




Nature, Scope, and Basic Concepts of Economics



Course Teacher: Dr. Abdur Rashid Sarker
Professor
Department of Economics
The University of Rajshahi



learning objectives

Specific issues you will learn in this chapter:

- **Definition of economics**
- **Major themes of economics**
- **Opportunity costs and economic efficiency**
- **Economic systems**
- **Basic economic problems and their answers**
- **Decisions making agents**
- **Methods in economics**

What is economics?

- Xenophon had invented the term ‘economics’ in the fourth century BCE (Before the Common Era)
- The English term ‘economics’ is derived from the Greek word ‘Oikonomia’...meaning is managing a household with limited funds.
- However, economists are far from unanimous about the definition of their subject.

What is economics?

- Life is about choices
- Individuals, firms and governments cannot have everything they want; their desires are constrained by both time and resources
- Therefore they must choose from a range of possible options.
- Economics is not just something that exists in textbooks. It's all around us. Each one of us is an economic animal.
- Sir John Hicks, a famous Nobel Laureate, once said that a good economist should be able to communicate economic thinking in words, diagrams and algebra.
- So an economist must be multi-talented. It's not just about maths.

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What is economics?

Economists see the world differently, through the lens of economics.

For example, when asked "What's the optimal level of pollution in your town or city?" a common response is to say "Zero, of course!", but an economist is likely to say that the level will depend on society's preferences, but the optimal level is NOT going to be zero.

What the economist recognises is that pollution is a bi-product of almost all economic activity, the benefits from which society may be willing to offset some pollution.

That's the lens of economics



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What is economics? -major definitions

- Adam Smith in this book “ An Inquiry into the Nature and Causes of the Wealth of Nations” (1776) defined economics as a science of wealth.
- He explained how a nation’s wealth is created.

What is economics? -major definitions

- Smith argued that **the keys to the “wealth of nations” were production and exchange**, not the artificial acquisition of gold and silver at the expense of other nations.
- The wealth of a country consists, not its gold and silver only, but in its lands, houses, and consumable goods of all different kinds.
- Wealth should be measured according to how well people are lodged, clothed, and fed, not according to the number of bags of gold in the

What is economics? -major definitions

Three ingredients to wealth and prosperity

1. **Freedom:** giving people economic freedom to do what they wish with little interference from the state
2. **Competition:** individuals have the right to compete in the production and exchange of goods and services.
3. **Justice:** the actions of individuals must be just and honest, according to the rules of society.

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What is economics? -major definitions

Three ingredients to wealth and prosperity
These ingredients would lead to a natural harmony of interest between the participants/stakeholders.

His doctrine of self-interest/the invisible hand: “ By pursuing his own self-interest, every individual is led by an invisible hand to promote the public interest.

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What is economics? -major definitions

- Alfred Marshall in his book “Principles of Economics” (1890) defines economics as follows:
 - “Political Economy or Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment & with the use of material requisites of well-being”
- Economics is a study of wealth and a part of the study of man.

What is economics? -major definitions

- Lionel Robbins in his book “An Essay on the Nature and Significance of Economic Science” in 1932 defined economics as follows:

“Economics is a science which studies human behaviour as a relationship between ends and scarce means which have alternative uses.”

- (Ends refer to human wants and means are resources)

What is economics? -major definitions

The subject of economics is too broad.

According to Jacob Viner, “ Economics is what economists do”

A good definition of economics:

Economics is the study of choice under the condition of scarcity.

It is a social science. It is social because it involves people and their behavior. It is a science because it uses a scientific approach in investigation of choices.

An ‘imperialist’ social science.

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What is economics? Basic themes

1. Scarcity

The condition in which wants are forever greater than the available supply of time, goods, and resources.

Scarcity exists simply because it is human nature for people to want more than they can have, which forces people to make choices.

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What is economics? Basic themes

2. Choice

Choice and scarcity go together.

Individuals, businesses, and societies must choose among alternatives

What is economics? Basic themes

3. Specialization

Economics studies why participants in the economy (people, business, countries) specialize in tasks to which they are particularly suited.

According to Adam Smith, specialization creates wealth. Without specialization, we could not enjoy the high living standards.

Division of labour was Adam Smith's term for specialization.

What is economics? Basic themes

4. Exchange/trade

- Exchange complements specialization. Specialized producers cannot meet their own consumption needs from their own production.
- Exchange is all around us.
- A country like America exchanges its wheat for TV sets made in Japan.

Scarcity and Resources

- What does Scarcity force us to do?
- It forces us to make choices/ economic decisions (where to work, what to produce, how much to sell)
- What are Resources?
 - The basic categories of inputs used to produce goods and services
- What are the three categories of Resources?
- What is Entrepreneurship?
 - Entrepreneurship organizes resources to produce goods and services

Opportunity costs and efficiency

- **Efficiency** denotes the most effective use of a society's resources in satisfying people's wants and needs.
- **Economic efficiency** requires that an economy produces the highest combination of quantity and quality of goods and services given its technology and scarce resources.

Opportunity costs and efficiency

Opportunity costs

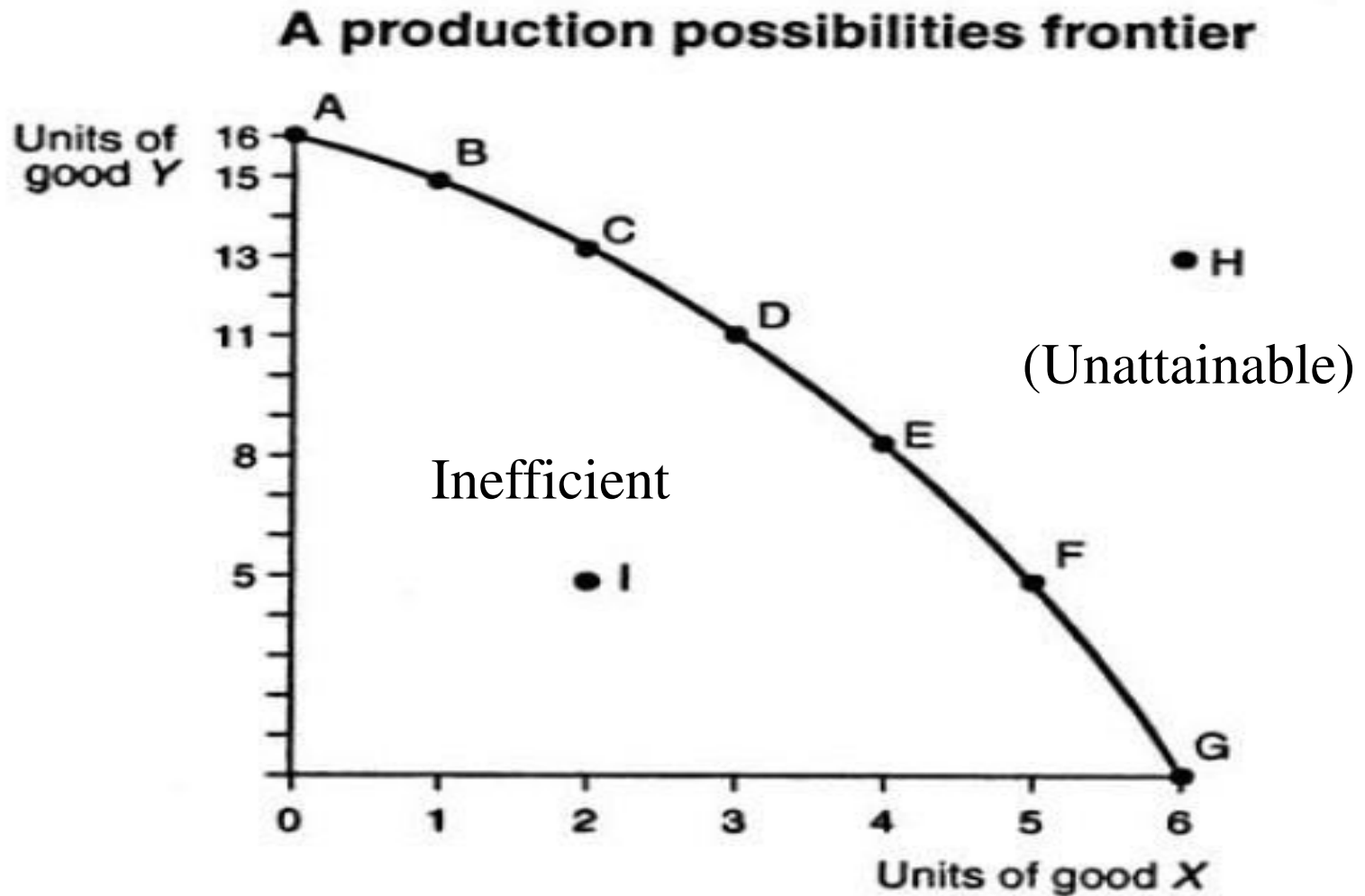
- In a world of scarcity, choosing one thing means giving up something else.

The opportunity cost of a decision or choice that one makes is the value of the highest valued alternative that could have been chosen but was instead forgone.

The Production Possibility Curve

- What is a PPC/PPF?
 - - A graphical device that is used for economic analysis of production decisions
 - A curve that shows the maximum combinations of two outputs that an economy can produce, given its available resources and technology
 - (Technology: The body of knowledge and skills applied to how goods are produced)
- Assumptions
 - Fixed resources, Fully employed resources, Technology unchanged

The PPF



Decision making agents

- Individuals
 - Individuals are the basic units of a society
 - the individual here will be understood as making decisions for his or her family or household
- Business firms
 - Business firms are artificial units
 - Every firm is ultimately owned by or operated for the benefit of one or more individuals.

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Decision making agents

- Governments
 - Governments are also economic decision-makers
 - Governments set the legal framework within which the entire economy works
 - Unlike firms and individuals, governments have the legal right to take property without consent (as by taxation)

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Decision making agents

- **Other agents**

- Trade unions and cartels (organization of sellers)
- Voluntary associations such as clubs, foundations, and religious institutions (through which individuals combine for collective consumption choices)

Objects of Choice and Economic Activities

The objects of economic choice are called *commodities or goods*

Consumption is the ultimate economic activity

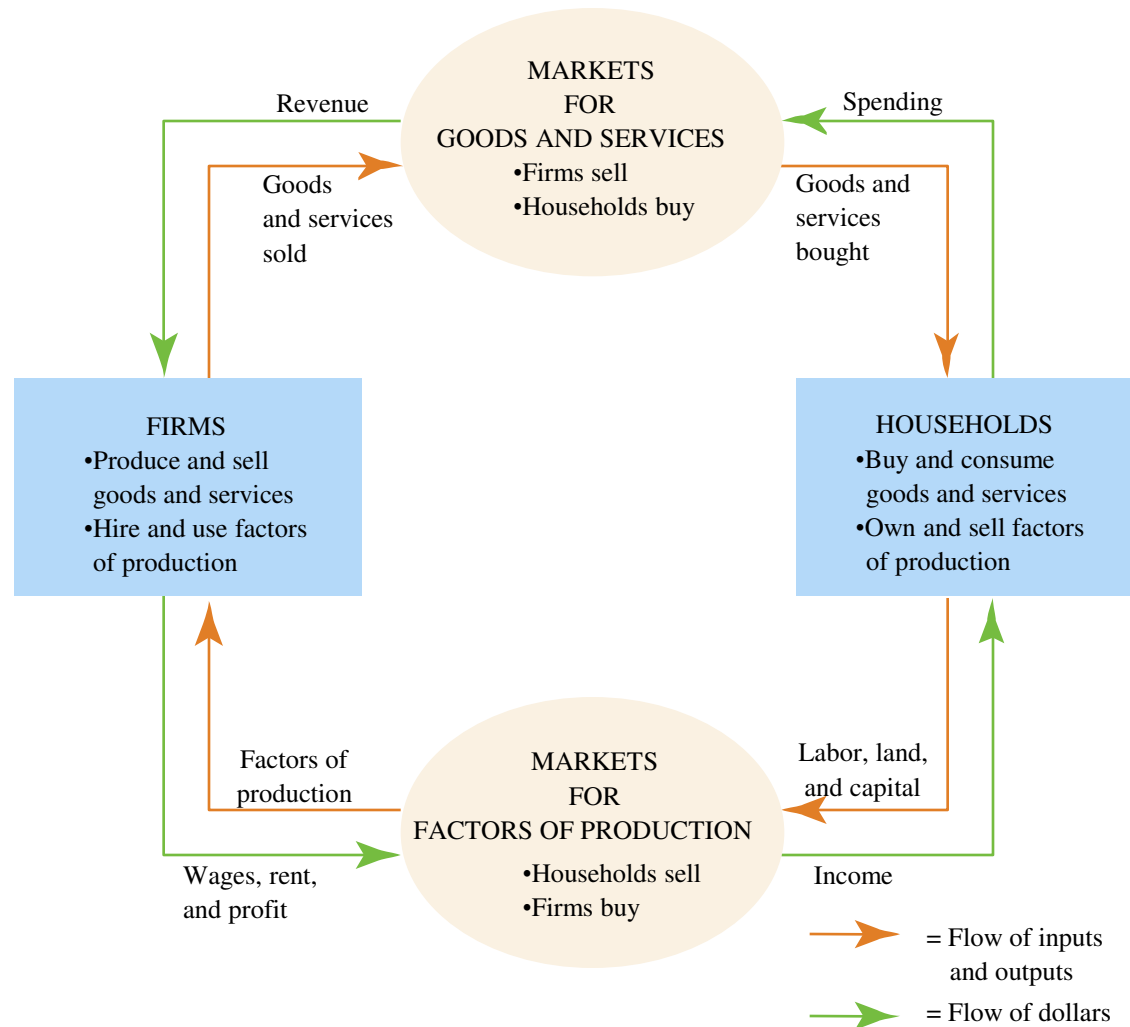
Production by individuals and firms is a second economic activity

The third main economic activity is *exchange*
– Trade neither creates nor destroys goods and services,

Inputs and Output Markets : The Circular-Flow Diagram

- The *circular-flow diagram* is a visual model of the economy that shows how dollars flow through markets among households and firms.
- Flow of economic activity

Figure 1 The Circular Flow



The Circular-Flow Diagram-flow of economic activity

- Firms
 - Produce and sell goods and services
 - Hire and use factors of production
- Households
 - Buy and consume goods and services
 - Own and sell factors of production

Our First Model: The Circular-Flow Diagram

- Markets for Goods and Services
 - Firms sell
 - Households buy
- Markets for Factors of Production
 - Households sell
 - Firms buy

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Three problems of every economy

What to produce?

- What commodities are produced (and in what quantities)?
- Should society devote its limited resources to producing civilian or military goods; luxuries or necessities?
- Should more agricultural or more industrial goods be produced?

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Three problems of every economy

How to produce ?

- Once the decision is made on what to produce, society must determine what combinations of the factors of production will be used.
- How are goods produced?
- A trade-off between using more workers and using more machines
- Will coal, petroleum, or nuclear power be used to produce electricity?
- Will bulldozers or workers with shovels dig dams?

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Three problems of every economy

For whom to produce?

- For whom are goods produced?
- Who gets to eat the fruit of economic activity?
- Will society's output be divided fairly equally?
- Will differences in wealth be allowed to pass from one generation to the next?
- What role will government play in determining *for whom?*
- Should government intercede to change the way the economy is distributing its output?

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Three problems of every economy

For whom to produce?

- Who will receive goods and services produces?
- It depends mostly on how income is distributed
- Individuals with the highest income have ability to buy the most goods and services.

Answering the problems

- Answers depend on the type of the **economic system**:

The set of organizational arrangements and institutions that are established to solve the economic problems is called **an economic system**.

[Forms of ownership, state interference in the economy, pricing and competition etc.]

The way in which the means of production and distribution of goods are organized

Answering the problems

- Types of economic system: *socialist, capitalist, and mixed*
- Centrally planned economy/centralized economy/socialist/communist
 - An economy in which government decides how economic resources will be allocated
 - Government decides what to produce, how to produce them and who would receive them

Examples: Former Soviet Union, Cuba, North Korea

Answering the problems

- Market economy/ free-enterprise economy
 - An economy in which government does not control economic activity (ME relies primarily on firms)
 - An economy in which the decisions of households and firms interacting in markets allocate resources
 - Markets, rather than the government, is the determining factor
 - All problems are solved by the price mechanism

Answering the problems

- Mixed economy
 - An economy in which most economic decisions result from the interaction of buyers and sellers in markets, but in which the government plays a significant role in the allocation of resources
 - Social security system/ safety nets
 - Public goods: roads, street lighting, and national defense, education and health services , protection of the environment

Answering the problems

- Answers to **what to produce**
 - In a **free-enterprise economy**, the “what to produce” problem is solved by the **price mechanism**
 - In a **mixed economy** such as ours, the government (through taxes, subsidies, etc.) modifies and, in some instances (through direct controls), replaces the operation of the price mechanism in its function of determining what to produce
 - In a completely **centralized economy**, **the dictator**, or more likely **a planning committee** appointed by the dictator or the party, determines what to produce

Answering the problems

- Answers to how to produce
 - In a **free-enterprise economy**, the “how to produce” problem is solved by the **price mechanism**
 - In a **mixed-enterprise economy**, the operation of the price mechanism in solving the “how to produce” problem is modified and sometimes replaced by a government action
 - In a **centralized economy**, this problem is solved by a planning committee.

Answering the problems

- Answers to “for whom to produce” ?
 - In market economy, the problem of “for whom to produce” is also solved by the price mechanism
 - In the name of equity and fairness, governments usually modify the workings of the price mechanism by taking from the rich (through taxation) and redistributing to the poor (through subsidies and welfare payments)
 - They also raise taxes in order to provide for certain “public” goods, such as education, law and order, and defense.

The Scope of Economics—Branches

Microeconomics—*mikros* -“small”

The microeconomics is concerned with the behaviour of individual actors/agents/units of the economy: households, business firms, and governments.

Microeconomic Questions

How many jobs will open up in the ICT industry?

What will happen to the cigarette price over next five years?

How would phone companies be affected by a tax on imported cell phones?

The Scope of Economics- branches

Macroeconomics-*makros* “large”

- It studies economy as a whole.
- The economic behavior of aggregates—income, employment, output, and so on—on a national scale
GDP, GNP, CPI, the unemployment rate, and the government surplus and deficit.

Questions

What are the determinants of inflation?

What is the relationship between the money supply and inflation?

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Methodology in Economics

Economists rely heavily on economic theories to explain how the economy works.

Logical theories explain how the economy works by showing how the facts fit together in a coherent manner.

To predict and explain the economic behaviour of individual consumers, business firms and the operation of individual markets economists use theories or models.

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MACROECONOMIC CONCERNS

Major concerns of macroeconomics are:

- ■ Inflation
- ■ Output growth
- ■ Unemployment

GOVERNMENT IN THE MACROECONOMY

There are three kinds of policy that the government has used to influence the macroeconomy:

1. Fiscal policy
2. Monetary policy
3. Growth or supply-side policies

Methodology in Economics

Theories

A theory is simply a plausible and coherent explanation of how certain facts are related.

A theory is a partially verified statement concerning the relationship among variables

A theory is a conceptualization or description, of a phenomenon that attempts to integrate all that we know about the phenomenon into a concise statement or question.

Methodology in Economics

Hypothesis

A prediction about the variables being studied

An educated and testable guess about the answer to research questions

An hypothesis can either be supported or refuted on the basis of data

Example: If people exercise for 30 minutes per day at least three days per week, then their cholesterol levels will be reduced

Positive Versus Normative Analysis

- *Positive statements* are statements that attempt to describe the world as it is.
 - Called descriptive analysis
- *Normative statements* are statements about how the world should be.
 - Called prescriptive analysis
 - Also called policy economics

Why do we study economics?

- There are four main reasons to study economics:
 - to learn a way of thinking,
 - to understand society,
 - to understand global affairs, and
 - to be an informed voter.