Unit – I

1. INTRODUCTION:

Economics is a popular, useful and significant social science. It involves economic activities of man. Economic activities are those activities, which are concerned with the efficient use money and other such scarce means. These means are used to satisfy the wants of the man. In short, Economics is the study of those activities of human beings, which are concerned, with the satisfaction of man's unlimited wants by utilizing the usually limited resources.

In this lesson we shall first focus on definitions of economics. We shall also discuss definitions of economics centered on wealth, welfare, scarcity, and growth.

1.1 ECONOMICS: AN INTRODUCTION:

The term '*Economics*' is derived from two words of Greek language, namely, *Oikos* (household) and *Nemein* (to manage), meaning thereby *household management*.

Earlier, it used to be called as Political Economy. In fact, Indian scholar and philosopher, *Chanakya (Kautilya)* in his famous book *'Arth-Shastra'* has examined both kinds of activities, i.e. economics and political. Greek philosopher *Aristotle* had used the term economics to mean the management of '*family and the state*'.

Dr. Marshall was the first to use the term 'economics' in *1890* in his famous work "*Principles of Economics*".

Economics is barely 200 year old. *Adam Smith*, the *Founder of Modern Economics*, shaped the form in which we study Economy today. His famous book "*An Enquiry into the Nature and Causes of Wealth of Nations*", published in 1776, is still acclaimed even today.

Till the end of 18^{th} and the mid of the 19^{th} century (1776 – 1850), several great Economists like *Ricardo, Malthus, J. B. Say,* etc., had fully supported the thoughts of *Adam Smith*. These economists are known as classical economists. From the middle of 19^{th} century to the first three decades of the 20^{th} century (1850-1930) economists like *Menger, Walras, Cournot, Marshal, Pigou*, etc., had made significant contributions to the development of the study of Economics. In 1933, Prof. *Ragnar Frisch*, a famous economist of Oslo University, Norway, divided the study of economics into two parts:

i) Micro Economics, and

ii) Macro Economics

CONCEPT OF ECONOMICS:

According to modern economists, like *Samuelson, Boulding, Luftwitch,* etc., Economic relates to: *Economics activities, Economic system, and Economic policies. Marshall* and other neo-classical economists have widened the concept of Economics by including in it the study of those activities of social beings, which are connected, with the material requisites of welfare.

ECONOMIC ACTIVITIES:

The concept of Economics is concerned with the study of economic activities. *Prof. Boulding* has divided economic activities into the following parts:

- *Consumption*
- *Production*
- *Exchange*
- *Product Pricing*
- *Factor Pricing*

Consumption: Consumption is that economic activity which is concerned with the use of economic goods and services for the satisfaction of human wants.

Production: Production is that activity which is concerned with increasing the utility or value of the goods and services. There are five factors of production:

- *Land,*
- *Labour,*
- *Capital,*
- *Enterprise, and*
- *Organization*

Exchange: Activity relating to the buying and selling of a product is a factor of production is called exchange. This buying and selling is mostly done in terms of money. This activity is also called price determination and it is divided into two parts:

Product Pricing: It relates to the determination other price other product under different conditions of the market, viz. perfect competition, monopoly and imperfect competition.

Factor Pricing: It relates to the determination of the price of different factors of production. Price of land is rent that of labour is age, that of capital is interest and price for the services of the entrepreneur is profit. This activity is also called 'distribution'.

Chapman has rightly said, "*Economics is that branch of knowledge that studies consumption, production, exchange and distribution of wealth*."

Objectives of Economic Activities:
According to modern economist *Ragnar Frisch,* economic activities have two main objectives:

- *Proper allocation of the resources, and*
- *Efficient use of resources*

The study of economic activities is split up into two parts. Proper allocation of resources is Microeconomics and efficient use of resources is Macroeconomics.

MICRO ECONOMICS:
Micro Economics covers the following:

- *Theory of Demand,*
- *Theory of Production,*
- *Production Function,*
- *Price determination,*
- *Factor pricing or distribution, and*
- *Economic Welfare*

MACRO ECONOMICS:
Macroeconomics is the study of aggregates or average covering the entire economy. It therefore, includes:

- *National income,*
- *Full employment,*
- *Inflation,*
- *International Trade,*
- *Public Finance,*
- *Money and Banking Institutions,*
- *Economic growth,*
- *Trade / Business Cycles*

1.2 ECONOMIC SYSTEMS:
On the basis of the organization and institutions relating to economic activities, the economic systems are divided into three parts:

Capitalism:

In this system people are free to consumer, produce and change the goods. There is no interference of the government in the economic activities of the citizens. People can accumulate private property.

Socialism:

Under this economic system, activities like consumption, production, exchange etc. are fully under the control of the government. People cannot keep private property.

Mixed Economy:

Under this system some economic activities are controlled by the government while other are managed by the people as they wish.

ECONOMICS POLICIES:

As a result of the operation of economic systems there arise several economic problems like: unemployment, price rise, poverty, depression, etc. In order to tackle these problems, study of economics examines such policies as:

- *Monetary policy,*
- *Fiscal Policy,*
- *Price Policy,*
- *Economic planning, and*
- *International Liquidity*

In short, *Anatol Murad* says, "The Economics is the description of the nature and behaviour of an economy or of an economic system and investigation of economic problems with the object offering solutions."

1.3 LOGIC OF ECONOMICS:

Economics is a popular, useful and significant social science. It involves economic activities of man. Economists use the scientific approach to understand economic activities.

- *Observation of facts,*
- *Measurement,*
- *Explanation, and*
- *Verification.*

Observing and Collecting facts: To begin with, facts relating to a subject are observed. In economics, facts relating to economic activities are observed. For example, an economist observes that when price rise, ordinarily demand contracts. When a consumer buys large quantity of a commodity then its utility diminishes. In this way, the economists collect facts pertaining to economic activities.

Measurement: Facts are subjected to measurement in science. For this purpose, facts are properly classified and presented. In Economics also, facts are measured. An economist will try to measure how much demand has fallen as a result of a given rise in price. If there is unemployment in the country, what is the number of unemployed? At which rate the national income of the country is growing? With a view to measuring these facts the economist seeks the help of mathematics, statistics and econometrics.

Explanation: After observing, compiling and measuring the facts, these are explained in a systematic manner. In Economic, laws are framed by establishing a relationship between the cause and effect of a fact. For example, the *Law of Demand* is formulated in Economics on the basis of the study of the relationship between change in price (cause) and the change in demand (effect).

Verification or Validity of Laws: The final feature of science is that by applying the scientific laws to real life it is verified whether the same are valid or not. For this purpose experiments are also conducted. Validity of laws of Economics is also subjected to verification. For instance, many laws of Economics, such as, the Law of Diminishing Returns, Law of Diminishing Marginal Utility, etc., are treated as valid because they apply to the real situations in life.

Positive economics / science and Normative economics / science:

Eminent classical economists like Senior and modern economists like Milton Friedman, Lord Robbins etc. are of the opinion that economics is only a positive science. It studies the following:

- *What is?*
- *What was? and*
- *What will be?*

Study of economics explains what the rate of wage is, how is it determined? It does not explain what ought to be the rate of wage.

Normative economics / science: Many eminent economists, like, *Marshall, Pigou, Hawtrey, Wolf,* etc. regard economics as a normative science. A normative science is one that aims at determining 'norms' or 'values' or 'ideals'. It is a science whose object is also to assist in the solution of concrete problems. J.N. Keynes has aptly said, normative science or a regulatory science is a body of systematized knowledge relating to criteria of 'what ought to be' and concerned with the ideal as distinguished from the actual. The object of normative science is the determination of ideals. "As a normative science, economics offers several suggestions. For example, it counsels that there should be economic development of the country, prices should be stabilized, full employment should be achieved, income should be equitably distributed etc. Economics is not concerned with examining the facts only but it has to set economic norms as well. In the words of *Pigou*, "Economics is chiefly valuable neither as an intellectual gymnastic nor even as a means of winning truth for its own sake, but as a

handmaid of Ethics and a servant of practice, "Economics is therefore not concerned with mere collection of facts. It is not enough for the economist to explain and analyze the problem. He has to offer suggestions for the solution of concrete problems. He has to pronounce judgements and tender advice on economic issues. *Wootton* rightly says, "*It is very difficult for economists to divest their discussion completely of all normative significance*." Normative statements are not verifiable.

1.2 CENTRAL PROBLEMS OF AN ECONOMY

Scarcity is the root cause of all economic problems. We know that resources are scarce or short in supply in relation to demand; but wants or ends are unlimited. As a consequence, we face the problem of choice among so many of our wants. This is because scarce means have alternative uses. Thus, we have to choose among the most urgent and less urgent wants. In fact, the basic problem of an economy is the problem of choice. More precisely, problem before us is to take right decisions in regard to the goals or ends to be attained and the way, the scarce means to be utilized for this purpose. Every economy faces some fundamental problems called as central problems of an economy. These are the following:

(1) What goods and services are to be produced? The first major problem faced by an economy is what types of goods and services to be produced. As resources are limited, we must choose between different alternative collection of goods and services that may be produced. It may also imply whether to produce capital/producer goods or consumer goods. Moreover, we have to decide about the quantity of the goods to be produced in the economy.

(2) How to produce these goods and services? The next problem we have to tackle is the problem of how to produce the desired goods in the economy. Thus the question of techniques to be used in the production comes in the mind. Whether we should use labour-intensive technique or capital – intensive technique? Labour-intensive method of production implies more use of labour per unit than capital whereas; capital-intensive technique indicates more use of capital per unit than labour. The choice depends on the availability of resources. A labour surplus economy can well use the labour–intensive technology.

(3) For whom these goods and services are to be produced? Once we have decided what goods to be produced and what techniques to be used in the production of goods, we are encountered with another problem, i.e., the problem of distribution of goods in the economy. This is the problem of sharing of national income.

(4) Are the resources efficiently used? We have also to see that scarce resources are efficiently utilized. This is the problem of economic efficiency or welfare maximization.

(5) Are the resources fully employed? An economy must also try to achieve full employment of all its resources.

(6) How to attain growth in the economy? An economy is to ensure that it is attaining sufficient growth rate so that it is able to grow larger and larger and develop at faster rate. It should be able not only to make a structural change from agrarian to industrial sector but also to increase per capita and national income of the country. An economy must not remain static. Its productive capacity must increase continuously.

It is clear that the basic problem of an economy is the economizing of resources. The economizing problem arises in every type of economic society owing to the fact that resources are scarce in relation to multiple wants/ends.

1.2.1 PRODUCTION POSSIBILITY CURVE

The production possibility Curve is a graph that depicts the trade-off between any two items produced. It is also known as Transformation Curve or Production Frontier, which shows the maximum feasible quantities of two or more goods that, can be produced with the resources available. In other words, it indicates the opportunity cost of increasing one item's production in terms of the units of the other forgone. Prof. Samuelson analyzed the economizing problem by the use of production possibility curve.

Thus, a PPC shows the maximum obtainable amount of one commodity for any given amount of another commodity, given the availability of factors of production and the society's technology and management skills.

The concept is used in macroeconomics to show the production possibilities available to a nation or economy, and also in microeconomics to show the options open to an individual firm. All points on a production possibilities curve are points of maximum productive efficiency or minimum productive inefficiency: resources are allocated such that it is impossible to increase the output of one commodity without reducing the output of the other. That is, there must be a sacrifice—an opportunity cost—for increasing the production of any good. All resources are used as completely as possible (without the situation becoming unsustainable) and appropriately.

The production possibility curve does not remain stationary. It moves outward overtime with growth of resources and improvement in technology. This is because we get more output from the same quantities of resources. The table below illustrates production possibilities of a simple economy producing two commodities—cars and computers. Two production possibilities - E and F are shown. When the economy decides to put more resources for the production of computers, it must sacrifice some resources from the production of cars. Thus, when 10000 computers are decided to be produced, 5000 cars cannot be produced as the resources are now diverted to the production of computers.

Production possibilities	Computers (in 000's)	Cars (in 000's)
E	5	15
F	10	10

The below fig. 1.1 derived from the table above, shows the production possibility curve. If all resources in the economy are utilized in the production of cars, OA units of cars can be produced.

On the other hand, if all resources are put in the production of computers, OB units of computers would be produced in the economy. Joining points A and B, we get production possibility curve AB. In case, the economy decides to produce both the commodities by using the available resources, it can produce various combinations of cars and computers by staying on the curve AB, such as at E or F. At point E, it can produce OS units of cars and OT units of computers. Similarly, at F, ON units of cars and OM units of computers can be produced. Thus, the points E, F or any other point on curve AB show maximum feasible combinations of cars and computers which can be produced with the resources available. Point C in the figure is not attainable or feasible for the economy as it is above the production possibility curve AB, i.e., beyond the capacity of the economy. Again, it will not produce at point D which is though attainable but not desirable, because in that case the economy's resources will not be used most effectively.

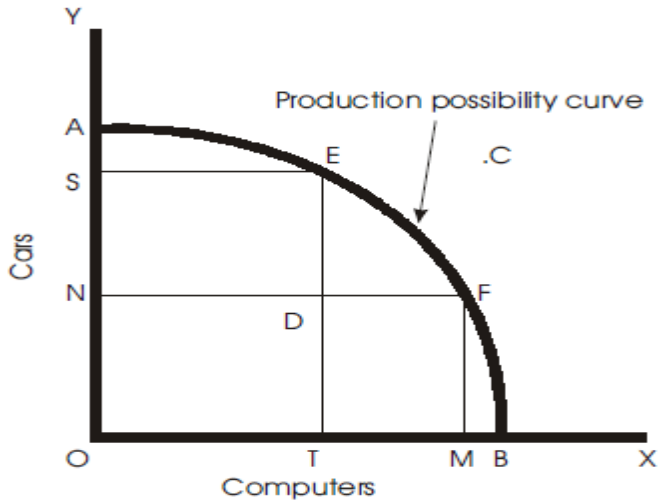

Fig. 1.1

It is, thus, seen that to produce more computers, some units of cars are to be sacrificed, i.e., cars can be transformed to computers. The rate at which one product is transformed into another is called **marginal rate of transformation** (MRT). Thus, MRT between cars and computers is the units of cars (in our case, 5000), which has to be sacrificed for the production of computers. MRT increases, as more of one commodity is produced and less of another. This makes Production Possibility curve concave to the origin.

Uses of Production Possibility Curve

The production possibility curve has a number of uses. It helps in finding the solution of the basic problems of production—what and how to produce and for whom to produce goods in the economy. Besides, whenever government decides to divert its resources, say, from necessaries to luxuries, it may utilize the concept of production possibility curve. It can also help in guiding the diversion of resources from current consumption goods to capital goods and increase productive capacity to attain higher levels of production.