# GS FOUNDATION FOR CSE 2024
# ECONOMY-1
# ORIENTATION & SOME BASIC CONCEPTS

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HISTORY
OPTIONAL FOUNDATION 2.0
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# 1. SYLLABUS, SIGNIFICANCE AND PLAN

## A) PRELIMS SYLLABUS

1. Economic and Social Development – Sustainable Development, Poverty, Inclusion, Demographics, Social Sector Initiative, etc.

## B) MAINS SYLLABUS

1. Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

2. Inclusive growth and issues arising from it.

3. Government Budgeting.

4. Major crops cropping patterns in various parts of the country, different types of irrigation and irrigation systems storage, transport and marketing of agricultural produce and issues and related constraints; e-technology in the aid of farmers.

5. Issues related to direct and indirect farm subsidies and minimum support prices; Public Distribution System- objectives, functioning, limitations, revamping; issues of buffer stocks and food security; Technology missions; economics of animal-rearing.

6. Food processing and related industries in India- scope and significance, location, upstream and downstream requirements, supply chain management.

7. Land reforms in India.

8. Effects of liberalization on the economy, changes in industrial policy and their effects on industrial growth.

9. Infrastructure: Energy, Ports, Roads, Airports, Railways, etc.

10. Investment models.

## 1) CLASS PLAN:

1. 15-20 Lectures - Fundamental Concepts
   a. Micro-Economics Basics
   b. Macro Economics
      i. National Income
      ii. Inflation and Associated Issues
      iii. Fiscal Policy, Government Budgeting
      iv. Money Supply, Monetary Policy and Banking

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v. External Sector (BOP, Current Account, Capital Account, Foreign Investment, Forex Reserves, Exchange Rates, Trade, Import Exports etc.)
vi. International Agencies (WTO, IMF, World Bank - Key contributions and need of reform)

2. 15-20 Lectures - Key Issues in Indian Economy as per the Mains Syllabus
   a. Cover each and every bullet point of the syllabus along with Mains PYQs

## 2) SIGNIFICANCE OF ECONOMICS FOR EXAM:

**Prelims**:

| **Year** | **Number of Questions** (from Core Economy, Economy CA, ESI and Budget) |
|---|---|
| 2013 | 19 |
| 2014 | 18 |
| 2015 | 18 |
| 2016 | 17 |
| 2017 | 17 |
| 2018 | 22 |
| 2019 | 20 |
| 2020 | 23 |
| 2021 | 14 |
| 2022 | 18 |
| 2023 | 16 |

**Mains:**
Around **10 Questions** every year will be coming from the 10 bullet points related to economy given in the syllabus.

**<u>Pre-Requisite</u>**: 0

**Study material**: Class Notes + CA Notes
Indian Economy by SANKARGANESH (if students want to read anything for fundamentals)

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## 2. ECONOMICS AND ECONOMY

### 1) WHAT IS ECONOMICS?

- The term economics in English language has its origin in **two Greek words**: *Oikos* (Household), and *Nemein (management).* Together, it means management of household.

- It is that branch of knowledge in which those activities of human beings are **studied** which they undertake to **acquire scarce means** (that is wealth/resources) to **satisfy their unlimited wants.**

**OR**

- It is a science of human behaviour concerned with **allocation of scarce resources/means** in such a manner that consumers can maximize their satisfaction, producers can maximize their profits and the society can maximize its social welfare.

- **Scarcity** and **Choice** is the essence of economics:
  - **Scarcity**: It refers to the situation when what you have is less than what you wish to have.
  - **Choice** refers to the process of selection from available limited alternatives. It emerges because resources are scarce, and resources can be allocated to alternative uses.

- **Summarizing the essence of Economics**:
  - Economics is a **science of human behaviour** when confronted with the problem of choice or the problem of allocation of scarce resources to their alternative uses for achieving the **objectives** of maximizing of satisfaction for the consumers, maximizing the profit for producers, and maximization of welfare for the society.

### 2) MICROECONOMICS AND MACROECONOMICS

- **Microeconomics** studies **economic relationships or economic problems at the level of an individual** - an individual household, an individual firm or an individual consumer.
  - It is concerned with determination of output and price of an individual firm or industry. Therefore, microeconomics is also sometimes referred as Theory of Price.
  - It includes the study of demand theory, production theory, price determination, and factor pricing.
    - » It examines how individual consumers make decisions about what to buy and how much to buy, as well as how firms decide what to produce, how much to produce, and at what prices to sell the goods and services.
    - » It also explores price elasticity, market structures (perfect competition, monopoly, oligopoly etc.)
  - Study of micro-economics **assumes that macro variables remain constant**, for e.g., it is assumed that aggregate output is given when we are studying determination of output and price of an individual firm or industry.

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   - **Market Forces** (of supply and demand) play a significant role in the context of microeconomic problems, like the problem of product pricing or factor pricing.

- When the problem of choice is studied at the level of the country as a whole (or at the level of different regions in the country) it is called **macroeconomics**.
   - It deals with topics like aggregate demand and supply, National Income, economic growth, inflation, employment, fiscal policy, monetary policy, and eternal sector.
   - It is also referred to as the **Theory of Income and Employment**.
   - Study of macroeconomics **assumes that micro-variables remain constant**, e.g., it is assumed that distribution of income remains constant when we are studying the determination of aggregate output and income level.

## 3) POSITIVE AND NORMATIVE ECONOMICS

- They are two distinct branches of economics that serve different purposes and have different methodologies. They are used to **analyze economic issues** and provide different types of economic analysis.

i. **Positive Economics**:
   - » It is concerned with describing economic phenomena as they are, without making judgements or value judgements.
   - » It seeks to provide objective, verifiable statements about economic behaviour and events.
   - » It is often considered "science" of economics because it relies on empirical data and factual analysis to draw conclusions. The positive economists aim to develop testable hypothesis and use empirical evidence to evaluate them. They deal with questions like "What is?" or "What will happen if". It focuses on understanding economic cause and effect relationships without expressing personal opinions or normative judgments.
   - » **Positive Economic Statements** can be proven true or false through empirical research, and they don't involve subjective value or moral considerations.
   - » **E.g.,** of Positive Economic Statements:
      - An increase in minimum wage will lead to reduction in employment among low-skilled workers.
      - Inflation rates over the past decade has hovered around 4.5%.
      - As the price of smart phone decrease, their demand also increases.

i. **Normative Economics**:
   - » Normative economics is concerned with **making value judgements** and expressing opinions about what should be done or what is desirable in the economy.
      - It deals with questions like "What ought to be?" or "What is the best policy?" etc.

   - » It involves subjective analysis and personal preference. It often takes into consideration ethical, political, and social considerations when evaluating economic policies and outcomes.

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- It is inherently subjective and thus can't be proven true or false through empirical analysis because it relies on value judgements that may vary from person to person.
  - **Examples** of normative statements are:
    i. Government must increase spending on healthcare to ensure access to affordable healthcare for all citizens.
    ii. Tax cuts for high income earners are unfair and should be reversed to redistributive wealth.
    iii. Policies that prioritize environmental sustainability should take precedence over short-term economic growth.

In summary, the **Positive economics** seeks to provide objective, value free analysis of economic phenomenon, while **normative economics** involve making subjective value judgements and recommendations about economic policies and outcomes. Though both branches are important for understanding and addressing economic issues, they serve different purposes and use different methods of analysis.

## 4) ECONOMICS VS ECONOMY

- **Economics** is the **academic discipline that studies** how individual businesses, governments, and societies allocate their limited resources to satisfy their wants and needs.

- **Economy** refers to system or structure of a region, country or even the world that involves production, distribution, consumption of goods and services.
  - It encompasses all economic activities and include various elements like businesses, households, government entities, financial institutions, and international trade.

- In Summary, economy refers to the actual system or structure of economic activities in a given area or sector, while "economics" is the academic field that studies the principles, theories, and concepts related to these economic activities. Economics help us understand and analyze the functioning of economies and the choices made within them.
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## 5) SIMPLE ECONOMY VS COMPLEX ECONOMY

- **These terms are used to describe the level of sophistication, organization and diversity of economic activities within a given system.**
  i. **Simple Economy**: This is characterized by limited range of economic activities, products, and transactions. It often exists in small, traditional, less developed societies or communities which are characterized by farming, hunting, gathering, or barter system. In this kind of economy, the interactions are localized, and there is very less specialization of labor or production. Money, if used, is very scarce, and economy relies on barter system. The economic decisions are often based on tradition, customs, and immediate needs.

  ii. **Complex Economy**: This economy is characterized by high degree of specialization, division of labor, and a wide range of economic activities and products. It exists in modern,

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industrialized societies and nations with advanced market and extensive infrastructure. Here degree of exchange is very high, mutual inter-dependence is high, income levels and wants of people are also high.

## 6) TYPES OF ECONOMY: CENTRALLY PLANNED, MARKET ECONOMY AND MIXED ECONOMY

| **Aspect** | **Centrally Planned Economy** | **Market Economy** | **Mixed Economy** |
|---|---|---|---|
| Ownership of Resources | Government owns most resources and controls production and distribution. | Private individuals and businesses own resources and production is driven by private enterprise. | Combination of public and private ownership of resources and production. |
| Resource Allocation | Government decides what, how, and for whom to produce | Decisions are made by consumers and producers (Market) on the basis of demand and supply in the market. | Combination of government and market forces. |
| Price Determination | Prices are typically set by government and may not reflect market. | Prices are determined by market dynamics (demand and supply) | Prices are influenced by market forces, but regulations may exist. |
| Role of Competition | Limited competition and monopolies controlled by the state. | High degree of competition with minimal government intervention. | Competition exists, but some industries may be regulated or controlled to varying degree. |
| Government Intervention | Extensive government involvement in the economy, including planning, production, and distribution. | Limited government intervention in the economy, primarily to enforce property rights, contracts, and maintaining market competition. | Government plays a role in regulating certain aspects such as consumer protection, and environmental concerns. |
| Economic Flexibility | Limited flexibility in responding to changing market conditions. | High degree of flexibility and ability to adapt to market changes. | Greater flexibility than in a centrally planned economy but less than in a pure market economy. |
| Consumer Sovereignty | The consumer is not sovereign/God | The consumer is sovereign/God (and its consumer who decide demand) | Consumer is sovereign but some government control may be there. |

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| | | | |
|---|---|---|---|
| Private sector vs Public Sector | Public sector dominates the economic activity | Private sector dominates the economic activity | Both public sector and private sectors dominate the economic activity. |
| Examples | North Korea, Cuba, former soviet Union. | United States, UK, Singapore, | Many Western European Countries, Canada, India. |

## 3. CENTRAL PROBLEM OF AN ECONOMY

- Since the resources are scarce/limited, and not every need of every individual can be satisfied, an economy has to make some choices.

- **Economic Problem** is basically the problem of choices.
  - Since the resources are scarce/limited (and given the fact that resources have alternative uses), we have to make a choice regarding allocation of resources to alternative uses with a view to maximize economic gain at the individual level and maximizing social welfare at the level of economy as a whole. Thus, economic problem is basically a problem of choices.

- **Key factors behind Economic Problem**:
  - Unlimited Wants
  - Limited or Scarce Resources
  - Alternative Uses

- **Central Problem of an Economy:** Every kind of economy (advanced or developing, large or small) face three central problems: What to Produce? How to Produce and for whom to Produce.
  a. **What to Produce?**
     - Since the means are scarce, every economy has to make a choice as to which wants needs to be fulfilled and which ones can be forgone.
       - For e.g. If consumer goods need to be prioritized or capital goods.

  b. **How to Produce?**
     - It involves the question about how to organize the production to produce something more efficiently.i.e. more production at less cost.
     - It is essentially the Problem of Choice of **Techniques**.
       - In developing countries like India it involves the question weather we should use a labor intensive technology or Capital Intensive technology.
       - For e.g., handloom or machine-made clothing. This will bring the conflict between employment on one hand and efficiency on the other hand.

  c. **For Whom to Produce?**
     - Since resources are scarce, needs of everyone can't be fulfilled.
     - This question basically revolves around whether to produce for **rich** or to produce for **poor**.
       - Producing for poor promote social justice, reduce inequality. But there is a hidden cost here, by producing for poor, the production for rich reduces. Rich could have given more profit which could have contributed to more investment and thus more economic growth.

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- Thus, **the problem is of choice - Social Equality** or **GDP Growth**.

- **Add on problems for developing countries**:
  - When compared to developed economies, developing economies like India face some other add on problems. They include:
    i. **How to achieve fuller utilization of Resources?**
       - Underutilization of resources (unemployed resources) leads to output being lesser than **potential output**. i.e., low level of GDP.

    ii. **How to achieve growth of resources?**
       - Because of less developed technology various resources like minerals, natural gas etc remain underutilized.

- **Solution of Central Problems in different economies:**
  - Various approaches can be taken to solve the above central problems of economy. They include Market Economy Approach, Socialist Economy (Centrally Planned Economy) approach or Mixed Economy Approach.
  - In Market Economy the central problems (What, how and for whom to produce) are **solved through market forces of supply and demand**.
  - In **Centrally Planned economies**, the central problems (what, how and for whom to produce) are solved by the central authority.
  - In **mixed economies**, both 'market forces' as well as 'central authority' play their role. While market forces allow maximization of profits, the central authority focuses on social welfare.

## 4. FUNDAMENTALS OF MACRO-ECONOMICS

### 1) CLASSIFICATION OF GOODS:

- There are so many types of goods in the economy. Shoes, shirts, machines, farm tools, staplers, cement, minerals etc. These goods can **be classified in two different ways**:
  - **Final Goods and Intermediate Goods**, and
  - **Consumption Goods and Capital Goods**

#### A) FINAL GOODS AND INTERMEDIATE GOODS

- **Final Goods** (also known as consumer goods or end products) are items that are purchased by households or businesses for direct consumption or use. They are ready for consumption and don't require further processing or transformation.

  - They can be classified in two types:
    - **Final Consumer Goods**: Finally purchased by the consumers for the satisfaction of their wants.
      - Bread and Butter

- **Final Producer Goods**: Finally purchased by producers and are generally used as fixed assets in the process of production.
  - Agri-tools used by farmers.

» Expenditure on final consumer goods by the households is called consumption expenditure and the expenses on final producer goods by the producers is called Investment Expenditure.
  - **Expenditure on Final Goods** = Consumption Expenditure + Investment Expenditure.

» **Note**: Only final goods are included in the estimation of national product or national income.

- **Intermediate Goods** (also called producer goods) are used in production process to create other goods and services. They are not meant for final consumption but for further processing or assembly.
  - » **E.g.**
    - Raw material, semi-finished materials, other products used during manufacturing.
    - Note: Shirt purchased by retailer from wholesaler for resale are intermediate goods. This is because value is still to be added to shirt through sale.
  - » **Expenditure on intermediate goods by producers** during an accounting year is called intermediate consumption or intermediate cost. If intermediate consumption is deducted from the value of output, we get 'gross value addition' (also called Gross Value Added, or Gross Product of the producer). Thus,
    - **Value of output - Intermediate consumption = Gross Value Added**

- **Note: The same goods may be final or intermediate**
  - » For e.g.
    - Onion bought by a household is a final good whereas Onion bought by a restaurant which is going to cook some food for customers and sell this food is an intermediate Good.
  - » **What matters is the end use of the goods.**
    - If the good is used by producer as raw material, it is an intermediate good. If it is **purchased and resold,** then also it is intermediate good.
    - If it is used by producer as a **fixed asset** (like chairs used in the classroom or tractors used by farmers), it is treated as final goods. Goods purchased by households for final consumption is to be treated as final goods.

- **Question?**
  - » **Purchase of a Display Screen always means the purchase of a final good. Do you Agree?**

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## B) CONSUMPTION GOODS AND CAPITAL GOODS:

- **Consumption Goods or Consumer Goods**:
  - Consumer Goods are items that are produced and sold to satisfy the needs and wants of humans.
    - E.g., sugar used by households.

- **Consumption goods** can be categorized in the following ways:
    a. **Durable Consumption Goods**: Can be used for several years and are of relatively high value (e.g. TV, Car etc.)
    b. **Semi-Durable Consumption Goods**: Can be used for around 1 year. E.g., Clothes, electric bulbs etc.
    c. **Non-durable or Single Use Consumption Goods**: Used in a single act of consumption. (for.e.g. toothpaste, bread, butter, LPG etc.). They are of relatively low value.
    d. **Services**: Non-material goods which satisfy human wants for e.g., medical services, legal services, househelp services etc.

- **Capital Goods**:
    - They are also known as **producer goods** and are used by businesses to produce other goods and services. They are not used for immediate consumption but for the production of additional goods and services. They are **fixed assets** of the producers and are **repeatedly used in the process of production**. They are also of high value.
        - E.g., Buildings, machinery, factories, vehicles used for business purposes etc.

    - They are used by the producers either for (i) the replacement of capital stock, or for (ii) addition to the capital stock.
    - Capital goods **also involve depreciation**.
    - **Expenditure** on capital goods is called investment expenditure.

- **Note**:
    - Both consumption goods and capital goods are final goods and therefore are used in the estimation of national income.

- **Question:** All producer goods are not capital goods. Why?

## 2) CONCEPTS AND COMPONENTS OF CONSUMPTION EXPENDITURE

- In macroeconomics, consumption expenditure refers to aggregate consumption expenditure in the economy.
- **Consumers** in an economy are broadly classified as: (i) **Households** (ii) **Government** (iii) non-profit private institutions (like NGOs, gurudwaras etc.)
- **Aggregate Consumption Expenditure** = Consumption expenditure by the households + consumption expenditure by the government + consumption expenditure by the nonprofit private institutions (NGOs, temples, mosques, gurudwaras etc.)

## 3) CONCEPTS AND COMPONENTS OF INVESTMENTS

- Investments refers to increase in the stock of capital. Change in the stock of capital is called 'capital formation'.

- **Fixed Investment vs Inventory Investment**:

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- Investment has two components: Fixed Investment and Inventory Investment
  - **Fixed investment** refers to increase in the stock of fixed assets (like plant and machinery) during an accounting year. It is also called fixed capital formation. This implies increase in the stock of capital formation in terms of fixed assets.
    - **Significance of Fixed investment**:
      - **Raises production capacity; Leads to higher level of output -> leads to economic growth.**
  - **Inventory Investment** refers to increase in inventory stock.
    - Inventory stock includes (i) Stock of finished goods (unsold once) (ii) semi-finished goods (iii) Raw materials.
    - **Significance** of inventory investment:
      - Ensures uninterrupted supply of inputs to producers.
      - Help in dealing with uncertainty of market.
      - Helps in dealing with increased demands quickly.

- **Gross Investment, Net Investment and the Concept of Depreciation**
  - Gross investment refers to total production of capital goods during the year. This include (i) capital goods used for the replacement of existing capital stock (which is worn out) and (ii) capital goods used as a net addition to the existing capital stock.
  - **Gross investment** = Net Investment + Depreciation (expenditure on replacement of worn-out fixed assets or replacement investments)

- **Concept of Depreciation**
  - Depreciation is a loss of value of fixed assets in use on account of:
    1. Normal wear and tear
    2. Accidental Damage
    3. Expected Obsolescence (going down of value when fixed assets become obsolete due to change in technology or demand)
  - It is also called consumption of fixed capital.
  - Thus, due to depreciation, fixed asset needs to be **replaced from time to time**.

## 4) STOCKS AND FLOWS

- **Meaning of Stock**: A stock is a quantity measured at a particular point of time.
  - For e.g., Bank Balance; wealth; Capital; water in overhead tanks; amount of stored food; number of workers in a company; population of the country etc.
  - All such values are stock values as these are measured at a specific point of time.

- **Meaning of Flow**: A flow is quantity measured over a specified period of time.
  - For e.g., wages (per day or per month); flow of water (per second); production (per year); capital formation; interest on capital; sale; number of births etc.

- **Note:**

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- Flow impacts the stock. (e.g., greater the salary, more would be bank balance).
- Stock impacts the flow (e.g., greater the capital, more will be annual production)

- **Question**: Which of the following is stock and which is flow?
  - Investment; Monetary Expenditure; A hundred rupee note; a family's consumption of milk; services of a driver; production of cement; machinery of an automobile company.

## 5) FACTORS OF PRODUCTION

- In economy, factors of production are resources/inputs that are used to produce goods and services. These factors are inputs required in the production process and are essential for creating economic value.
- The **Four primary factors of production** are:
  1. **Land**: It refers to all natural resources used in the production process. It includes not only the land area but also minerals, water, forests, and other natural resources that can be found on or beneath the land's surface.
     - **Rent** is the payment made by producer to owner of the land.
  2. **Labor**: It refers to human efforts that go in the production of goods and services. This includes physical labour, skills, knowledge abilities of the workforce.
     - **Wage** is the payment made by the producer to the Laborers.
  3. **Capital**: Capital refers to the tool, machinery, equipment, building, and other physical assets that are used in the production process.
     - It includes both physical capital as well as financial capital. It is important for increasing the productivity and expanding the capacity of an economy.
     - **Interest** is the payment made by the producer to the capital owners.
  4. **Entrepreneurship**: It represents human innovation, risk taking abilities etc that drive the production process. Entrepreneurs identify the opportunities, organize the other factors of production, and assume the risk associated with starting and managing the business. They play a critical role in economic development and growth.
     - **Profit** is the payment made by the producer to the entrepreneurs.

- **A fifth factor of production**: Some economists include technology and knowledge as a fifth factor of production, emphasizing the importance of innovation and information in modern economies.

## 6) FOUR SECTORS OF ECONOMY

- From macro-economic point of view, Economy is often divided into **four sectors**: **1) Household Sector 2) Producer Sector (Business Sector) 3) Government Sector 4) External Sector** (Foreign Sector)

  1. **Household Sector**:
     - It represents the individual consumers and families within the economy. I.e., All the 140 crores plus population residing in India will constitute India's household sector.
     - They are consumers of goods and services.

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- They are <u>also **owners of factors of production**</u> and thus <u>receive income through wages, rents, interests, profit</u> etc.
- They use this income to <u>purchase goods and services</u> for personal consumption.

2. **Business Sector (Producer Sector/ Private sector)**:
   - They include businesses, firms etc. involved <u>in production of goods and services</u> and owned by private individuals.
   - They include manufacturing units, service providers and all other types of businesses. <u>They generate output, create jobs</u>, <u>**and contribute to economic growth**</u>.
   - For production purposes, <u>the firms hire/purchase factors of production (land, labour, capital, entrepreneurial skills) from households</u>.
   - **Note:**
     - <u>Reliance Industries is business sector</u>, but <u>Mukesh Ambani</u> is part of Household sector.
     - <u>A PSU is part of government sector</u>, but <u>employee of PSU</u> (as an individual) is part of household sector.

3. **Government Sector**: It encompasses government at <u>all levels</u> (Central, state, local etc.). They <u>collect revenue through taxes, fees, etc</u>. and they <u>fund public goods and services</u>, such as infrastructure, education, healthcare, and defense.
   - **Government sector may act as both a <u>welfare agency</u> as well as a <u>producer</u>.**

4. **External Sector (Foreign Sector)**:
   - This sector <u>represents economic interaction with the rest of the world</u> including the <u>import and exports</u> of goods, services or capital.

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