

# Basic Concepts of Economics

## Definition of Economics

### (i) Wealth Definition

Adam Smith defined "Economics as a science which inquired into the nature and cause of wealth of Nations".

#### According to this definition:

- Economics is a science of study of wealth only;
- It deals with production, distribution and consumption;
- This wealth centered definition deals with the causes behind the creation of wealth; and,
- It only considers material wealth.

#### Criticisms of this definition:

- (a) Wealth is of no use unless it satisfies human wants.
- (b) This definition overlooks the angle of man and welfare.

### (ii) Welfare definition:

According to Alfred Marshall "Economics is the study of man in the ordinary business of life". It examines how a person gets his income and how he invests it. Thus on one side it is a study of wealth and on the other most important side, it is a study of well being.

#### Features:

- (a) Economics is a study of those activities that are concerned with material welfare of man.
- (b) Economics deals with the study of man in ordinary business of life. The study enquires how an individual gets his income and how he uses it.
- (c) Economics is the study of personal and social activities concerned with material aspects of well being.
- (d) Marshall emphasized on definition of material welfare. Herein lies the distinction with Adam Smith's definition, which is wealth centric.

### (iii) Scarcity definition

This definition was put forward by Robbins. According to him "Economics is a science which studies human behavior as a relationship between ends and scarce means which have alternative uses".

#### Features:

- (a) human wants are unlimited
- (b) alternative use of scarce resources
- (c) efficient use of scarce resources
- (d) need for optimization

### (iv) Growth Oriented definition

This definition was introduced by Paul. A. Samuelson. According to the definition "Economics is the study of how man and society choose with or without the use of money to employ the scarce productive resources, which have alternative uses, to produce various commodities over time and distributing them for consumption, how or in the future among various person or groups in society."

It analyses costs and benefits of improving patterns of resource allocation.

## Scope of Economics

### Traditional Approach

1. Economics is a social science.
2. It studies man's behavior as a rational social being.
3. It considered as a science of wealth in relation to human welfare.
4. Earning and spending of income was considered to be end of all economic activities.
5. Wealth was considered as a means to an end - the end being human welfare.

### Modern Approach

1. An individual, either as a consumer or as a producer, can optimize his goal is an economic decision.
2. The scope of Economics lies in analyzing economic problems and suggesting policy measures.
3. Social problems can thus be explained by abstract theoretical tools or by empirical methods.
4. In classical discussion, Economics is a positive science.
5. It seeks to explain what the problem is and how it tends to be solved.
6. In modern time it is both a positive and a normative science.
7. Economists of today deal economic issues not merely as they are but also as they should be.

8. Welfare economics and growth economics are more normative than positive.

### **Subject Matter of Economics**

The subject matter of economics is presently divided into two major branches. Micro Economic and Macro Economics. These two terms have now become of general use in economics.

### **Micro Economics**

Micro economics studies the economic behavior of individual economic units. The study of economic behavior of the households, firms and industries form the subject-matter of micro economics. It examines whether resources are efficiently allocated and spells out the conditions for the optimal allocation of resources so as to maximize the output and social welfare. For example, micro economics is concerned with how the individual consumer distributes his income among various products and services so as to maximize utility. Thus, micro-economics is concerned with the theories of product pricing, factor pricing and economic welfare.

### **Macro Economics**

Macro economics deals with the functioning of the economy as a whole. For example, macro economics seeks to explain how the economy's total output of goods and services and total employment of resources are determined and what explains the fluctuation in the level of output and employment. It deals with the broad economic issues, such as full employment or unemployment, capacity or under capacity production, a low or high rate of growth, inflation or deflation. It is the theory of national income, employment, aggregate consumption, savings and investment, general price level and economic growth.

### **Interdependence between Micro Economics and Macro Economics**

- Micro Economic analysis and Macro Economic analysis are complementary to each other;
- The basic goal of both the theories is same: the maximization of the material welfare of the nation.
- From the micro economic point of view, the nation's material welfare will be maximized by achieving optimal allocation of resources.
- From the macro economic point of view, the nation's material welfare will be maximized by achieving full utilization of productive resources of the economy.
- The study of both is equally vital so as to have full knowledge of the subject-matter of economics.
- The contemporary economists are concerned with both micro economics and macro economics.

### **Nature of Economics**

Nature of economics refers to whether economics is a science or art or both, and if it is a science, whether it is positive science or normative science or both.

### **Economics as a Science**

It has been often stated that economics is a social science. Economics as a social science studies economic activities of the people. Economics is a systematic body of knowledge as it explains cause and effect relationship between various variables such as price, demand, supply, money supply, production, national income, employment, etc. Economic laws, like other scientific laws, state what takes place when certain conditions (assumptions) are fulfilled. This is the traditional Deduction Method where economic theories are deduced by logical reasoning. The law of demand in economics states that a fall in the price of commodity leads to a large quantity being demanded 'given other things', such as income of the consumer, prices of other commodities, etc., remaining the same. In economics we collect data, classify and analyze these facts and formulate theories or economic laws. The truth and applicability of economic theories can be supported or challenged by confronting them to the observations of the real world. If the predictions of the theory are refuted by the real-world observations, the theory stands rejected. If the predictions of the theory are supported by the real-world events, then the theory is formulated. The laws of economics or economic theories are conditional subject to the condition that other things are equal. Economic theories are seldom precise and are never final; they are not as exact and definite as laws of physical and natural sciences. The laws of physical and natural sciences have universal applicability, but economic laws are not of universally applicable. The laws of physical and natural sciences are exact, but economic laws are not that exact and definite.

### **Economics as an Art**

Various branches of economics, like consumption, production, distribution, money and banking, public finance, etc., provide us basic rules and guidelines which can be used to solve various economic problems of the society. The theory of demand guides the consumer to obtain maximum satisfaction with given income. Theory of production guides the producer to equate marginal cost with marginal revenue while using resources for production. The knowledge of economic laws helps us in solving practical economic problems in everyday life.

### **Economics as a Positive Science**

A positive science is that science in which analysis is confined to cause and effect relationship. Positive economics is concerned with the facts about the economy. It studies the economic phenomena as they exist. It finds out the

common characteristics of economic events. It specifies cause and effect relationship between them. It generalizes their relationship by formulating economic theories and makes predictions about future course of these economic events.

### **Economics as a Normative Science**

The objective of Economics is to examine real economic events from moral and ethical angles and to judge whether certain economic events are desirable or undesirable. Normative economics involves value judgment. It deals primarily with economic goals of a society and policies to achieve these goals. It also prescribes the methods to correct undesirable economic happenings.

### **Economics as a Science and an Art**

Being a systematized body of knowledge and establishing the cause and effect relationship of a phenomenon, Economics is a scientific study. The laws of economics are conditional. Economics cannot predict with so much certainty and accuracy as the subject deals with the behavior of human beings as such controlled experiment is not possible. Some economists prefer to treat economics as an art. Every science has an art or a practical side. Every art has a scientific side which is theoretical. Economics deals with both theoretical aspects as well as practical side of many economic problems we face in our daily life. Thus, Economics is both science as well as an art.

### **Central Problem of all Economies**

In case of any economy, whatever the economy required cannot be satisfied fully. Economic resources or means of production are limited and they can be put to alternative uses. Every economy faces some common problems.

#### **1. What to produce?**

A country cannot produce all goods because it has limited resources. It has to make a choice between different goods and services. Every economy has to decide what goods and services should be produced.

#### **2. How to produce?**

As an economy decides to produce certain goods, it faces the problem to decide how these goods will be produced.

The problem arises because of unavailability of some resources. It also involves the choice of technique of production. A country may produce by labour intensive methods or by capital intensive methods of production, depending upon its stock or man power.

#### **3. For whom to produce?**

Goods and services are produced for people who have the means to pay for them. A country may produce mass consumption goods at a large scale or goods for upper classes. All it depends upon the policies of the government as well as private producing units.

### **Few Fundamental Concepts**

**1. Wealth:** By wealth we mean the stock of goods under the ownership of a person or a nation.

#### **(i) Personal wealth**

It means the stock of all goods like houses and buildings, furniture, land, money in cash, money kept in banks, clothes, company shares, stocks of other commodities, etc. owned by a person. Health, goodwill, etc., can also be considered to be parts of an individual's wealth. In Economics, they are transferable goods (whose ownership can be transferred to another person). These are considered to be components of wealth.

#### **(ii) National wealth**

It includes the wealth of all the citizens of the country. There are public properties whose benefits are enjoyed by the citizens of the country but no citizen personally owns these goods. Natural resources (mineral resources, forest resources, etc), roads, bridges, parks, hospitals, public educational institutions and public sector projects of various types (public sector industries, public irrigation projects, etc.) are example of public properties. There is some personal wealth which is to be deducted from national wealth. Example, if a citizen of the country holds a Government bond, it is personal wealth. But from the point of view of the Government, it is a liability and, hence, it should not be considered as a part of the nation's wealth.

### **2. Wealth and Welfare**

Welfare means the satisfaction or the well-being enjoyed by society. Social welfare depends on the wealth of the nation. In general, wealth gives rise to welfare, although they are not same. If wealth of society increases, but the distribution among the citizens of the country is very unequal, this inequality may create social jealousy and tension.

Economists, however, assume that when wealth increases, welfare increases too. Similarly, when wealth decreases, welfare is assumed to decrease.

### **3. Money**

Anything which is widely accepted in exchange for goods, or in settling debts. In Barter System, goods were used as medium of exchange. When general acceptability of any medium of exchange is enforced by law, that medium of exchange is called the legal tender, (example, the rupee notes and coins). When some commodity is used as a medium of exchange by custom, it is called customary money.

### **4. Markets**

A system by which the buyers and sellers of a commodity can come into touch with each other (directly or indirectly). In Economics, a market for a commodity is a system. Here, the buyers and the sellers establish contact with each other directly or indirectly. They have a view to purchasing and selling the commodity.

#### **Functions of a market**

The major functions of a market for a commodity are : (i) to determine the price for the commodity, and (ii) to determine the quantity of the commodity that will be bought and sold. Both the price and the quantity are determined by the interactions between the buyers and the sellers of the commodity.

### **5. Investment**

Investment means an increase in the capital stock. For a country, as a whole, investment is the increase in the total capital stock of the country. For an individual, investment is the increase in the capital stock owned by him.

#### **Real investment and portfolio investment**

Investment may be of 2 types : real investment and portfolio investment.

**(a) Real investment :** Real investment means an increase in the real capital stock, i.e., an addition to the stock of machines, buildings, materials or other types of capital goods.

**(b) Portfolio investment :** Portfolio investment essentially means the purchase of shares of companies. However, it is only the purchase of new shares issued by a company that can properly be termed as investment (because the company will use the money for expanding its productive capacity, i.e., the company's real capital stock will increase). Purchase of an existing share from another shareholder is not an investment because in this case the company's real capital stock does not increase.

#### **Gross investment and net investment**

In any economy, the aggregate investment made during any year is called gross investment. The gross investment includes (a) inventory investment and (b) fixed investment. Investment in raw materials, semi-finished goods and finished goods is referred to as inventory investment. On the other hand, investment made in fixed assets like machineries, factory sheds etc. is called fixed investment. By deducting depreciation cost, of capital from the gross investment, we get net investment. So,  $\text{Net investment} = \text{Gross investment} - \text{depreciation cost}$ .

### **6. Production**

Production means "creation of utility". It also refers to creation of goods (or performance of services) for the purpose of selling them in the market. At present, both material goods and services are considered as production. Production must be for the purpose of selling the produced goods (or, services) in the market.

#### **Factors of production**

The goods and services with the help of which the process of production is carried out, are called factors of production. Economists talk about four main factors of production : land, labour, capital and Entrepreneurship (or organization). They are also called as the inputs of production. On the other hand, the goods produced with the help of these inputs, are called as the output.

### **7. Consumption**

By consumption, we mean satisfaction of wants. It is because we have wants that we consume various goods and services. Moreover, it is assumed that, if we have wants, these can be satisfied only through the consumption of goods and services. Thus, consumption is defined as the satisfaction of human wants through the use of goods and services.

### **8. Saving**

Saving is defined as income minus consumption. Whatever is left in the hands of an individual after meeting consumption expenditure is the individual's saving. The sum-total of funds in the hands of an individual is obtained by accumulating the saving of the past years. Saving is generated out of current income of an individual. Savings are created out of past income of an individual.

### **9. Income**

The income of a person means the net inflow of money (or purchasing power) of this person over a certain period. For instance, an industrial worker's annual income is his salary income over the year. A businessman's annual income is his profit over the year.

### **Wealth and income**

The difference between wealth and income must be clearly understood. A person (or a nation) consumes a part of the income and saves the rest. These savings are accumulated in the form of wealth. Wealth is a stock. It is stock of goods owned at a point of time. Income is a flow; it is the inflow of money (or purchasing power) over a period of time.

### **10. Consumer Surplus**

The concept was introduced by Prof. Marshall in Economics. The excess satisfaction or utility that a consumer can enjoy from the purchase of a thing when the price that he actually pays is less than the price he was willing to pay for it. It is the difference between individual demand price and market price. The price that a man is willing to pay is determined by the marginal utility of the thing to him. The concept is derived from the Law of Diminishing Marginal Utility. As a man consumes successive units of a commodity, the Marginal Utility from each unit goes on falling. It is often argued that the surplus satisfaction cannot be measured precisely. It is difficult to measure the marginal utilities of different units of a commodity consumed by person.

### **11. Capital**

In a fundamental sense, capital consists of any produced thing that can enhance a person's power to perform economically useful work. Example, a stone or an arrow is capital for a caveman who can use it as a hunting instrument. Capital is an input in the production process. It refers to financial resources available for use. Capital is different from money. Money is used simply to purchase goods and services for consumption. Capital is more durable and is used to generate wealth through investment. Capital is something owned which provides ongoing services. Economic capital is used for measuring and reporting market and operational risks across a financial organization.

### **12. Utility**

Utility, or usefulness, is the ability of something to satisfy needs or wants. Utility is an important concept in economics because it represents satisfaction experienced by the consumer of a good. Utility is a representation of preferences over some set of goods and services. One cannot directly measure benefit, satisfaction or happiness from a good or service, so instead economists have devised ways of representing and measuring utility in terms of economic choices that can be counted. Economists consider utility to be revealed in people's willingness to pay different amounts for different goods. Total utility is the aggregate sum of satisfaction or benefit that an individual gains from consuming a given amount of goods or services in an economy. The amount of a person's total utility corresponds to the person's level of consumption. Usually, the more the person consumes, the larger his or her total utility will be. Marginal utility is the additional satisfaction, or amount of utility, gained from each extra unit of consumption. Total utility usually increases as more of a good is consumed. Marginal utility usually decreases with each additional increase in the consumption of a good. This decrease demonstrates the law of diminishing marginal utility.

### **Law of Diminishing Marginal Utility**

This Law is a fundamental law of Economics and relates to a man's behavior as a consumer. The Law states that as a man gets more and more units of a commodity, marginal utility from each successive unit will go on falling till it becomes zero or negative. Marginal utility means the additional utility obtained from one particular unit of a commodity. It is expressed in terms of the price that a man is willing to pay for a commodity. The basis of the Law is satiability of a particular want. Although human wants are unlimited in number yet a particular one can be fulfilled.