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INDIAN ECONOMY

CIVIL SERVICES EXAMINATION 2025

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Unit I

Introduction to Economy

CHAPTER 1

FUNDAMENTALS OF ECONOMICS

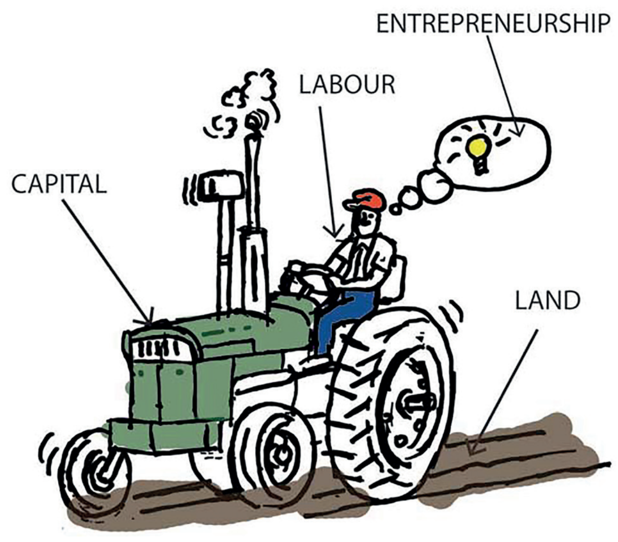
1.1 Basics

Economics is a social science analyzing the production, distribution and consumption of goods and services. In other words, it is discipline that deals with what choices people make; how and why they make them while making purchases.

Scarcity is the basic economic problem that exists because we as humans have unlimited wants that cannot be met by the limited amount of resources in the world. Any good or service that has a non-zero price is considered scarce. It will cost you something to consume that good or service. Without scarcity, people would consume everything they could possibly consume and would not have to make choices or trade-offs between goods and services. Therefore, Economics is the study of how societies allocate scarce resources to produce valuable commodities and distribute them among different people.

1.2 Factors of Production

Factors of production refers to the inputs that are used in the production of goods or services in the attempt to make an economic profit. The factors of production include land, labour, capital and entrepreneurship.



A. Land

- Land is an economic resource encompassing natural resources found within a nation's economy.
- This resource includes timber, land, fisheries, farms and other similar natural resources.
- Land is usually a limited resource for many economies. Example: India has 17.7% of the global population but only 2.4% of the global land.

B. Labour

- Labour represents the human capital available to transform raw material or natural resources into consumer goods.
- Human capital includes able-bodied individuals capable of working in the nation's economy and willing to provide various services to other individuals or businesses.
- This factor of production is a flexible resource as workers can be allocated to different areas of the economy for producing consumer goods or services.
- Human capital can also be improved through training educating or re-skilling workers.

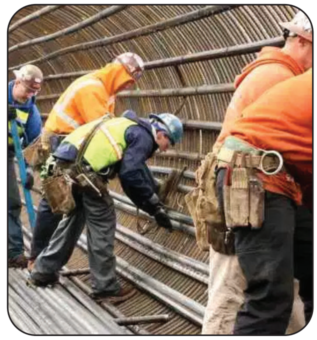
C. Capital

- Capital also represents the investment in durable physical assets made by individuals and companies which are used to produce goods or services. These assets include buildings, production facilities, equipment, vehicles etc.
- Capital represents the monetary resources companies use to purchase natural resources, land and other capital goods.
- Capital thus refers to man-made goods used in supply of other products.

D. Entrepreneurship

- Economic resources can exist in an economy and still not be transformed into consumer goods.
- Entrepreneurs usually have an *idea* for creating a valuable good or service and assume the *risk* involved with transforming economic resources into consumer products for which they earn profit.

The Factors of Production

Land	Capital	Labor	Entrepreneur
			
NATURAL RESOURCE Land includes the "gifts of nature" or natural resources not created by human effort.	**MAN MADE RESOURCE** Capital includes the tools, equipment, and factories used in production.	**HUMAN CAPITAL** Labor includes people with all their efforts and abilities.	**ORGANIZE** Entrepreneurs are individuals who start a new business or bring a product to market.

1.3 Types of Goods

A. Final Goods

Any good or service purchased by the consumer (Individual or Enterprise) can be for final use or for use in further production. An item that is meant for final use and will not pass through any more stages of production or transformations is called a *final good*.

Features:

- It will not undergo any *further transformation* at the hands of any producer.
- Once it has been sold, it passes out of the *active economic flow*.
- Apart from this, they undergo transformation by the action of the ultimate purchaser, during their consumption.

Example: The tea leaves purchased by the consumer are not consumed in that form – they are used to make drinkable tea which is consumed. Similarly, most of the items that enter our kitchen are transformed through the process of cooking. But cooking at home is not an economic activity even though the product involved undergoes transformation. Home cooked food is not sold to the market and hence is final good.

B. Intermediate Goods

Of the total production-taking place in the economy, a large number of products do not end up in final consumption and are not capital goods either. Such goods may be used by other producers as material inputs. Examples are steel sheets used for making automobiles and copper used for making utensils. These are intermediate goods, mostly used as raw material or inputs for production of other

Basis of Difference	Consumer/Consumption Goods	Capital Goods
Definition	Consumption goods are those goods that are used by the consumers and have no use in future.	Capital goods are those goods that have a future use and are used for production of consumption goods.
Purpose	Consumer goods are purchased in order to fulfil personal consumption needs. They sustain Consumption of people.	Capital goods are purchased for manufacturing of consumption goods.
Satisfaction of Human Wants	Directly satisfy human wants and hence have a direct demand.	Indirectly satisfy human wants and hence have a derived demand.
Transformation	May/May not be transformed in the process of production/consumption.	Don't get transformed in the process of production.
Target Market	Consumer	Manufacturers

Basis of Difference	Consumer/Consumption Goods	Capital Goods
Demand	Consumption goods have high demand.	Demand for capital goods is comparatively less.
Pricing	Comparatively cheap.	Costlier in comparison to consumption goods
Impact on Production Capacity	Help to raise the labour productive capacity.	Help to raise both labour and capital productive capacity.
Expected Life	Usually Limited (in case of FMCG's- Fast Moving Consumer Goods).	Life covers more than one productive cycle. They undergo wear and tear and hence require replacement and repair.
Types	• **Durable Goods:** Goods that can be used repeatedly over a considerable period. • **Non-Durable Goods:** Used up in a single act of consumption. • **Services**.	
Examples	Television Sets, Mobile Phones, Milk, Fruits, etc.	Machinery, Building, Furniture etc.

commodities. Continuing the above example, if the same cooking or tea brewing was done in a restaurant where the cooked product would be sold to the customers, then the same items such as tea leaves would cease to be final goods and would be counted as inputs to which economic addition takes place. Thus, it is not in the nature of the good but in the economic nature of its use that a good becomes a final good.

1.4 Study of Economics

The study of economics can be subcategorized into Microeconomics and Macroeconomics.

- **Microeconomics** is the study of economics of the individual or business decision regarding allocation of resources given the scarcity and government intervention.

  Microeconomics includes concepts such as relationship between *supply and demand, price of goods and services and relationship between wages, employment, inflation*.

- **Macroeconomics** is the study of the performance and structure of the whole economy rather than specific individual markets.

  Macroeconomics includes concepts such as *inflation, international trade, unemployment, and national consumption and production, savings and general price levels*.

1.5 Schools of Economic Thought

There are also schools of economic thought. Two of the most common are Classical and Keynesian.

- The **Classical view** believes that *free markets* are the best way to allocate resources and the government's role should be *limited* to that of a fair and strict referee.
- In contrast, the **Keynesian approach** believes that markets do not work well at allocating resources on their own and that governments must step in from time to time and actively reallocates resources efficiently.

1.6 Types of Economy

1.6.1 In Terms of Role of State

The most contentious issue that has affected civilized history of humankind is how the production process in an economy should be organized. Whether the production should be the sole responsibility of State/Government or should it be left altogether to the private sector?

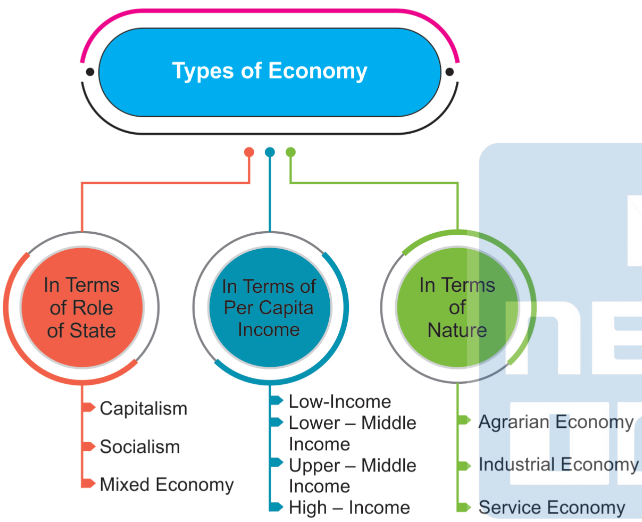
Every society has to answer three questions, which determine the type of economic system:

- What goods and services should be produced in the country?
- How should the goods and services be produced? Should producers use more human labour or more capital (machines) for producing things?

Type of Economy	What is Produced	How it is Produced	How it is Distributed
Capitalist/Market Economies (Example: UK,US, Canada)	Whatever people are willing to buy & sell.	Business Owners determine the most efficient legal methods of production.	Determined by how much a person is able or willing to pay.
Socialist/Command Economies (Example-Soviet Union, Cuba)	Whatever the government decides.	However the government decides.	However the government decides, Generally to create equality for all on the bases of Class/Caste/ Gender.

- How should the goods and services be distributed among people?

Based on the answer of these three questions, the economic systems are classified into 3 categories:



A. Capitalist

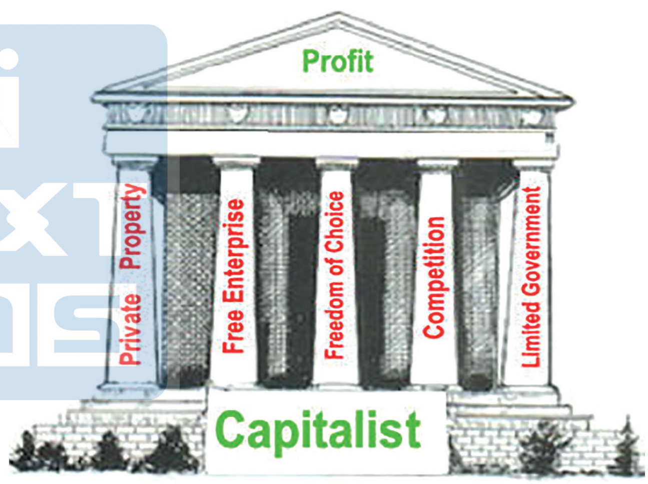
The capitalistic form of economy has its origin in the famous work of **Adam Smith** – *An Enquiry into the Nature and the Causes of the Wealth of Nations* (1776). He stressed on '*laissez faire*' state i.e., non-interference by the government.

The decisions of what to produce, how much to produce and at what price to sell,are taken by the market, by the private enterprises in this system with the state having no economic role.

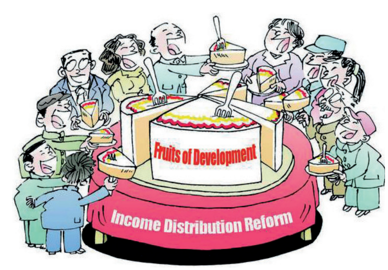
- In a capitalist economy, the market determines prices through the *laws of supply and demand*.

  For example, when demand for coffee increases, a profit-seeking business will boost prices in order to increase its profit. If, at the same time, society's appetite for tea diminishes, growers will face lower prices and aggregate production will decline.
- If labour is cheaper than capital, more labour-intensive methods of production will be used and vice-versa.
- In a capitalist society, the goods produced are distributed among people not on the basis of what people need but on the basis of what people can afford and are willing to purchase.

  This means that a sick person will be able to use the required medicine only if he/she can afford to buy it; if they cannot afford the medicine, they will not be able to use it even if they need it urgently.



B. Socialist



The socialistic form of economy was rooted in the ideas of historical change proposed by the German philosopher **Karl Marx** (1818-83). More specifically, this kind of economic system first came up in the erstwhile USSR after the Bolshevik Revolution (1917) and got its practical shape in the People's Republic of China (1949).

Under a true socialist system, it is the government's role to determine output and pricing levels. The challenge is synchronising these decisions with the needs of consumers. A socialist society answers the above three questions in a totally different manner:

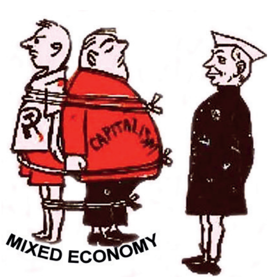
- **Distinction from Capitalist Economy:** In principle, distribution under socialism is supposed to be based on what people need and not on what they can afford to purchase. Unlike capitalism, for example, a socialist nation provides free healthcare to the citizens who need it. Strictly, a socialist society has no private property since everything is owned by the state.
- Socialistic economy emphasized the *collective ownership of the means of production* (property and assets) and it also ascribed a large role to the state in running the economy.
- **Distinction between Communist and Socialist Economy:** Socialism and Communism are often used in place of each other despite being fundamentally different from each other. Communist economy advocates withering away of the state where means of production would be owned by community.
- In *Communism*, All economic resources are publicly owned and controlled by the government. Individuals hold no personal property or assets.

  In *Socialism*, Individuals can own personal property but all industrial and production capacity is communally owned and managed by a democratically elected government.
- In *Communism*, Class is abolished. The chances of one worker earning more than the other are nonexistent.

  In *Socialism*, Classes exist but the differences between them are greatly reduced. It is possible for some people to earn more than others.

C. Mixed Economy

It is an economic system that features characteristics of both capitalism and socialism. A mixed economic system allows a level of private economic freedom in the use of capital, but also allows for governments to interfere in economic activities in order to achieve social aims whenever required.



Mixed economic systems are not laissez-faire systems: the government is involved in planning the use of resources and can exert control over businesses in the private sector.

For example, Governments seeks to redistribute wealth by taxing the private sector, and using funds from taxes to promote social objectives.

Model Adopted by India

The leaders of Independent India had to decide the type of economic system most suitable for our nation, which would promote the welfare of all rather than a few.

Among the different types of economic systems, socialism appealed to Jawaharlal Nehru the most. However, he was not in favour of the kind of socialism established in the former Soviet Union where all the means of production, i.e. all the factories and farms in the country, were owned by the government. There was no private property. It was not possible in a democracy like India for the government to change the ownership pattern of land and other properties of its citizens in the way that it was done in the former Soviet Union, this would have created upheaval among the industrial classes and stunted India's grown story.

The leaders found the answer in an economic system, which, in their view, combined the best features of socialism without its drawbacks. In this view, India would be a ***socialist society with a strong public sector*** but also with private property and democracy; the government would plan economy with the *private sector being encouraged* to be part of the plan effort. This was done because modernisation projects had long gestation period, large capital required and risk which the nascent private sector couldn't shoulder.

So, after Independence, India opted for the Mixed Economy. In the process of organizing the economy, some basic and important infrastructural economic responsibilities were taken up by the State Governments (centre and state) and rest of the economic activities was left to private enterprise i.e. the market.

But once the country started the process of economic reforms in early 1990s, the prevailing state-market mix was redefined and a new form of mixed economy began to be practised.

- The redefined mixed economy for India had a declared favour for the market economy.
- Many economic roles, which were under complete government monopolies, were now opened for participation by the private sector. Examples are many - telecommunication, power, roads, oil and natural gas, etc.
- At the same time, social sector such as education, healthcare, drinking water, etc. were given extra emphasis by the state so as to create a balance between profit seeking interest of private sector with the welfare obligation of the state.

The economic system of India was a mixed economy in pre-1991 years as it is in post-1991 years but the composition of state-market mix has gone for a change (For detailed reasons that why india adopted mixed economy, refer socio-economic planning).

1.6.2 In Terms of Per Capita Income

The *World Bank* classifies economies based on their GNI (Gross National Income) per capita. The categories are given below:

Categorisation of Economy (Yearly)	
Economy	**Per Capita GNI (2022)**
Low-Income	$1,085 or less
Lower Middle-Income	Between $1,085 and $4,255
Upper Middle-Income	Between $4,255 and $13,205
High-Income	$13,205 or more

Low-Income and lower middle-income economies are usually referred to as *developing economies*, and the Upper Middle Income and the High Income are referred to as *Developed Countries*. India is categorized in the Lower Middle Income Category with per capita GNI of $2170 as per World Bank.

1.7 Structural Composition

The contribution made by the different sectors of the economy, namely the agricultural sector, the industrial sector and the service sector in the GDP of the country makes up the structural composition of the economy.

A. Primary Sector

The primary sector involves the extraction of raw materials from the natural resources. Therefore, this is sometimes known as the *Extraction Sector*. This extraction results in raw materials and basic foods, such as coal, wood, iron and corn. Since most of the natural product we get are from agriculture, dairy, forestry, fishing, it is also called *agriculture and allied sector*. People engaged in primary activity are called *red collar workers* due to the outdoor nature of their work.

B. Secondary Sector

The secondary sector involves the transformation of raw materials into finished or manufactured goods. This sector is rightly called the **manufacturing sector**. Since the manufacturing is done by the industries this sector is also called the **industrial sector** such as automobiles, textiles, etc. People engaged in secondary activity are called *blue collar workers*.

Examples of manufacturing sector:

- Small workshops producing pots, artisan production.
- Mills producing textiles,
- Factories producing steel, chemicals, plastic, car.
- Food production such as brewing plants, and food processing.
- Oil refinery.

C. Tertiary Sector

The service sector helps in development of primary and secondary sector is concerned with the intangible aspect of offering services to consumers and business. It involves retail of the manufactured goods. It also provides services, such as insurance and banking. Its provide value addition to transportation and production of goods created through secondary sector. This sector jobs are called *white collar jobs*.

Sector	Contribution to GDP	Proportion of Workforce Employed
Agriculture	18%	63%
Industry	23%	14%
Services	59%	23%

D. Quaternary Sector

The quaternary sector is said to be the *intellectual aspect* of the economy. It includes education, training, the development of technology and research and development. It is also called the *knowledge sector*. It is the process, which enables entrepreneurs to innovate better manufacturing processes and improve the quality of services offered in the economy. Without this growth of technology and information, economic development would be slow or non-existent.

E. Quinary Sector

Quinary sector, which includes the *highest levels of decision making* in a society or economy. This sector includes top executives or officials in such fields as government, science, universities, nonprofit, healthcare, culture and the media. It may also include police and fire departments, which are public services as opposed to for-profit enterprises.

These include services that focus on the creation rearrangement and interpretation of ideas. Profession under this category is called *gold collar professional*.

Economists sometimes also include domestic activities (duties performed in the home by a family member or dependent) in the quinary sector. These activities, such as childcare or housekeeping, are typically not measured by monetary amounts but contribute to the economy by providing services for free that would otherwise be paid for.

1.8 Structural Transformation of Indian Economy

Structural transformation in an economy is usually associated with the changes in sectoral composition of output, employment and changes in the rural-urban composition of output and employment.

As a country develops, it undergoes 'structural change'. The natural economic movement of a country goes from agrarian economy to an industrial economy to a service economy. But, India's growth story has been different and India has leapfrogged from an agrarian economy to a service economy.

1.8.1 Peculiar Structural Changes

- The share of agriculture in Indian GDP fell from more than 40% in the early 1960s to around 17% by the end of the 2000s.
- It is to be noted that the rate of decline in the agricultural share accelerated as the rate of economic growth increased.
- The share of industry as a whole rose from about 20% in 1960 to around 28% in 2009, whereas the share of manufacturing alone disappointingly stayed at around 15% during the entire period, again a sign of sluggish structural transformation.
- By 1990 the share of the service sector was 40.59 per cent, more than that of agriculture or industry, like what we find in developed nations. This phenomenon of growing share of the service sector was accelerated in the post 1991 period.
- Presently, service sector has emerged as the largest and fastest growing sector of the economy with around more than fifty percent contribution to the GDP.
- The increasing contribution of service sector to GDP growth is referred as *Growing Tertiarization of Indian Economy*.

1.8.2 Reasons for Asymmetric Structural Transformation of Indian Economy

The reason for asymmetric structural transformation of Indian economy is on account of account of rapid increase in tertiary sector and slow growth in secondary sector.

A. Reasons for Slow Growth in Secondary Sector

1. **Stringent Labor Laws:** The labour laws in India are extremely complicated. e.g, Industrial Disputes Act-1947 provides that if you are a manufacturing firm with 100 workers or more, you cannot dismiss any of them under any circumstances unless you get prior approval from the government which is rarely given. The law is to be followed even if the industry is going bankrupt. Thus, the investors are not willing to enter into this sector.
2. **Inadequate Skilled Workforce:** The manufacturing sector, for it to grow, requires an educated workforce with the necessary skills and training. India's skill ecosystem needs to be fixed.
3. **Basic Infrastructure:** Roads, connectivity and transportation are slow and costly when compared to developed nations which is a huge deterrence to Industries. Uninterrupted power supply is another challenge.
4. **Small Size:** Small enterprises, because of their smaller size, suffer from low productivity, preventing them from achieving economies of scale.
5. **Low Spending on R&D:** Currently, India spends about 0.7% of GDP on research and development, a considerably small amount when compared with other developed nations. This prevents the sector to evolve, innovate and grow.

B. Reasons for Rapid Increase in Tertiary Sector

1. **Advent of Information and the knowledge economy** which has enhanced the growth of the high productivity segment of the services. It is also attributed to well educated and fluent English speakers and human

resources. This has led to India's success is software and ITeS significant service exports.

2. **Public Services** grow more rapidly where national government have significant role in planning and production in the economy as a whole.
3. A large part of the service sector consists of soft infrastructure such as *banking*, *insurance*, *finance*, *transport* and *communications*, *education*, *Health* etc. An urgent requirement of development is the proper expansion of social and physical infrastructure as provided by these services.
4. **Increasing urbanization** may be regarded as another cause as it is closely associated with a rise in demands for infrastructure services such as communication, public utilities and distribution services.
5. **Tourism** is becoming more and more international as knowledge is being spread through television and internet thereby promoting various services like hotel accommodations.
6. Also with increasing **complexities** of modern industrial organization, manufacturing industries have become service oriented. This has been reflected in the increasing functions of accounting finance, legal services, advertising, marketing, public relations etc.

TRY SOME PRELIMS PREVIOUS YEAR QUESTIONS

1. Which of the following activities constitute the real sector in the economy?

1. Farmers harvesting their crops.
2. Textile mills converting raw cotton into fabrics
3. A commercial bank lending money to a trading company
4. A corporate body issuing Rupee Denominated Bonds overseas

Select the correct answer using the code given below:

(a) 1 and 2 only (b) 2, 3 and 4 only
(c) 1, 3 and 4 only (d) 1, 2, 3 and 4

(2022)

Ans. (a)

2. In the context of any country, which one of the following would be considered as part of its social capital?

(a) The proportion of literates in the population
(b) The stock of its buildings, other infrastructure and machines
(c) The size of population in the working age group
(d) The level of mutual trust and harmony in the society

(2019)

Ans. (d)