200 hryvnas) is a nominal income of a depositor and that is shown in figure 14.3. Can a depositor be satisfied by his activities which ensured an increase of money? Not yet, one should pay attention to a change of purchasing power of money during that period of time. Everyone knows that money is valuable not because of itself, its power is in ability to be exchanged into other goods and services. That's why one should take into consideration a level of inflation.

Explicit interest can be determined as margin between index of nominal interest and index of inflation. If, for example, in six months

a depositor had withdrawn a money sum from a bank which totaled 120% from the deposited sum and inflation index for that period totaled 115%, then real income for that period totaled 5% from the deposited sum according to simplified system of calculations. If inflation index is higher than index of nominal income, that will mean that a depositor did not receive any real income, a sum of money which had less purchasing power was returned to a depositor;



Terms to receive real income:
 index of inflation = less than
 120%

– *accumulation of money*. It is not difficult to notice that the sum of money we get for month turns out to be evidently insufficient to purchase a range of goods and services. That’s why, obtaining those goods and services becomes possible either in the result of money accumulation, regular saving of a part of the received income from consumption, or through execution of the corresponding credit. Besides, people usually strive to have some reserve for the case of the extraordinary expenses.

Formation of bank’s credit resources is a result of its work to attract deposits. **Credit** is allocation of the money means for the temporary use and for a fixed price certain payments. **Creditor** is the one who accommodates loan, **borrower** is a recipient of a loan. Features of credit are the following: credit recovery, fixed periods of the use, payment, material security or any other guaranteed coverage.

Money has its price. **An interest** is a price a borrower has to pay for the credit use. The interest value is determined in the money (monetary) units. **An interest rate** is a price of the loan in percents

from its value. An interest rate regulates demand and supply of money. With a lower price of money borrowers are ready to use credits more often, with an increase in money price, vice versa – less. An increase of an interest rate results in an increase of the value of the credits supply, and its decrease results in cutback.

Central bank and its basic functions

Bank and nonbank financial and credit institutions are the key subjects of monetary and credit system (fig.14.4). Banking institutions are central bank (National Bank of Ukraine) and commercial banks. Nonbanking financial and credit (pecuniary) institutions, carrying out special functions which are dealt with monetary and credit sphere, include credit unions, lombards, and some other structures.

National bank of Ukraine is not dealt with direct crediting of enterprises and households. In credit system, in economy as a whole, it has other functions. This is “a bankers’ bank”, the basic link in monetary regulation of economy.

In Ukraine, as in majority of countries, central bank is owned by a state. It carries out the following basic functions:

– ***Monetary and credit regulation (monetary accommodation)***. While regulating money supply in national economy, central bank has opportunity to influence a degree of business activity of enterprises, employment, and inflation. Central bank is the only issuing centre of cash. As to the credit money supply, its expansion can be dealt not only with activity of central bank but with the work of commercial banks as well, which are able to create (multiply) credit money. Central bank has opportunity only to limit or expand that ability of commercial banks;

– ***control of commercial credit institutions’ activity***. System of the fractional reserves used in banking business creates a potential danger of the run on the bank and a raise of a banking panic. “Effect of falling dominoes” when collapse of one financial structure results in a line of the subsequent falls (bankruptcies) can have distracting consequences for economy. That’s why, banking business needs rather strict “rules of the game” and effective control for their observation;

– ***credit and settlement services of government***. National bank of Ukraine functions as a bank servicing financial operations of the country’s government;

– ***Creation and storage of the official gold and foreign exchange reserves***. Any state strives to have such reserves. They, in particular, are necessary to regulate the currency rates, security of special foreign economic operations and so on.

Instruments of monetary – and credit regulation

Central bank has a range of instruments at his disposal which it uses to regulate economy. Their effect, as the whole monetary policy, is based on regulation of the volume and structure of the monetary supply. Such instruments include the following:

1. Change of the discount rate. In figure 14.4 the central bank's ability to credit commercial banks is shown. Those loans, as any other else, are given for some payment. The *discount rate* is an interest rate on the loans given by central bank to commercial banks. Changing the discount rate, central bank influences the processes taking place in economy to a certain degree. Let's examine that on the example. Let the National Bank of Ukraine make a decision to increase a discount rate from 8 up to 10%. On the monetary market, as on any other else, a law of demand is in effect: quantity of the purchased goods decreases with a price increase for the unit and increases with its decrease. A discount rate is a price of credit money sold by central bank. Its increase will stimulate reduction of borrowings and will result in limitation of the money supply. The last one must be a curbing factor of inflation. And vice versa, a decrease of a discount rate makes credit money of central bank more accessible for commercial banks and that results in an increase of the money supply which, in its turn, can become a stimulus for a business activity increase, production growth, and creation of new jobs.

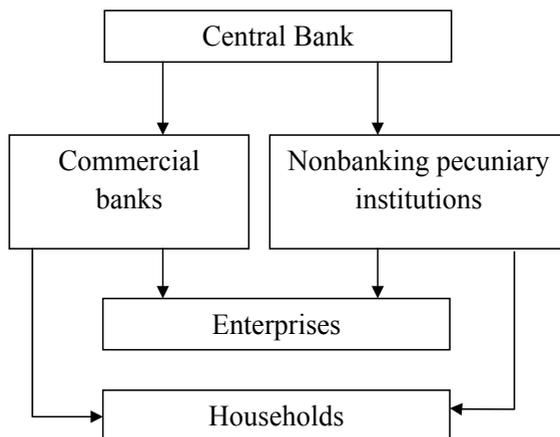


Fig. 14.4. Subjects of monetary and credit system

2. Change of the legal reserve rate. Commercial banks must reserve some part of resources from the accepted deposits in an obligatory order. Those payment means can't be used by commercial banks for

crediting. The *reserve rate* is a legal reserve of the payment means which commercial banks must have in relation to the sum of the accepted deposits.

The reserve rate for Ukraine's commercial banks is set by the National Bank. It can be differentiated by the types of deposits. In the result of the reserve rate use limitation of credit opportunities of commercial banks takes place: real credit resources become less than potential ones.

While changing the value of the reserve rate, central bank influences the volumes of the money supply. An increase of the reserve rate will mean limitation of the money supply, a decrease of commercial banks' ability to create money through crediting, and a decrease will mean expansion of the money supply, and an increase of the mentioned above ability.

3. Conducting operations on the open market. A state in economy acts as a seller and buyer of the securities. Operations on the open market are called operations of a state on purchasing and selling of its securities carried out with households and enterprises. The main subject of the purchase and sale in those operations is government bonds. When a state buys securities from commercial banks, enterprises, and population it carries out money payments and increases the money supply with the help of that. Commercial banks, in particular, have the increased credit resources and potential of crediting increases. If a state sells securities that results in a decrease of the money supply, because commercial banks have a decreased potential of crediting.

Variants of monetary and credit policy

In dependence on purposes which monetary policy is oriented on, and in dependence on the order of the use of regulating instruments, it is accepted to differentiate restriction and expansion monetary policy.

Restriction monetary policy (policy of "expensive money") is carried out through restriction of the money supply and is directed to the inflation curbing. It supposes an increase of the interest rates on credits, makes credit resources less accessible, and reduces investment expenditures. A total demand is decreased and growth of the general price level in economy is curbed in the result of that policy. Thus, a purpose of the expensive money policy – is the inflation pressure curbing. At the same time, restriction policy itself has a danger of unemployment growth which is dealt with reduction of the investment expenses and business activity level.

Expansion monetary policy (policy of "cheap money") is carried out through expansion of the money supply and is directed on stimulation of production and employment growth. Its implementation is dealt with reduction of the interest rates on credits, and expansion of the

access to loans. The result of the corresponding actions is expressed in an increase of the investment expenses, growth of the total demand, and as a result, an increase of production volumes, and expansion of the number of jobs. At the same time, expansion policy has a danger of inflation acceleration.

CONCLUSIONS

1. Taxes are obligatory payments of households and enterprises into a state's budget. The sources of taxes can be the different forms of income. The object of taxation can be an income, property, value (its part) of purchased specific goods, services and so on.

2. National taxes are effective on the territory of the whole country. They are set by country's parliament. Local taxes are collected by the local bodies on a special territory and are completely taken by local budgets.

3. The tax rate is a value of a tax on the unit of the taxation object. Under proportional taxation the tax rate is constant to any value of the taxation object, under progressive taxation it increases with the growth of that value, and under regressive taxation it decreases.

4. The basic functions of tax and budget system include the following: creation of budgets for purchasing goods and services; regulation of production and enterprises' investment activity; regulation of inflation; redistribution of income.

5. The main problems of a state budget are the following: problem of balance; problem of the means distribution by the levels of budget system; problem of the means distribution by the budget items. Deficit of a state budget is an excess of expenses against the received income. The level of budget deficit is determined as relation of the deficit volume to the gross domestic product expressed in percents. A state debt (internal, external) is the money means borrowed by a state.

6. Commercial bank is a financial institution (pecuniary) accepting deposits and giving commercial loans. The reserves of commercial bank are its assets which can be used to satisfy depositors' requirements. The degree of liquidity of assets is determined by how quickly and with what costs those assets can be sold. Banking system of the fractional reserves gives a chance for commercial banks to create credit money.

7. While accepting money to deposits, a bank pays an interest payment for the right to use the money means. An interest can be nominal one (a sum of the money received) and explicit one (outrunning losses from inflation). Depositors place money with a purpose to carry out payment operations, obtain income, and accumulate money.

8. Central bank performs the functions of monetary regulation, control over the commercial banks' activity, monetary service of government, creation and storage of gold and foreign exchange reserves of the country.

9. Instruments of monetary policy of central bank are the following: a change of the discount rate, a change of the reserve rate, and conducting operations on the open market. Restriction monetary policy is carried out through restriction of the money supply and is directed on the inflation curbing. Expansion monetary policy is carried out through expansion of the money supply and is directed on stimulation of production and employment growth.

The main terms and concepts

1. Taxes
2. Sources of taxes
3. Tax rate
4. Objects of taxation
5. National and local taxes
6. Proportional taxation
7. Progressive taxation
8. Regressive taxation
9. Direct and indirect taxes
10. Income tax
11. Tax on profits
12. Value-added tax
13. Excise tax
14. Special taxes (fees)
15. Shadow economy
16. Laffer curve
17. Functions of financial system
18. Deficit of a state budget
19. Government (state) debt
20. Money supply
21. Cash
22. Credit money
23. Monetary aggregates
24. Commercial bank
25. Reserves of commercial bank
26. Reserve rate
27. Degree of assets liquidity
28. Nominal and explicit interest
29. Credit
30. Functions of central bank
31. Discount rate
32. Rate of legal reserves
33. Operations on the open market

UNIT 15. INTERNATIONAL ECONOMIC RELATIONS

Ukraine's economy, as any other country, is not an isolated or closed system. It is easy to make sure of that. Look at the manufactured things you use every day. Among them, for sure, you'll find out many goods of the foreign origin. At the same time, many Ukrainian goods are used by households and enterprises in other countries as well. Our life would be worse and the degree of needs satisfaction would be less if our country didn't carry out economic cooperation with other countries all over the world. The way that cooperation is organized, is very important. This and the next units are devoted to the research of the basis of international economic cooperation. We'll study the reasons, significance, different forms of international economic relations, a place and role of Ukraine in international labour division and its main foreign economic problems in this unit.

15.1. World (global) economy: nature and development stages

Nature of the world (global) economy

Today no one country can guarantee normal economic development of its economy without cooperation with other countries. Closeness of relations and degree of one country's dependence on the other country allow to make conclusion about existence of special economic formation such as world economy. **World (global) economy** is the aggregate of the interconnected national economies interacting on the basis of international labour division.

Origin of the global economy has become the consequence of *internationalization of economic life*, which is considered as a process of establishment and deepening of stable relations among enterprises of different countries as well as countries as a whole.

On one hand, internationalization rationalizes and optimizes production conditions, gives opportunities to reduce costs for obtaining a unit of production at the expense of specialization and cooperation, to improve satisfaction of consumers' needs in different goods, to increase labour effectiveness and total volumes of production. On the other hand, dependence of the national economy world (global) economy increases. Conditions of goods distribution are now determined by not only internal circumstances but by the demand situation for them in other countries.

Besides, the national economic subjects buy a significant quantity of resources and consumer goods on the foreign markets.

Discrepancy of the consequences of the economy internationalization is schematically demonstrated in figure 15.1.

International labour division is assumed as the basis of economic life internationalization, that is, specialization of different countries within the global economy in certain goods and services production with the purpose to sell them on the foreign markets.

Factors of country's specialization are the following:

- geographical location, natural and climatic conditions – the way out to the sea, proximity, remoteness, accessibility to some markets, peculiarities of a climate, a quality and relief of the land and so on;
- resource potentialities – resources endowment, labour resources provision and provision of other kinds of resources;
- historical and cultural peculiarities – availability of historical monuments and cultural originality which attract tourists;
- historical traditions and experience – original types of production, original technologies and so on.

A process of international labour division is developing in modern conditions. It includes such peculiarities:

- deficit intensification of the national natural resources or worsening of mining and geological conditions for their extraction. Countries, being in such situation, strive to decide their problems at the expense of an increase of the raw material and energy resources importing;
- aggravation of competition on the national market which stimulates a search for the new sales markets, first of all, abroad; appearance of the opportunity to reduce production costs at the expense of cheaper labour force attraction or the use of foreign capital, technology, and experience of management;
- search for the ways to increase competitiveness of their goods at the expense of their production abroad with a purpose to save the transportation costs, and to avoid customers' duty payment.

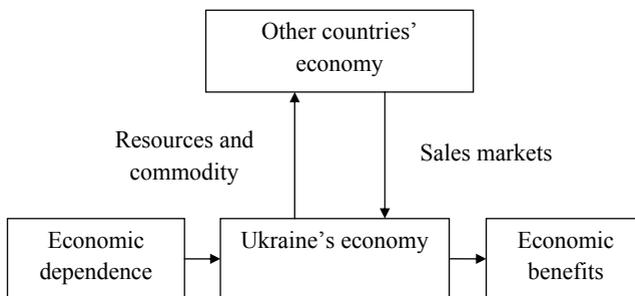


Fig. 15.1 Discrepancy of the consequences of production internationalization

Stages of the global economy development

In the global economy development one can distinguish several stages:

1. World trade stage. It begins in the period of geographical discoveries in the XVth-XVIth centuries, when the world economy origin and economic relations establishment among countries was observed. The following is characteristic to that period:

- absolute dominance of foreign trade in foreign economic relations;
- inequality in relations and nonequivalent exchange;
- absence of the stable relations and legal basis for regulation of international economic relations;
- frequent use of violence in international relations.

International labour division starts its formation in the result of trade development. Specialization arises, inequality of natural resources distribution and specific features of climatic conditions are, first of all, in its basis.

2. Foreign investments stage begins from the second half of the XIXth century. The distinctive peculiarities of the second stage are the following:

- active development of such form of international relations as foreign investments. Foreign investments are investments placement in other countries with the purpose to receive larger profits than inside the country. They testify the higher degree of closeness in relations among countries, orientation on stability in relations which supposes countries' confidence to each other;
- perfection of the foreign trade forms. Intellectual property (patents, licenses), know-how, information and so on become the new objects of purchase and sale;
- appearance of the new forms of foreign economic relations – international migration of labour force, scientific and technical cooperation and so on.

Growing closeness of relations and interconnection of the national economies prepare preconditions for transition to the third stage.

3. Economic integration stage. It begins from the middle of the XXth century. **Economic integration** is a process of a mutual tangle of production processes of different countries which needs pursuing coordinated policy. Its characteristic features include the following:

- active development of production operation abroad on the basis of vertical and horizontal integration.

An investing company organizes goods manufacturing abroad under vertical integration, which differs from its range of manufacture and is a stage of the indivisible technological process. The finished

goods of one range of manufacture are produced under horizontal integration in those countries where the production costs are the lowest;

- establishment of international economic institutions coordinating subjects' activity of different countries to achieve the common purposes.

4. Globalization stage. *Globalization* is formation of the transnational, planetary level of international economy with its characteristic regularities. Beginning of that stage is in the second half of the 80s of the XXth century. Economic integration was realized on the level of separate regions first of all (Western Europe, Latin America, countries of South-Eastern Asia and so on) but globalization becomes a planetary phenomenon.

Globalization exceeds the limits of just one of the development tendencies in the world economy. Scale rapprochement, one can say universalization, in economic, social, political, and spiritual spheres of countries' activity takes place. Mutual influence of different spheres of society's activity increases significantly.

This influence is called *universummization*.

The main *features of globalization* are the following:

- scale interdependence of the national economies. From one hand, no one country can develop effectively outside world community. From the other hand, world community depends on economies of separate countries more and more;
- rapprochement of the national price levels for the most important goods (especially power ones and some other raw material resources);
- establishment of the world markets of investment resources;
- creation of the world infrastructure of financial markets.

This generates opportunities for the fast flow of financial resources from one country into the other. That includes both the chances and threats (one of the conformations – financial crises in 1997–1999);

- recognition of the same human values as priority ones (human rights, right of the nation to self-determination and so on) by absolute majority of countries.

Internationalization of production and development of productive forces is the objective basis of globalization.

The following can be named as direct preconditions:

- information revolution which provided the technical basis to create global information networks;
- internationalization of capital and tightening of competitive struggle on the world markets;
- deficit of natural resources and aggravation of the struggle for their control;

Strengthening of the technogenic load on nature and spreading of weapons of mass destruction which increase a risk of global catastrophes appearance.

Position of the subjects of world economy

Various countries enter the world economy today. In dependence on *the level of economic development* they can be divided into developed, of middle development, and poorly developed countries. As a rule, a criterion to include a country to this or that group is production of the gross national product per capita. Thus, they often show as a guide, that if the given index reaches up more than 10000 USD a year that is a sign of the developed country.

To characterize the level of country's development more precisely, the above mentioned parameter is completed with the analysis of the technical and technological levels of production, country's position in the world scientific and technical progress, and with a range of other characteristics.

Indicator of life quality is very often used in international comparisons today, it is formed as generalizing characteristic of populations' material well-being, situation in public health, political stability and security, unemployment level, political freedom, and gender equality. Ireland, Switzerland, Norway, Luxembourg, Sweden, Austria, Iceland, Italy, and Denmark are the world leaders according to that parameter.

If relatively successful situation with the level of population's life, unemployment, inflation, health service and other problems is characteristic for developed countries, then those problems are acute ones in poorly developed countries. Nearly 40% of the Earth's population lives in conditions of absolute poverty. Many of the poorly developed countries saved their monoculture economy (more often of raw materials type) which was established in the period of their colonial dependence.

Industrial, industrial-agrarian and agrarian countries can be distinguished on the basis of the *production branch structure* analysis. This structure is mobile, because during economic progress many agrarian countries become agro-industrial firstly and then industrial ones in time. Today there is a reason to believe that a part of the highly developed countries can be considered as postindustrial ones where the so-called information society was formed.

Poorly integrated and integrated countries can be found out by *the degree of integration into world economy*. The degree of integration is usually measured with the help of the system of the following parameters: value of the foreign trade turnover per capita; share of the

foreign trade turnover in the gross national product; share of export in the total volume of production; share of import in the total volume of consumption.

Modern world economy is a global competition as well. After the Second World War a maximum share of world production fell on the USA. However, in the second half of the 50s Western European countries, having restored their economy and united in organizational way, strengthened their positions significantly and began to compete equally with the USA for the sales markets and spheres of capital investment. Since the end of the 60s Japan has joined the leaders. In the end of the XXth century China declared about itself very seriously.

15.2. International trade

Absolute advantages and comparative costs

Like labour division among enterprises inside a country which leads to appearance and development of commodity production, international labour division gives a birth to international trade. This is the oldest form of international economic relations.

During last years the annual volume of the world trade was being increased by 7-8% and in 2006 reached almost 26 trillion USD. The largest world traders today are the USA (11% of world trade), Germany (7.9), China (6.7), and Japan (4.2%). The first ten world traders also include France, Great Britain, Italy, Canada, Holland, and Hong Kong. Export of Singapore, Chile, and Finland is developing in the most dynamic way. International trade turnover of Ukraine in 2006 was a little more than 84 milliard USD.

Country's participation in international labour division can be built up with the availability of *absolute advantages* in it in some commodity production. Say, there are the lowest costs for oil production in the world in the Middle East countries. This is an absolute advantage.

However, there is a principle of absolute advantage in the basis of international specialization not in all cases. Countries' participation in international labour division can be built up on *comparative advantages* of this or that country in some commodity production. This circumstance was noticed by *D. Ricardo* in the beginning of the XIXth century. Benefit from international trade in that case will result in specialization and exchange of a large quantity of goods of better quality in comparison with opportunities of their production inside the country under the same costs.

Let's examine the factor of comparative advantages on the hypothetical example. In table 15.1 cost data are presented for production of A and B goods in Ukraine and the world prices for them, as well.

If we make comparisons by the factor of absolute values, then, it is obvious, Ukraine has no advantages. But international trade is not only an export, it is an import too. Selling one product, a country gets opportunity to purchase the other product for the earned money.

Table 15.1

Comparative costs of production, money units

Product	Costs for production of the commodity unit in Ukraine	World market prices
A	2000	1500
B	200	100

Let's suppose that Ukraine uses the resources for 4000 money units to manufacture product B, producing 20 commodity units. If those resources are reoriented to product A production, then it is possible to get two units of product A additionally. Earnings from their selling on the world market (3000 money units) will allow to buy 30 units of the product B at the world prices, and that testifies in favor of Ukraine's specialization in product A production. In general the principle of comparative costs, while determining the objects of export and import, can be presented by the following inequality:

$$P_{ni}/P_{ii} > P_{ne}/P_{ie},$$

where P_{ni}/P_{ii} – ratio of the national price of the imported product to its world price.

Thus, a country has opportunities to export those products the comparative costs of which are lower than abroad. And vice versa, it is expedient to import those products which relative cost of production inside the country is higher than abroad.

The main indices of foreign trade

Condition of country's foreign economic activity, first of all, is characterized with the help of *export and import* indices and *trade balance*, as well.

The significant part of Ukraine's turnover falls on the countries of the former USSR. Thus, the share of CIS countries in Ukrainian export of goods is 33% and in import it is 45%. The main trade partner of Ukraine is Russia (table 15.2). Nearly 26% of the foreign trade turnover of our country falls on it.

Russia (36.2%), China (7.7%), Germany (7.4), Poland (4.2%) take the leading positions among the products suppliers into Ukrainian markets (table 15.3). Russia and Turkmenistan are dominating suppliers of mineral resources used as sources of power into Ukraine.

Table 15.2

Structure of goods export from Ukraine by countries in 2010

<i>№</i>	<i>Country</i>	<i>Specific weight of the country in Ukraine's export, %</i>
1	Russian Federation	25.9
2	Turkey	6.1
3	Italy	4.8
4	Byelorussia	3.5
5	Poland	3.3
6	Germany	3.0
7	USA	1.7
8	Hungary	1.6

During last years one of the problems of Ukraine's foreign trade activity is the availability of credit balance in trade balance. From one hand, it is connected with the fact that transition to the purchasing of mineral resources used as sources of power (principle item of import) at the world prices has resulted in the sharp rise in prices for import.

Table 15.3

Structure of goods import into Ukraine by countries in 2010

<i>№</i>	<i>Country</i>	<i>Specific weight of a country into Ukraine's import, %</i>
1	Russian Federation	36.2
2	China	7.7
3	Germany	7.4
4	Poland	4.2
5	Byelorussia	3.9
6	USA	2.9
7	Italy	2.3
8	Turkey	2.0

From the other hand, the main branches – Ukraine's exporters – face still more severe competition on the world markets.

Products of machine building are only about 1.4% in the structure of export. The main share falls on raw materials. Here technological, organizational and other problems existing in Ukraine's economy are expressed. In general structure of import 50% fall on raw materials and 60% fall on mineral resources used as sources of power.

A sum of export and import is called *foreign trade turnover*, and a margin is called *trade surplus (net export)*. Debit balance of trade balance means an excess of export over import, credit balance means an excess of import over export. What condition is preferable for a country?

This question can't be answered simply. A significant debit balance of the trade balance will testify that a part of gross product produced in a country is used abroad, and an import doesn't compensate reduction of domestic consumption. Besides, money earned in that way from export and not used to pay import, can be one of the factors to increase inflation processes, as a supply of money is increased without a corresponding cover in commodities.

If import exceeds export for a long period of time, then the problem of import payment arises. Rather often the source for import payment in that case is credit. That's why, a credit balance of the trade balance can result in an increase of a country's external debt and can influence its development negatively.

However, as export of goods is not a single source to get currency, and import is not a single direction of its use, then trade balance can be considered as a constituent part of balance of payments which will be examined in the next unit.

State foreign trade policy

A situation in country's foreign trade relations is significantly determined by the type of foreign trade policy pursued by a state. From the period of mercantilism two types its types are known: protectionism and liberalism.

Protectionism (protection – patronage) is a state's economic policy which is aimed to promote national economy development through its defending from foreign competition. More often to pursue this policy a state uses the following instruments:

– *establishment of customs duty*. **Duty** is a special tax of a state on the goods imported into the country or exported from the country. As a rule, duty is used to receive profit into the state's budget, to defend national producers from foreign competition, to regulate commodity supply on the domestic market, to hold antidumping events, to regulate state's balance of payments (in details about that – in the next unit);

– *imposition of special quotas*. Those are quantitative restrictions for import and export of certain goods introduced for a certain period of time. The so called voluntary quoting is spread in the world practice. For example, Japan “voluntarily” restricts quantity of its cars exported to the USA and the USA doesn't impose import of those cars with an increased duty;

– *licensing of export and import*. This means issuing of special permissions for foreign trade operations with certain goods.

Liberalism or free trade supposes free trade and limited interference of a state into foreign economic activity. With that, the customs duty, restricting export or import, comes to minimum and the free order of exporting and importing of goods is established.

Liberalization of foreign trade can be considered as one of the tendencies in modern global economy. There are the countries' communities (for example, European Union) where a free of duty trade is being carried out.

Protectionism undergoes changes, as well. The special stress in this policy is being laid now not on import restriction but on the various encouraging of national goods exporting.

A choice of this or that foreign trade policy by a certain country is determined, first of all, by the degree of competitiveness of its national products and by the state of the national foreign trade balance. Insufficient development of national economy and credit balance of trade balance facilitate pursuing of protectionist policy. Assurance in ability of national producers to compete equally with foreign producers encourages a free trade.

15.3. International movement of resources

Each national economy has a certain set of resources: capital, labour, entrepreneurial skills and so on. Money capital can be referred to them to some extent, its availability serves as a precondition for real attraction of productive resources. A modern stage of world economic relations gave strength to the resources dynamics, stipulated obtaining of the ability by them to move from one country into the other in large scales. Thus, foreign investments and labour migration are rather large-scale in modern conditions.

Motives and forms of foreign investments

The final purpose of commercial investment is to gain profit. That's why, entrepreneurs are constantly searching for spheres to use their capital with greater profit. Development of the foreign economic relations gradually broadens the limits of a search and withdraws a search outside the limits of national economy. As there are stable interstate differences in the prices for resources, taxes, levels of different branches development, state of competition and so on, then a natural difference in profitability of investment arises. Added with sufficient development of international trade and political stability, the above mentioned facts encourage movement of capital from one

country into the other with the purpose to get greater profit, and that is the nature of foreign investments.

Foreign investments can be carried out in different forms (fig.15.2). In dependence on the investment subject they can be divided into *private and official*. National borrowings, government grant, credits given by different international organizations can be referred to the last one. Private investment plays the main role in international capital movement.

Private investments can be divided into *entrepreneurial capital and loan capital* by the character of the use. In its turn, in *entrepreneurial capital* the following can be distinguished: *direct investments* (establishment of subsidiary enterprises, affiliated organizations, purchase of controlling block of shares and so on), and *portfolio investments* (acquisition of the corporate rights which don't give the opportunity to control operation of an enterprise). *Loan capital* is giving accommodation of the loans, placement of money in the form of fixed deposits in commercial banks, purchasing of bonds and so on. Undoubtedly, direct investments have the greatest importance for the country which is a capital recipient. Those are the resources which are "for a long time" and "seriously". Portfolio investments and especially loan capital are more mobile, and they easily enough "leave" economy of the country-recipient under the influence of a range of circumstances.

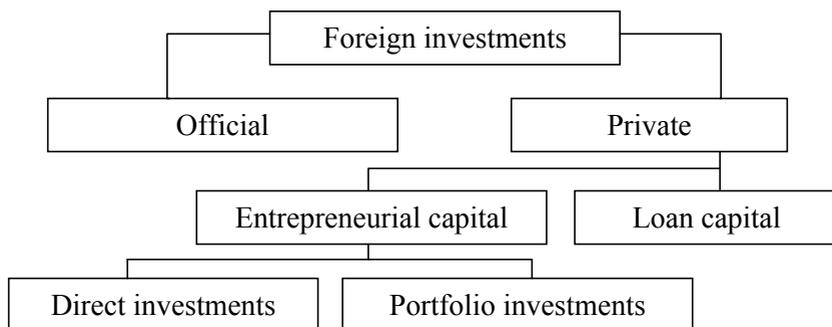


Fig. 15.2 Foreign investments forms

Foreign investments influence the economy of exporting and importing sides differently.

For *exporting countries* this influence results in the following:

- higher average profitability of investments is achieved because of their outflow from the least profitable branches inside the country and their placement into more profitable spheres abroad;

- favorable conditions to increase a range of goods export are created. Construction of enterprises abroad by the firms encourages, in particular, export of equipment for them from exporting country;
- internal resources are decreased. Capital movement into other countries can curb growth of internal productive capabilities of exporting country and negatively influence conditions of country's economic development.

Importing country, as a rule, feels an influence of foreign investments in the following directions:

- modern techniques and technologies often enter the country together with foreign investments. However, it is necessary to be aware that this, as a rule, is not the latest but that is used for a rather long period of time inside the exporting country. That's why, it is difficult to appear among the world leaders, having orientation only on the foreign capital import.

- conditions to speed the rates of economic growth are created. Foreign investments are an original dope for national economy. It begins to develop more quickly. But it is not excepted that during some time foreign investor's profit will flow abroad and that will negatively result in the rates of economic growth;

- internal competitive struggle is strengthened and that, from one hand, forces national producers to work efficiently and, from the other hand, can result in appearance of serious problems related to competitiveness.

That's why, importing country has to form a state policy in the sphere of foreign investments attraction very carefully.

Labour force migration

Besides capital movement in modern conditions, a large-scale shift of such resource as labour from one country into the other is observed. Modern migration of labour force is, consequence of rather high degree of processes development of economic activity internationalization as a whole, when alongside with world commodity markets, world labour markets develop as well.

The reasons of labour force migration can be the following:

- national discrepancies in wage (salary). The essential differences of countries by the development level, by social protection, by historical traditions and so on lead to situation when one and the same labour in different countries is paid in different ways. It is known, for example, that an employee, carrying out unskilled job, gets wage which is several times higher in the USA, than a lot of people in the countries of Latin America;
- national peculiarities in the employment situation. In poorly developed countries unemployment can reach dozens in percents,

and in the developed countries it is usually up to 6 – 8%. Besides, a significant number of jobs appear to be open in the developed countries and it is related to their low prestige. Immigrants usually agree to do such work.

– employers are inclined to prefer foreign workers rather than home ones in some cases. The point is that immigrants, as a rule, can't use the labour law and social guaranties provided for national workers. That's why, it is much cheaper to hire a foreigner.

15.4. Coordination of international economic relations

Scale of foreign economic relations, their closeness, versatility, and significance for national economies require establishing of the appropriate international legal regime. Like inside any country a state develops “rules of the game” for the economic subjects, in the world economy different interstate agreements determine a regime of the world economic relations subjects' activity. With that, one should differentiate the main ***functions of such international regulation*** of economic activity:

– *protection of competition*. The threats for competition originate from different sources. One of them is power of transnational corporations. They act as global economic structures and they are very difficult to compete with. Unfair competition often appears, as well, dumping is one of its forms. Dumping is goods selling on the other countries' markets at the underselling prices, that is, lower the normal level for those countries. An importing country has the right to use the so-called antidumping duty in such case. While determining the normal level of price, the prices for a certain product (analogous to it) are usually taken as the basis, and they dominate during a certain previous period in the importing country or on the markets of the third countries. An important argument in dumping evidence is the fact of goods selling at the prices lower than production costs;

– *coordination of efforts in decision of joint tasks*. The joint problems for participating countries of international relations are, for example, stability of international currency, decision of global ecological problems and so on;

– *interstate guarantees for private entrepreneurship*. This, in particular, refers to the steps in protection of foreign investments, elimination of double taxation and so on.

The most important role in regulation of world economic relations is played by ***international economic organizations***. The following ones are emphasized:

1. *International Monetary Fund* (IMF) was established in 1944 to facilitate development of international trade and currency cooperation

through establishment of the norms for the currency rates regulation and control for their observance, multilateral system of payments and elimination of currency restrictions, and to provide credit resources for their members in currency difficulties.

2. *International Bank of Reconstruction and Development* (IBRD, World bank) was established in 1945 to stimulate economic development of participating countries, to facilitate international trade development, and to support balance of payments.

3. *World Trade Organization* (WTO) was established in 1995 as successor of GATT (General Agreement on Tariffs and Trade, signed by 23 countries in 1947). The main task of WTO is liberalization of world trade through subsequent reduction of import duty and elimination of different nontariff barriers. Countries participating in WTO undertake commitments to grant the most favored nation treatment in mutual trade on nondiscriminatory basis, on mutual granting of the national regime for goods and services of the foreign origin, “transparency” of trade policy, settlement of commercial disputes through consultations and negotiations.

4. *European Union* is the largest interstate regional union which was established in the result of international economic integration. Organization has gone through several stages in its development:

– 1957 – 1986: creation of the free trade zone and customs union within European Economic Community (EEC) established in 1957 by six European countries (Belgium, France, FRG, Italy, Luxembourg, and Netherlands). Trade restrictions in mutual trade of participating countries were eliminated and common customs tariff for the third countries was established.

– 1987 – 1992: creation of the common market. “Four freedoms” were achieved – free movement of goods, services, capital, and labour force inside the union;

– Since 1993 up to the present time: development within economic union. In 1993 participating countries ratified Maastricht agreement and European Economic Community (EEC) was transformed into European Union (EU) on the basis of that agreement.

European Union today it is a common market, joint regulation of economic activity, the use of euro as common currency. It unites more than 25 countries of Europe.

Ukraine actively cooperates with the above mentioned countries and with other international organizations as well. During the years of independence it has become a member of almost 100 international organizations, participating country in almost 50 multilateral economic agreements, concluded and implemented more than two thousand of bilateral agreements.

CONCLUSIONS

1. In its development global economy has gone through the stage of world trade, foreign investments, economic integration and now it is at the stage of globalization.

2. Modern world economy is characterized by the availability of the different groups of countries in it, which can be classified in dependence on: the development level (developed countries, of middle and poor development); branch structure (industrial, industrial-agrarian, agro-industrial, and agrarian); degree of integration into world economy (integrated and poorly integrated).

3. The oldest form of international economic relations is foreign trade based on international labour division. International labour division is based not only on absolute but also on the comparative advantages of this or that country in some product manufacturing. Benefit from the foreign trade for a country is in obtaining a greater quantity of better quality goods through specialization than it could be produced inside a country under the same costs.

4. Protectionism is a state's economic policy facilitating national economy development through its protection against foreign competition. Liberalism supposes free trade and restricted intervention of a state into foreign economic activity.

5. Foreign investments and labour force migration are modern forms of resources and money movement from one country into the other. Foreign investments as investments of resources into economy of other countries can be carried out in the form of state and private investments. The last ones are divided into direct and portfolio investments.

6. The reasons of labour force migration are national discrepancies in wage (salary); national peculiarities in the unemployment level and employment structure; preferences which can be got by foreign workers when hired for the job.

7. "The rules of the game" form different kinds of interstate agreements in world economy. The main directions to regulate international relations are the following: protection of the market and competition, coordination of efforts to decide joint tasks, and interstate guarantees for private entrepreneurship.

The main terms and concepts

1. World (global) economy
2. Internationalization of economic activity
3. International labour division
4. Stages of world economy development

5. Economic integration
6. Globalization
7. International trade
8. Export
9. Import
10. Absolute advantages
11. Comparative advantages
12. Trade balance
13. Foreign trade turnover
14. Trade surplus
15. Protectionism
16. Duty
17. Liberalism
18. Foreign investments
19. Direct and portfolio investments
20. Labour force migration
21. Dumping
22. International economic organizations

**UNIT 16. INTERNATIONAL PAYMENTS
(SETTLEMENTS, CLEARING)**

The distinctive feature of international economic operation is participation at least of two countries' currencies in them.

Buying party, for example, Ukraine is ready to pay in national currency for the delivered goods but selling party, for example, Russia, expects to get currency of its own country in the end. That's why, transaction is implemented either when the goods buyer, first of all, gets seller's currency and then pays delivery or when a seller agrees to get buyer's national currency as payment for goods delivery with its following selling. In any case the necessity in the existence of one more market – currency market – arises.

The content of the given unit includes consideration of peculiarities of the currency market functioning, conditions for creation of demand, supply and price equation in that market. We'll also examine a structure of the country's payment balance which in general characterizes results of the country's foreign economic activity. Special attention will be paid to different ways of the currency rates formation and international currency systems development.

16.1. Exchange rate and payment balance

Exchange rate and foreign trade

Usually a concept "currency" is used to "designate" a certain country's monetary unit. Currency is Ukrainian hryvna, USA dollar, Russian rouble, Japanese yen and other monetary units.

The first problems of the exchange proportion of one currency into the other in international payments appeared in connection with the foreign trade. Under gold coin monetary system an exchange was carried out according to the weight content of coins. Further on, when sphere of national currencies exchange was significantly expanded and their relation with gold became mediated, currency markets were established where different currencies play the role of the purchase and sale subjects. Their specific prices – the exchange rates – are formed.

Exchange rate is a price of national currency expressed in monetary units of other country or a price of foreign currency expressed in national monetary units.

Exchange rate influences significantly a country's foreign economic activity, first of all, foreign trade. Let's consider that using the following example.

Let's suppose that in some basic period one hryvna corresponded to five Russian roubles (1 hryvna=5 roubles). Let's analyse the influence of the hryvna rate increase in 1.2 times as much, or 1 hryvna=6 roubles, on exportation of Ukrainian goods and importation of Russian goods. That will mean that if in the basic period a plant producing sugar, having earned 5 milliard roubles for its goods on Russian market, could get 1 milliard hryvnas for them, then this sum is now transformed only into 0.83 milliard hryvnas. To keep the former earnings in hryvnas, the exporter will be forced to increase prices, and that can negatively influence the competitiveness of his goods on the Russian market.

On the contrary, importation from Russia becomes more beneficial in the examined situation. Russian exporters, while exchanging earnings got in hryvnas into Russian currency, will get 1.2 times as much. This encourages them to deliver products into Ukraine's markets and gives them an opportunity to reduce the prices slightly and increase competitiveness of their products with that.

Contrary situation will be observed when the hryvna rate in relation to Russian national currency is reduced.

In that way, an increase of the national currency rate makes exporting less beneficial and encourages importing; a decrease interests exporters and restricts import operations.

Balances of international payments

Country's foreign economic activity creates the two flows of foreign currency: input flow (for example, earning from goods exporting) and output flow (for example, payment of importing). Integral indices of the results of those flows can serve balances of international payments as a ratio of monetary claims and liabilities, proceeds and payments of one country in relation to other countries. Several types of balances of international payments are used, among them the most important are the following: balance of claims and liabilities, balance of international debt, and balance of payments.

Balance of claims and liabilities is used to find out net-creditor countries and net debtor countries. It characterizes ratio of all debts to this country from the side of foreign partners to some date and liabilities of that country in relation to them, independently of the maturity. From one hand, one can judge on the scope of foreign economic activity by it, especially in the sphere of international credit.

However, from the other hand, it doesn't show rather completely the state of affairs, because in relation to both foreign debts and liabilities of the country there can be both overdue items and payments, the maturity on which has not come yet. Besides, foreign debtor's reliability is not taken into consideration here.

Balance of international debt (it can be called as balance of international investments) doesn't take into account a current debt (say, Ukraine's debt for deliveries of Russian oil this year) but shows only ratio between external assets and the country's gold and foreign exchange reserves and liabilities to foreign investors.

Balance of payment is one of the most widespread balances of international payments. It is a ratio of payments abroad and receipts from abroad for a certain period of time (year, quarter, and month). While building it, the fact is considered that all foreign economic operations can be subdivided into credit (receipts of foreign currency) and debit operations (spending of foreign currency). That's why, the first are used with the sign "plus" and the second ones with the sign "minus" in the balance. Thus, goods exporting and borrowings got by a country are credit operations, and goods importing and crediting of other countries are debit operations.

Structure of balance of payments is formed by:

- *current accounts* (export and import of goods and services, income from foreign investments in other countries and payments to foreign investors inside the country, balance of international private and state transfers and so on);
- *capital accounts* (inflow and outflow of capital);
- *legal reserves* (used to settle imbalance of balance of payments on current transactions and capital movements).

With the help of table 6.1 a structure of a country's balance of payments is presented in a simplified way.

In the end the total surplus of balance of payments must be a zero balance. Such "zero correction" is carried out at the expense of the legal reserves manipulation. If the surplus on current transactions and capital movements, is, for example, a credit balance, then legal reserves (first of all, foreign currency previously accumulated) are decreased. If that surplus is a debit balance, then legal reserves are increased. In the first case transaction with legal reserves is related to credit reserves, and in the second case transaction is related to debit ones.

Thus, indices of the legal reserves changes are always equal to the indices of the surplus of balance on current transactions and capital movements but with an opposite sign. This balance is often called a surplus of the overall balance. It can be *active balance* (proceeds of money into the country exceed their "withdrawal" from the country) or *passive balance* (expenditure exceeds proceeds). How can one estimate the consequences of this or that surplus condition of the balance of payments for the country?

Scarcely, a state has to set a task for itself to achieve annual equilibrium of the money receipts into the country and its external

payments. Obviously, that some discrepancy of the input flows and output flows is not significantly dangerous for country's economic stability. However, the limits are important as everywhere.

Prolonged active surplus of balance of payments can have a range of negative consequences. Thus, debit balance of trade balance means that import doesn't exceed export and, as a result, a real level of consumption is less than potentially possible one. If a surplus of balance of payments is formed under the influence of a significant excess of capital inflow against its outflow, then country becomes a receiving party with all possible negative consequences.

Table 16.1

Basic elements of the country's balance of payments

<i>Credit</i>	<i>Sum (+)</i>	<i>Debit</i>	<i>Sum (-)</i>
Export of goods	+	Import of goods	-
Export of services	+	Import of services	-
Income from foreign investments	+	Payments to foreign investors	-
Money transfers of private persons and states into the country	+	Money transfers of private persons and states from the country	-
Surplus of balance on current transactions (+, -)			
Growth of foreign investments	+	Growth of foreign (overseas) investments	
Surplus of balance on capital movement (+, -)			
Surplus of balance on current transactions and capital movement (+, -)			
Legal reserves (-, +)			

Besides, a prolonged excess of the currency inflow into the country against its outflow can cause inflation, devaluation of the national monetary unit and an increase of the overall level of prices on domestic market.

A prolonged passive surplus of balance of payments conceals no less danger in itself. In that case, to cover deficit of foreign currency it is necessary to use the legal reserves reducing their volume. But those reserves are not limitless. To correct situation a state is forced to introduce different protectionist's steps curbing import and encouraging export.

One of the consequences of deficit of balance of payments can be a change of the rate value of national currency. Exchange rate, from one hand, reflects the condition of balance of payments, and from the other hand, it is one of the factors of its balance. That's why, issues of the exchange rates formation deserve special consideration.

16.2. Formation of the exchange rates

Factors of the exchange rate

Exchange rate can be formed in a free way, that is, can be determined exceptionally by a free market game of the currency supply and demand. However, a significant influence of the exchange rate on conditions of foreign economic activity, and condition of national economy in the whole will also influence a state's interference into that sphere of economic life. That interference can have different character.

One can observe situations when a state, using administrative methods, sets an exchange rate. In that case market regulators are practically completely switched off from price formation under the currency exchange. But more often a state interference has no such a totalitarian character, a state only influences an exchange rate to some extent. What must be that limit, what is better – the purely market or mixed regulation – are the subjects for discussions among economists.

Thus, among the *factors determining an exchange rate* in modern economy those related to market and those related to a state influence can be emphasized. Let's examine basic factors among them.

1. Ratio of the income growth rates in different countries. If national income in Ukraine grows more quickly than in Russia, then Ukrainian buyers will relatively increase a demand for goods both of domestic and foreign production. Growth of demand for Russian goods will result in growth of demand for roubles.

The demand curve in the graph (fig.16.1) will shift to the right, the equilibrium price will increase and that will testify an increase of the rouble rate and a decrease of hryvna rate. If more rapid growth of national income is observed in Russia, then analogous considerations will lead us to a conclusion about growth of the hryvna rate and a decrease of the rouble rate.

Thus, a national exchange rate is in the reverse dependence on relative changes in country's income in comparison with the rest of countries.

2. Relative change of the price level. Rapid price growth on the domestic market makes goods relatively cheaper abroad. Buyer strives

to change over his expenses to purchase foreign goods. This, naturally, results in a demand increase for foreign currency and in a shift of the curve in the graph to the left. The national exchange rate decreases. Consequently, a relative change of the price level makes a reverse influence on the national exchange rate.

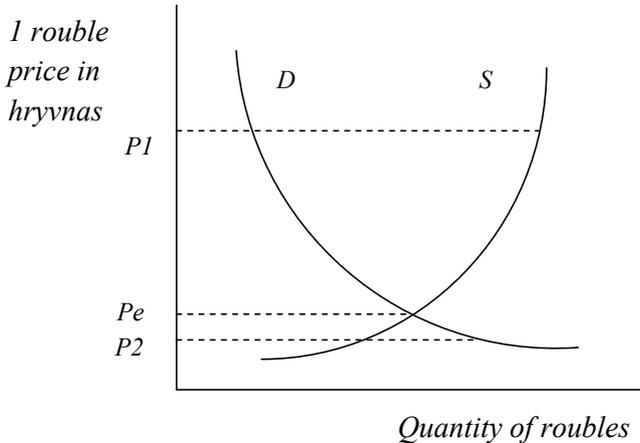


Fig. 16.1 Market formation of the exchange rate

3. Relative real interest rates. If real interest rates on bank investments of any country are higher than in other countries, then it is more attractive to keep free money resources in them. That increases inflow of foreign currency and shifts a supply curve to the right and that results in a decrease of the exchange rate and in appropriate growth of the national monetary unit exchange rate.

4. Price expectations of buyers and sellers. It was possible to observe repeatedly in Ukraine how, expecting for the next price jump, the managing subjects tried to save their savings, converting them into US dollars. That resulted in spasmodic growth of demand for dollars in periods proceeding a new turn of inflation. At the same time, sellers of dollars were striving to keep them, expecting to get more benefit when selling. Such actions from the sellers' and buyers' side resulted in a sharp increase in the dollars rate and a decrease in the Ukrainian monetary unit exchange rate.

Market mechanism of exchange formation

Mechanism of the exchange rates formed in a free way reminds a mechanism of the free pricing in conditions of perfect competition.

Price of any foreign currency in the national monetary units will be determined as the equation price, that is, equalizing supply and demand of that currency. In fig.16.1 demand (DD) and supply (SS) graphs of national currency are presented, its price is expressed in hryvnas.

The value of demand for roubles increases while its exchange rate decreases. Diminishing character of the demand curve is caused by the fact that it becomes more beneficial to purchase Russian goods with rouble cheapness.

But the roubles supply has contrary direction in the change. As growth of the rouble exchange rate makes export to Russia less beneficial, then that decreases an inflow of roubles for the hryvna exchange.

System of the freely forming rates has ability to support a stable equilibrium of the foreign currencies supply and demand through continuous restoration of the equation price level in the national monetary units (P_e) in fig.16.1). If the rate turns out higher than equation one (P_1), then Russian currency supply will exceed a demand for it, and this, as it is known, will result in price reduction: it will change, reaching the equation level. If the rate settles lower than the equation value (P_2), then competition among currency buyers will be increased, and that will result in rouble rate movement to the equation value through an increase.

Free character of the currency rates formation allows them to respond flexibly to the influence of the factor of currency demand and supply which was examined in the first point of this paragraph.

As majority of economic phenomenon, system of the freely forming exchange rates influences national economy in contradictory ways. First of all, one should notice ability of the free exchange rate to eliminate both active and passive surplus of balance of payments.

Let's suppose that the rate 1 hryvna=5 roubles was set under equilibrium balance of payments. What will happen if, for example, inflation rates in Russia turn out higher than in Ukraine? Obviously, that in such situation a demand for rouble will decrease, and a demand curve will shift to the left (fig.16.2).

Under the former equation exchange rate (P_{e1}) the earnings from foreign economic transactions will be AC1 and the need in roubles will decrease down the AB level. Active surplus of balance will be BC. However, flexible respond of the exchange rate to the established situation will result in a shift of the equilibrium point to the O position and rate reduction down the level (P_{e2}). This will cause some reduction of Ukrainian export to Russia and growth of Russian import to Ukraine. In the end, equilibrium of all payments and receipts

will be restored, that is, active surplus of balance of payments will be eliminated. The same conclusions can be made, while analyzing situation with passive surplus of balance caused, for example, by more rapid growth of national income in Ukraine.

However, such automatism in balance of payments regulation doesn't always fit a society smoothly. It introduces a rather essential additional element of risk into foreign economic activity. A lot of factors influence the exchange rate and that reduces accuracy of its dynamics forecasting. Under the unstable exchange rate foreign partners face an increase of the risk level when concluding contracts and can prefer domestic trade. The unpredictably changing exchange rate keeps back foreign investments.

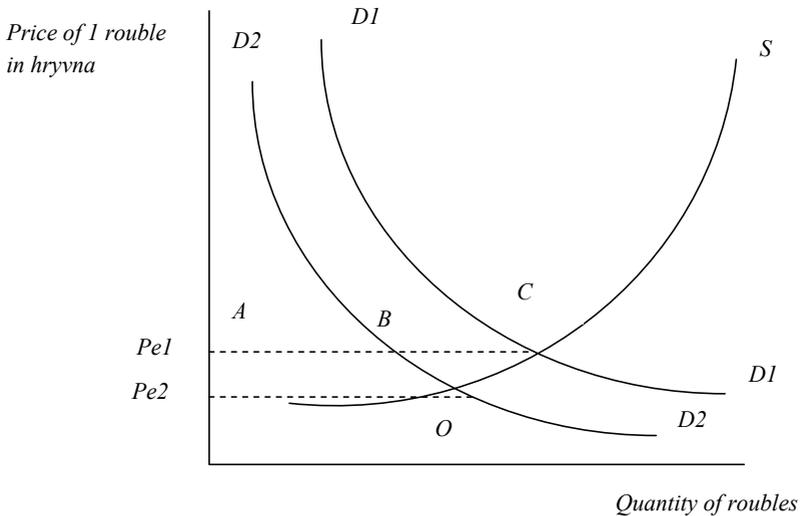


Fig. 16.2. Restoration of the equilibrium exchange rate

Even having received the planned amount of profit in national currency, while converting it, for example, into dollars, one can not provide the desirable level of profitability. That's why, the unstable exchange rate restrains development of trade relations.

Besides, the rapidly changing exchange rates can influence national economy in destabilization way, causing inflationary or deflationary processes. Especially that is related to the countries with the significant specific weight of the foreign trade turnover in gross domestic product. That's why the states strive to control the processes of exchange rates establishment.

State influence on the exchange rates

State regulation of the exchange rates brings about a range of *advantages*: stability of conditions of foreign economic activity is provided, currency risks are decreased, chances of precise results of the trade and investment operations forecasting are increased.

In general, the problem of a certain exchange rate support can be brought to the problem of the ratio support of the foreign currency supply and demand at the relatively unchangeable level. If due to the force of active surplus of balance of payments a demand for foreign currency turns out lower than supply is, then, threatening with the national exchange rate growth, a state (central bank) acts as a buyer, increasing its legal reserves at the expense of that. If conditions are created to reduce the national exchange rate, then a state carries out currency intervention: it begins to sell foreign currency, increasing supply and decreasing legal reserves with that.

Legal reserves manipulation is a basic method of the state support of the national exchange rate. However, its use supposes availability of the sufficient legal reserves. They can be formed mainly at the expense of active surplus of balance of payments in previous years. But if passive surplus of balance of payments is observed for a long period of time, then even the most significant legal reserves will be exhausted.

One another widespread way of the state support of the exchange rate is trade policy. Encouraging or keeping back export or import activity, a state can increase or decrease demand and supply on the foreign currency market, striving to save the former coordinates of the crossing point of their graphs.

To regulate the exchange rates a state can use the *administrative measures*. Method of the foreign currency use rationing especially stands out among them. According to this method all subjects of foreign economic activity are obliged to sell a fixed part of earnings in foreign currency to a state which distributed it itself, determining, from its point of view, the most important import items. In such situation import is limited by the real earning from export. Some part of demand for foreign currency remains unsatisfied.

However, as experience demonstrates, currency administration has a range of negative consequences. In particular, a role of the subjective factor in determination of the needs in export increases. Market mechanism, practically, is switched off, and determination of the managing subjects (who will be given an opportunity to import goods) is up to the state structures. This gives a birth to discrimination and voluntarism.

A state can regulate the exchange rate through corresponding internal macroeconomic policy. Thus, for example, in the case of

a threat for the hryvna rate decrease because of the more rapid growth of national income in comparison with other countries, and corresponding growth of demand for foreign currency, a state can increase taxes and keep back accumulation of population’s purchasing capacity with that.

Currency convertibility

Regime and sphere of national currency application chosen by a state are the most important aspects of currency operations regulation. In dependence on that, currency is subdivided into freely convertible currency, and inconvertible (soft) currency, partially convertible currency.

If currency is used only to serve the internal economic processes and is not exchanged into foreign currencies, it is called *inconvertible* or domestic (local) currency (fig. 16.3).

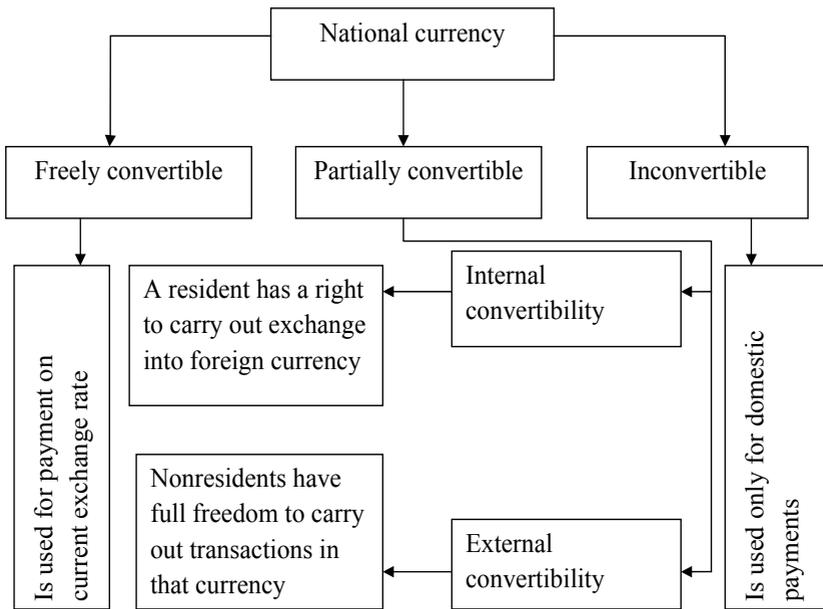


Fig. 16.3. National currency convertibility

In that case a state introduces import and export prohibitions of foreign and national currencies, their purchasing and selling. This regime is used, as a rule, in poorly developed countries.

The so-called *partially convertible currencies* can be used. Prohibitions for the foreign currency use are saved under such regime either for separate operations or for the individual subjects. For example, a freedom for payment of current transaction in foreign currency (export-import transactions, private transfers of money abroad and so on) can be provided but import of the last one for investing can be prohibited. Partial convertibility is considered internal one when a state doesn't restrict carrying-out of transactions with foreign currency for residents, that is, for natural persons constantly living in that country and legal persons registered in that country but prohibits currency transactions for nonresidents, that is, for all other subjects. Partial convertibility will be external if the right to carry out transactions with foreign currency is provided for nonresidents but they are prohibited for residents.

Freely convertible currency is freely exchanged into other foreign currencies in all types of transactions: current one – those related to the daily foreign economic activity, credit, and foreign investments. The US dollar, euro, Japanese yen are included to those currencies. Just freely convertible currencies are the basis of modern international currency system.

16.3. International approaches to the exchange rates regulation

System of gold standard

The so-called gold standard monetary system was used for a long time in the majority of the countries all over the world under which the exchange rates were set on the basis of the gold standard. Countries were striving to maintain the fixed rates of their currencies, that is, proportions of the national currency exchange into foreign countries set and fixed by a state beforehand. The following was necessary for them:

- to set a certain gold content of the national monetary unit and guarantee exchange of paper money into gold in that proportion;
- to maintain correspondence between the gold reserve and quantity of money circulating;
- to provide conditions of free trade;

Let's demonstrate effect of gold standard on the hypothetical example. Let's suppose that for some historic period 1 Troy ounce of gold (31.1 gram) costs 35 dollars and 70 francs. Then the dollar rate will be 2 francs. What will happen if the prices of the France's internal market increase more quickly than in the USA? Demand for dollars

will be increased and for francs will be decreased. The franc rate in relation to dollar will start to decline. Situation stimulating francs exchange into gold with its following exchange into dollars arises. French gold will gradually flow into the USA. But observance of the second condition for the gold standard existence will force France to reduce money supply. This will cause reduction of consumer demand and will result in economic downturn (or slowdown of growth) and unemployment. A franc supply decrease will restore the former exchange rate. Maintenance of the fixed exchange rates on the gold standard basis creates more or less predicted conditions of foreign economic activity and provides automatic restoration of balance of payments equation: debit balance is eliminated by the country's gold reserve increase; credit balance is eliminated by the decrease of that reserve. At the same time, many countries had to pay with production slowdown and unemployment for observance of the gold standard conditions. Besides, unfavorable situation in economy for a certain period of time could lead to country's gold reserve depletion and impossibility to observe gold standard in future.

“Gold standard” modernization

A critical blow on the gold standard monetary system was delivered by “Great Depression” in 1929 – 1933. Many countries in conditions of deep recession turned out not to be able to maintain the fixed currency exchange into gold.

Basic principles of the world currency system for the period after the Second World War were developed at the International Conference in *Breton-Woods* (USA, 1944). A new system was called upon to save basic advantages of the old gold standard system and try to eliminate its disadvantages related to the slowdown and unemployment.

Basic principles of Breton-Woods system can be formulated as follows:

- maintenance of the gold as world money functions under simultaneous use of national monetary units, first of all, US dollars, as international payments and reserve currencies;
- obligatory exchange of reserve currencies into gold for foreign governments and central banks at the official rate;
- establishment of the gold (or dollar) content of their own monetary unit by all countries-members of IMF and determination of currency par value between their own currency and currencies of all other countries;
- admissible deviation of the market exchange rates must not be more than 1% in relation to the fixed rate.

Active role in a new currency system was granted to the International Monetary Fund (IMF) established at the same conference. If in any country-member of IMF a threat appeared for a decrease of the national currency rate in relation to the other country's currency, then a deficit of foreign currency could be covered, in particular, at the expense of the following:

- reserve currency accumulated by a country in previous years;
- selling part of gold reserve to foreign country at its national currency;
- obtaining special credit from IMF in foreign state's currency.

Stability of dollar and ability of the USA to guarantee dollar exchange into gold was the basis of the new system. However, in 1950 – 1960s USA balance of payments more often turned out to be deficit than active one. That resulted in a sharp decrease of the USA gold reserve size.

Quantity of dollars in circulation exceeded the whole gold reserve several times as much. Real price of gold on the exchange markets was 10-15 times higher than gold standard. A threat to the dollar stability and dependability as reserve currency was formed. In 1971 USA made a decision to cancel the guaranteed exchange of 35 dollars for 1 Troy ounce of gold. The last gold standard bastion fell.

Currency system without “gold standard”

Under influence of the USA refusal from liabilities of official exchange its currency into gold, a range of other countries, first of all, western Union declined all responsibilities on maintaining dollar rate, and it resulted in the “free navigation” of the national currencies rates. Thus, a complete refusal from gold standard currency system has taken place in the world.

At the same time, there was understanding in the world community how dangerous is the absolutely free national currencies rates formation. Significant rates fluctuations are serious destabilizing factor in export and import transactions and financial flows.

Striving to find new approaches to provide reliability of the world currency system resulted in meeting of the countries-members of IMF in Kingston (Jamaica) in 1976. New principles of currency system functioning were determined there.

Basic changes were the following:

- cancel of the official price for gold and gold standards;
- complete cancellation of the official exchange of dollars into gold;
- permission of gold purchasing and selling at the market place;
- securing the right to choose a regime of exchange rates formation for the countries;

– transition from rates to the system of “floating exchange rates”.

They use, as a rule, the following statements while considering problems of the exchange rates formation in the world:

Firstly, continuous changes of conditions of foreign economic activity require continuous changes of the exchange rates. That means that fixation of the exchange rates contradicts conditions of economy effective functioning. Exchange rates must have an opportunity to change freely enough (“float”) to avoid stable active or passive surpluses of countries’ balances of payments.

Secondly, absolutely uncontrollable fluctuations of the exchange rates, especially of significant character in a short-term period, are able to disorganize trade and financial relations among countries, and damage essentially national economies. That’s why, the exchange rates regulation must be considered as one of the instruments to provide macroeconomic stability. Central banks of different countries must prevent serious short-term fluctuations of their exchange rates, make steps directed to oppose rates fluctuations and their smoothing. Thus, expediency to provide long-term flexibility of rates is recognized in world economy from one hand, and necessity of smoothing short-term fluctuations, from the other hand. System of the exchange rates in modern economy can be determined, perhaps, as the system of “controllable floating exchange rates”.

CONCLUSIONS

1. Currency is a monetary unit of any country. From the point of view of regime and sphere of application it can be freely convertible, partially convertible, and domestic or inconvertible currency.

2. Exchange rate is a price of national currency expressed in monetary units of other countries or a price of foreign currency expressed in national monetary units. An increase of the national currency rate makes export less beneficial and encourages import. A decrease of the national currency rate interests exporters and limits import transactions.

3. Integral indices of the incoming and outgoing flows of foreign currency for country – are balances of international payments, among them balance of payments stands out: ratio of payments to abroad and receipts from abroad for a certain period of time. It includes results of current transactions, capital movement, and changes in the official reserves.

4. Active surplus of balance of payments means an excess of receipts against payments on accounts of current transactions and capital movement, and an appropriate increase of official reserves as well. Passive surplus of balance of payments is, correspondingly, an excess of payments against receipts and a decrease of official reserves.

5. Freely forming exchange rates are determined in dependence on supply and demand ratio on the foreign currency market. Factors of the exchange rate include a relative change in income, relative change of the price level, relative change of the real interest rates, and price expectations of sellers and buyers.

6. A state influence on exchange rates can be carried out at the expense of the official reserves manipulations through pursuing corresponding foreign trade policy by method of rationalizing of the foreign currency use and by carrying out internal macroeconomic policy.

7. International systems of the exchange rates in their development have gone through the gold standard stage and the fixed exchange rates stage. Modern currency system is being built up on the use of the controllable floating exchange rates.

The main terms and concepts

1. Currency
2. Exchange rate
3. Balances of international payments
4. Balance of payments
5. Surplus of balance of payments
6. Freely forming exchange rates
7. Factors of exchange rate
8. Fixed exchange rates
9. State regulation of exchange rates
10. Currency convertibility
11. Gold standard
12. Basic features of modern currency system
13. Controllable floating exchange rates

DICTIONARY

A curve of production potentialities – a curve which shows possible sets of maximum volumes of production of two goods and services which could be created in conditions of full employment in economy with permanent resources and unalterable technology.

A holding or holding company is a business which possesses a controlling block of shares of other joint stock companies.

A share is a security without a fixed turnover period; it certifies a deposit of money with the purpose to create or develop a business and gives its owner the right to:– participate in business management;– get a part of business profit in the form of dividend;– participate in property distribution in the case of business liquidation.

Abstracting is intentional simplification of the researched object by excluding some of its details from the analysis.

Aggregate costs – the amount of fixed and variable costs for a certain volume of product.

Amortization – is a cost value of capital assets corresponding to their wear and tear, which is transferred into the cost of manufactured goods and accumulated in a special amortization fund.

An individual (sole) proprietorship – is a business established and controlled by one entrepreneur.

Average costs – value of aggregate costs for a unit of produced products.

Bank's deposit policy – measures taken by a bank to attract available cash flow.

Bill of exchange – promissory note of a certain subject to pay the amount prescribed in the note for a fixed period of time.

Book profit – proceeds minus paid costs, that is, external costs.

Budget deficit – is an excess of costs over profits.

Capital – created means of production.

Centrally-planned economy is such economic system under which state regulation of economic processes is absolutely dominating and its main tool is central (vertical) planning.

Circulation of production assets is a process of a forms change, and successive forms transformation from one functional form into the other.

Commercial bank – commercial organization dealt with entrepreneurship in the field of credit, carrying out mobilization of available funds and their following placement on the principles of payment, urgency, and recovery.

Commodity money is any goods valuable not only as money.

Commodity production – is such form of economic activity under which the manufactured product is intended for exchange.

Competition in economy is a rivalry of economic subjects for better realization of their economic interests.

Complementary goods – goods, the effective use of which is impossible without each other.

Conglomerate (diversified) growth of an enterprise. It is expansion of the company at the expense of penetration into branches which are not technologically connected.

Consumption fund – part of the gross national product used to meet personal needs of population.

Controlling block of shares – amount of shares holding of which gives an opportunity to carry out control over joint stock company's activity.

Cooperative is a business in which partners' resources and efforts are united with the purpose to fulfill special economic functions.

Costs of the enterprise – payments necessary to carry out to get necessary volumes of resources for production at its disposal.

Deduction – is putting forward the hypothesis and their future examination with the help of facts.

Deflation is a decrease of the total level of prices in economy.

Demand elasticity – extent of change of the demand value under a change of one of the factors which determine it.

Demand is quantities of product which consumers are ready and able to buy at certain prices per unit during some period of time.

Discount rate is an interest rate on loans given by central bank to commercial banks.

Dividend is a part of business profit charged for one share.

Division of labour – is a distinguishing and stable fixing of different kinds of labour activity for different people or their groups.

Division of labour between countries. This is specialization of different countries in output of special goods or services with a purpose of their delivery to the world market.

Dumping is goods selling on the other countries' markets at the underselling prices, that is lower the normal level for those countries.

Duty – a special tax of the state for imported or exported goods.

Economic cycle – aggregate of regularly repeated certain conditions of national economy – an increase and a decrease of production volumes.

Economic expansion rate – ratio of the volume of real gross domestic product to the end of a certain period of time to its value at the beginning of the same period of time expressed in percents.

Economic integration is a process of mutual tangle of production processes in different countries which needs pursuing coordinated policy.

Economic law – is a stable, repeated, typical connection between economic phenomena.

Economic policy is considered as the measures directed to the decision of economic problems.

Economic profit – entrepreneur's additional income got in the result of his more effective activity in a certain field- his better anticipation, better organization, better introduction of large innovations.

Economic resources – components necessary to create material benefits – natural raw materials, land, labour force, technical appliances, and managerial skills.

Economic theory is the science, which studies people's activity connected with achievement of effective usage of the limited resources for the best satisfaction of the needs in goods.

Economic union is an enterprise where two or more persons agree on its ownership and management with the purpose to carry out joint entrepreneurial activity.

Entrepreneurship is an initiative, independent economic activity of people directed to obtaining profits through organization and use of resources with the purpose to produce and sell goods.

Equilibrium price – is a price for a product unit, at which demand and supply coincide.

Exchange – an organization which carries out regular sales (of raw materials, securities, currency, etc.) on certain conditions.

Exchange rate is a price of national currency expressed in monetary units of other country, or a price of foreign currency expressed in national monetary units.

Extensive factors of economic growth – factors related to an increase of the applied resources efficiency.

External costs of the enterprise – monetary payoffs to resources suppliers who are not the owners of the given enterprise.

Foreign trade turnover – export and import amount for some period of time .

Freely convertible currency is freely exchanged currency into other foreign currencies in all types of transactions.

Global economy – complex of national economics interconnected between themselves and interacting on the basis of international labour division.

Globalization is formation of transnational, planetary level of international economy with its regularities.

Government enterprise – is an enterprise owned by government

and controlled by government.

Gross domestic product (GDP) – total market value of the final goods and services produced in the country during a certain period of time.

Gross nominal domestic product – volume of gross domestic product expressed in prices existing at the moment of its production.

Gross real net domestic product – adjusted volume of final goods and services production with inflation or deflation taken into consideration.

Horizontal growth of an enterprise. It is expansion of the volume of company's production within the branch.

Imposed costs of production - quantity of the other product (set of products), which you should refuse or which you have to sacrifice to get some quantity of the given product (set of products).

Income – volume of cash for a certain period of time.

Induction is a movement of the research from separate, definite facts to the general conclusions, and generalizations.

Inflation is an increase of the total level of prices in economy.

Intensive factors of economic growth – factors causing growth of production volumes at the expense of an increase in the applied resources efficiency.

Interest policy – measures taken by the bank related to placement of borrowed funds and receipt of appropriate income.

Interest rate – ratio of a loan price expressed in monetary units to its value taken in percents.

Intermediate product – is a product which is intended to modify, process or resale.

Internal costs of the enterprise – monetary payments which the owners of the given enterprise could get under the other way of their application.

Internationalization of economic life is a process of establishment and deepening of stable relations among enterprises of different countries as well as countries as a whole.

Investments (capital expenditures) – expenses for buying of cars and other means of production, development and an increase of production stocks.

Investor – household or enterprise spending money for production purposes.

Joint stock company. This is a business with restricted liability of its members; its capital is divided between the owners into the shares in the forms of corporation stocks.

Labor is a complex of a man's physical and mental features used in production process.

Law of demand - quantity of the purchased goods decreases with a price increase for the unit and increases with its decrease.

Law of increasing imposed costs – law according to which in the process of movement from one alternative to the other the value of costs to obtain each additional unit of benefit is increasing.

Law of supply – principle according to which quantity of goods supplied for sale is in direct dependence on a price for its unit.

Level of budget deficit is determined as relation of the deficit volume to the gross domestic product expressed in percents.

Liberalism or free trade supposes free trade and limited interference of a state into foreign economic activity.

Loan interest is a price paid for the use of money.

Macroeconomics is the branch of economic science studying economics as a whole.

Marginal costs – growth of aggregate costs necessary to get additional unit of product.

Marginal utility – is utility of the last portion of the benefit coming at a consumer's disposal.

Market infrastructure – complex of institutions providing circulation of different commodities.

Market is a way of interaction of economic subjects based on the price system and competition.

Market value of share – price, at which the sale of share is carried out on the market.

Means of production (manufacturing (productive) resources (factors)) – are all those things necessary to carry out the process of production (labour, capital, natural resources, and entrepreneurial skills).

Microeconomics is the branch of economic science studying behavior and relationships of different economic individuals at the levels of local and private economic connections.

Mixed economy – is the system of interrelation of market and state regulation of the economic processes.

Monetary expansion policy – policy carried out by the way of money supply expansion and intended to stimulate growth of production and employment.

Monetary restrictive policy – policy carried out by the way of money supply restriction and intended to curbing inflation.

Money is universally recognized means of exchange in economic relations.

Monopolistic competition – is such market situation when numerous sellers sell identical goods, aspiring to give them real or imaginary unique qualities.

Monopsony – availability of the only large employer on the labour

market.

Multiplier – numerical coefficient determining how many times the growth of one index will be more than the other index which caused its growth.

Natural (legal) monopoly is a pure monopoly, the existence of which is recognized by the society as an expedient one.

Naturalization of economy (production) – is an economic activity dealt with the self –sufficiency expression, expansion of the range of produced goods which is generated due to unstable economic relations, high level of inflation, and crisis situation in national production.

Net exports – difference between export and import.

Net product – gross domestic product minus depreciation deductions.

Nominal interest rate is a common interest rate, showing ratio of a price of loan to its value.

Nominal value of a share is that part of the authorized fund which is presented by this share.

Normal profit – payment for fulfillment of entrepreneurial functions which corresponds to some average public value under the established conditions.

Normative economic judgments are the estimating judgments concerning the issues: what economic ties must be, what economics must be, and what decisions should be made.

Original cost of funds – value of funds at the moment of their inflow into production.

Oversea investments – is investments placing in other countries with the purpose to get more profit than inside of the country.

Paper (symbolic) money- is the means of payment, the value of which as money exceeds production costs or value when used alternatively.

Positive economic points of view set up the really established economic ties without estimating whether they are good or bad.

Price – amount of money giving opportunity to purchase a product.

Privatization is an alienation of state property in favor of private subjects (households, businesses and other).

Production is an individual's influence on the substance of nature with the purpose to give it properties and forms which are useful to satisfy his needs.

Profit – volume of money inflows for a definite period of time.

Property is fixing of supervision power over economic resources and material values to special subjects.

Protectionism (protection – patronage) is a state's economic policy which is aimed to promote national economy development through its defending from foreign competition.

Pure competition is a market situation when a great deal of independent producers sell identical (standardized) product, and no one of them is able to control the market price.

Pure, or absolute, monopoly – is such market situation under which there is only one seller of product, having no close substitute.

Real gross domestic product – adjusted volume of goods and services production for a certain period of time with inflation or deflation taken into consideration.

Real interest rate is a nominal interest rate adjusted for the inflation level.

Real value of money – amount of goods and services which can be purchased for the money unit.

Rent is a price paid for the use of land and other natural resources, quantity of which is clearly defined (limited).

Replacement value of funds – value of funds determined by the terms of their reproduction in the given moment. It shows the cost of funds replacement with the similar ones in a specific period of time.

Salary (wage) is an income got by a person as a result of selling his physical and intellectual potentialities to create material values.

Savings – income left after payment of taxes and not spent for purchasing of consumer goods.

Shadow economy is an economic activity dealt with production and exchange of commodities and services which do not have legal registration or accounting.

Short-term period – period which is not enough for changing of the volumes and structure of the used physical capital, but which is enough for changing of the intensity extent of its use.

Social protection – government obligations to the society's members on their income formation, terms of certain goods and services obtaining, and jobs.

Stock exchange – an institute where purchase and sale of securities (shares, bonds, certificates) is carried out with certain extent of regularity and according to certain terms.

Subsidies – compensation of the enterprise's costs on production of some kinds of products or on carrying out some kinds of activity from government budget.

Subsistence (natural) economy – is such form of economic activity when labour products are intended to satisfy domestic needs of manufacturer, and which change over from the production sphere into consumption sphere.

Substitute goods are goods which are able to meet one and the same need.

Supply elasticity – extent of a change of the supply value under a change of one of the factors which determine it.

Supply is quantities of product which a seller is ready to sell at certain prices for some period of time.

System of free (clear) market is such economic system under which government regulates economic processes in the least way, while forces of free competition and market self-regulation achieve the greatest spread.

Taxes are obligatory payments of households and enterprises into a state's budget.

The law of diminishing marginal utility – the theory which states that the utility of each new portion of a product for a consumer becomes less than previous during the process of a demand satisfaction.

The needs – are the internal driving motives of a person's activity.

Transfer payments are a special kind of the state expenditures related to the direct redistribution of the income of society's members.

Unemployed – people, who have not job, but are able to work, ready to work and search for a job.

Unemployment level – ratio of the number of unemployed to economically active population expressed in percents.

Vertical growth of an enterprise. It is expansion of company's economic turnover at the expense of penetration into the adjacent branches.

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