

BASIC CONCEPT of ECONOMICS

Economics is the Social Science that describes the factors that determine the production, distribution and consumption of goods and services. It is the study of human efforts to satisfy unlimited wants with limited resources.

'Political Economy' was the earlier name for the subject, but economists in the late 19th century suggested "Economics" as a shorter term for "Economic Science" to establish itself as a separate discipline outside of Political Science and other Social Sciences.

Economics focuses on the behaviour and interactions of economic agents and how economies work. Consistent with this focus, primary textbooks often distinguish between Microeconomics and Macroeconomics.

Microeconomics examines the behaviour of basic elements in the economy, including individual agents and markets, their interactions, and the outcomes of interactions. Individual agents may include, for example, households, firms, buyers, and sellers. Macroeconomics analyzes the entire economy (meaning aggregated production, consumption, savings, and investment) and issues affecting it, including unemployment of resources (labour, capital, and land), inflation, economic growth, and the public policies that address these issues (monetary, fiscal, and other policies).

Other broad distinctions within economics include those between positive economics, describing “what is”, and normative economics, advocating “what ought to be”; between economic theory and applied economics; between

rational and behavioural economics; and between mainstream economics (more “orthodox” and dealing with the “rationality-individualism-equilibrium nexus”) and heterodox economics (more “radical” and dealing with the “institutions-history-social structure nexus”). Besides the traditional concern in production, distribution, and consumption in an economy, economic analysis may be applied throughout society, as in business, finance, health care, and government. Economic analysis may also be applied to such diverse subjects as crime, education, the family, law, politics, religion, social institutions, war, science, and the environment. Education, for example, requires time, effort, and expenses, plus the foregone income and experience, yet these losses can be weighted against future benefits education may bring to the agent or the economy. At the turn of the 21st century, the expanding domain of economics in the social sciences has been described as economic imperialism.

The ultimate goal of economics is to improve the living conditions of people in their everyday life.

There are a variety of modern definitions of economics. Some of the differences may reflect evolving views of the subject or different views among economists. Scottish philosopher Adam Smith (1776) defined what was then called political economy as “an inquiry into the nature and causes of the wealth of nations”, in particular as : a branch of the science of a statesman or legislator with the twofold objectives of providing a plentiful revenue or subsistence for the people ... and to supply the state or commonwealth with a revenue for the public services.

J. B. Say (1803), distinguishing the subject from its public-policy uses, defines it as the science *of* production, distribution, and consumption of wealth. On the satirical

side, Thomas Carlyle (1849) coined “the dismal science” as an epithet for classical economics, in this context, commonly linked to the pessimistic analysis of Malthus (1798). John Stuart Mill (1844) defines the subject in a social context as: The science which traces the laws of such of the phenomena of society as arise from the combined operations of mankind for the production of wealth, in so far as those phenomena are not modified by the pursuit of any other object.

Alfred Marshall provides a still widely cited definition in his textbook *Principles of Economics* (1890) that extends analysis beyond wealth and from the societal to the microeconomic level : Economics is a study of man in the ordinary business of life. It enquires how he gets his income and how he uses it. Thus, it is on the one side, the study of

wealth and on the other and more important side, a part of the study of man.

Lionel Robbins (1932) developed implications of what has been termed “perhaps the most commonly accepted current definition of the subject”: Economics is a science which studies human behaviour as a relationship between ends and scarce means which have alternative uses.

Robbins describes the definition as not *classificatory* in “picking out certain *kinds* of behaviour” but rather *analytical* in “focusing attention on a particular *aspect* of behaviour, the form imposed by the influence of scarcity”. He affirmed that previous economist have usually centered their studies on the analysis of wealth: how wealth is created (production), distributed, and consumed; and how wealth can grow. But he said that economics can be used to

study other things, such as war, that are outside its usual focus. This is because war has as the goal winning it (as a sought after end), generates both cost and benefits; and, resources (human life and other costs) are used to attain the goal. If the war is not winnable or if the expected costs outweigh the benefits, the deciding actors (assuming they are rational) may never go to war (a decision) but rather explore other alternatives. We cannot define economics as the science that studies wealth, war, crime, education, and any other field economic analysis can be applied to; but, as the science that studies a particular common aspect of each of those subjects (they all use scarce resources to attain a sought after end).

Microeconomics examines how entities, forming a market structure, interact within a market to create a market

system. These entities include private and public players with various classifications, typically operating under scarcity of tradeable units and government regulation. The item traded may be a tangible product such as apples or a service such as repair services, legal counsel, or entertainment.

In theory, in a free market the aggregates (sum of) of *quantity demanded* by buyers and *quantity supplied* by sellers will be equal and reach economic equilibrium over time in reaction to price changes; in practice, various issues may prevent equilibrium, and any equilibrium reached may not necessarily be morally equitable. For example, if the supply of healthcare services is limited by external factors, the equilibrium price may be unaffordable for many who desire it but cannot pay for it.

In microeconomics, production is the conversion of inputs into outputs. It is an economic process that uses inputs to create a commodity or a service for exchange or direct use. Production is a flow and thus a rate of output per period of time. Distinctions include such production alternatives as for consumption (food, haircuts, etc.) vs. investment goods (new tractors, buildings, roads, etc.), public goods (national defense, smallpox vaccinations, etc.) or private goods (new computers, bananas, etc.), and “guns” vs. “butter”.

Opportunity cost refers to the economic cost of production : the value of the next best opportunity foregone. Choices must be made between desirable yet mutually exclusive actions. It has been described as expressing “the basic relationship between scarcity and choice”. For example, if a baker uses a sack of flour to make pretzels (type of baked bread or

crisp biscuit) one morning, then the baker cannot use either the flour or the morning to make bagels (dense bread roll) instead. Part of the cost of making pretzels is that neither the flour nor the morning are available any longer, for use in some other way. The opportunity cost of an activity is an element in ensuring that scarce resources are used efficiently, such that the cost is weighed against the value of that activity in deciding on more or less of it. Opportunity costs are not restricted to monetary or financial costs but could be measured by the real cost of output forgone, leisure, or anything else that provides the alternative benefit (utility).

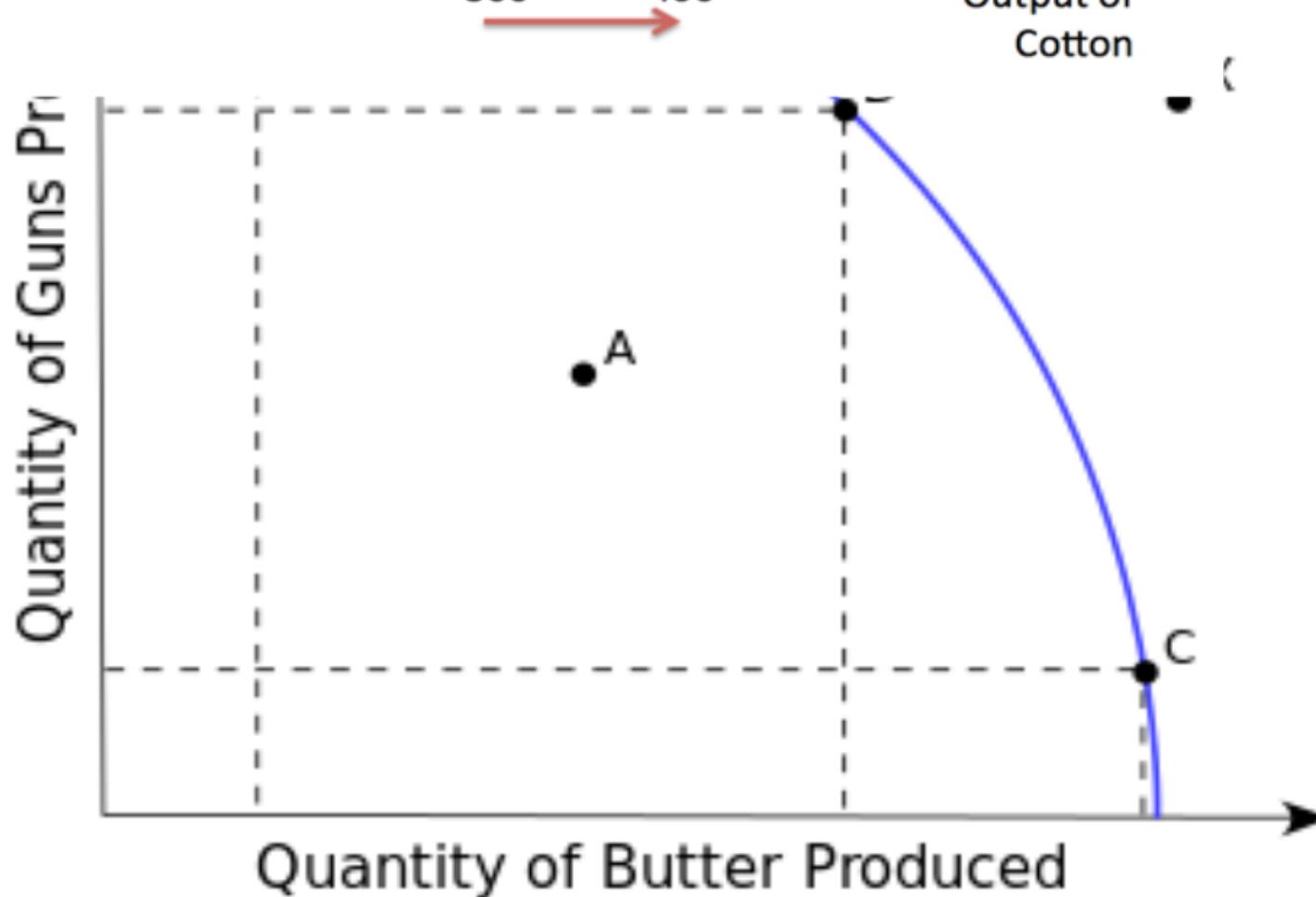
Inputs used in the production process include such primary factors of production as labour services, capital (durable produced goods used in production, such as an existing factory), and land (including natural resources). Other

inputs may include intermediate goods used in production of final goods, such as the steel in a new car.

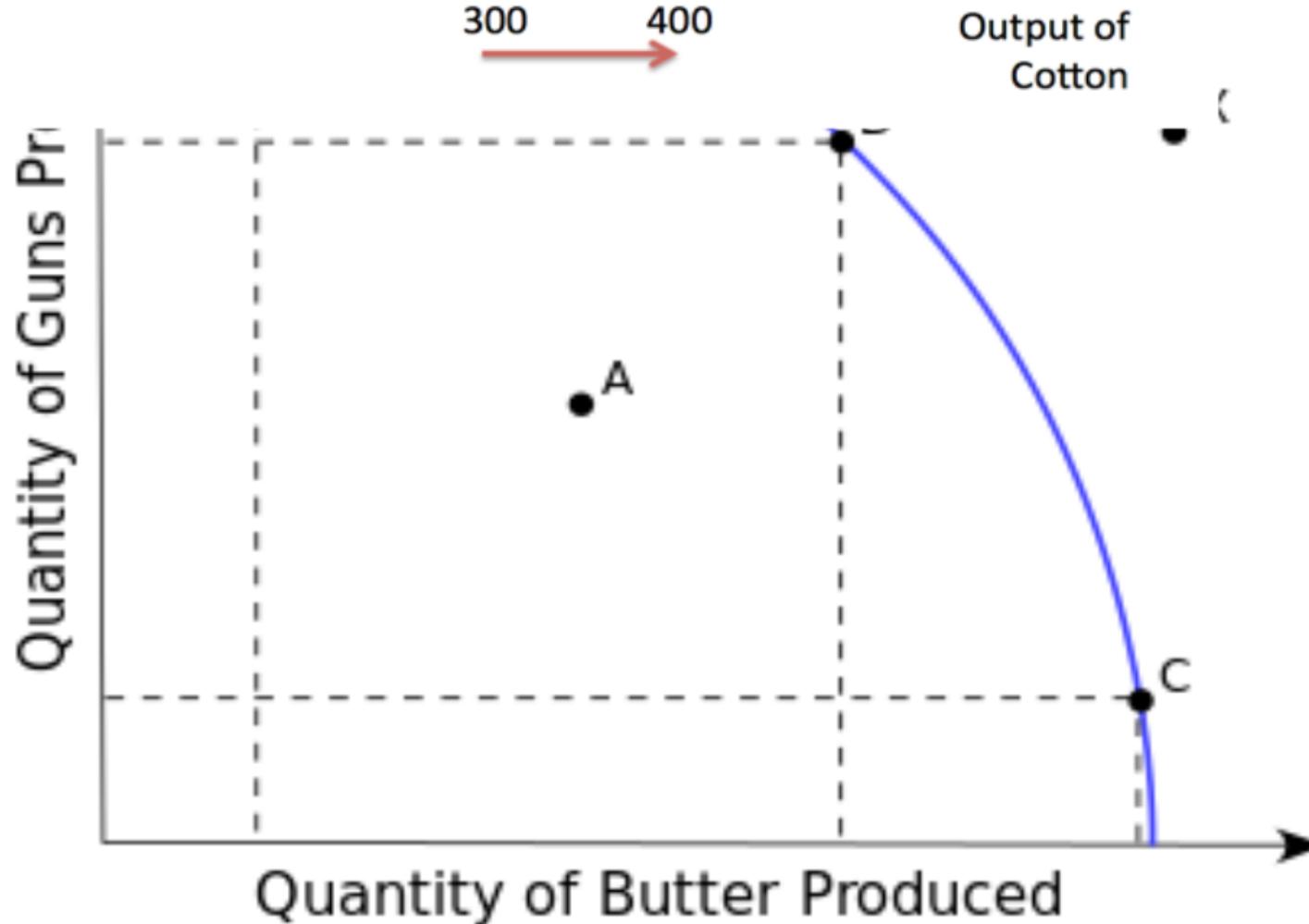
Economic efficiency describes how well a system generates desired output with a given set of inputs and available technology. Efficiency is improved if more output is generated without changing inputs, or in other words, the amount of “waste” is reduced. A widely accepted general standard is Pareto efficiency, which is reached when no further change can make someone better off without making someone else worse off.

Opportunity Cost - The cost of an economic decision. The classic example is “guns or butter.” What should a nation produce; butter, a need, or guns, a want? What is the cost of either decision? If we choose the guns the cost is the butter. If we choose butter, the cost is the guns. Nations must always deal with the questions faced by opportunity cost. It is a matter of choices. Resources are limited thus we cannot meet every need or want.

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The production-possibility frontier (PPF) is an expository figure for representing scarcity, cost, and efficiency. In the simplest case an economy can produce just two goods (say “guns” and “butter”). The PPF is a table or graph (in previous slide) showing the different quantity combinations of the two goods producible with a given technology and total factor inputs, which limit feasible total output. Each point on the curve shows potential total output for the economy, which is the maximum feasible output of one good, given a feasible output quantity of the other good.

Scarcity is represented in the figure by people being willing but unable in the aggregate to consume beyond the PPF (such as at X) and by the negative slope of the curve. If production of one good increases along the curve, production of the other good decreases, an inverse

relationship. This is because increasing output of one good requires transferring inputs to it from production of the other good, decreasing the latter.

The slope of the curve at a point on it gives the trade-off between the two goods. It measures what an additional unit of one good costs in units forgone of the other good, an example of a real opportunity cost. Thus, if one more Gun costs 100 units of butter, the opportunity cost of one Gun is 100 Butter. Along the PPF, scarcity implies that choosing more of one good in the aggregate entails doing with less of the other good. Still, in a market economy, movement along the curve may indicate that the choice of the increased output is anticipated to be worth the cost to the agents.

By construction, each point on the curve shows productive efficiency in maximizing output for given total inputs. A point inside the curve (as at A), is feasible but represents production inefficiency (wasteful use of inputs), in that output of one or both goods could increase by moving in a northeast direction to a point on the curve. Examples cited of such inefficiency include high unemployment during a business-cycle recession or economic organization of a country that discourages full use of resources. Being on the curve might still not fully satisfy allocative efficiency (also called Pareto efficiency) if it does not produce a mix of goods that consumers prefer over other points.

Much applied economics in public policy is concerned with determining how the efficiency of an economy can be improved. Recognizing the reality of scarcity and then

figuring out how to organize society for the most efficient use of resources has been described as the “essence of economics”, where the subject “makes its unique contribution.”

Wants : Simply the desires. Wants are different from needs. They are means of expressing a perceived need. Wants are broader than needs. The idea of want can be examined from many perspectives. In secular societies want might be considered similar to the emotional desire, which can be studied scientifically through the disciplines of psychology or sociology. Want might also be examined in economics as a necessary ingredient in sustaining and perpetuating capitalist societies that are organised around principles like consumerism. Alternatively want can be studied in a non-secular, spiritual, moralistic or religious way, particularly by Buddhism but also Christianity, Islam and Judaism.

In economics, a want is something that is desired. It is said that every person has unlimited wants, but limited

resources (Economics is based on the assumption that only limited resources are available to us from the infinite universe). Thus, people cannot have everything they want and must look for the most affordable alternatives.

Wants are often distinguished from needs. A need is something that is necessary for survival (such as food and shelter), whereas a want is simply something that a person would like to have. Some economists have rejected this distinction and maintain that all of these are simply wants, with varying levels of importance. By this viewpoint, wants and needs can be understood as examples of the overall concept of demand.

Needs : Needs are based on physiological, personal, or socio-economic requirements necessary for an individual to function and live. Food, cloth, shelter and other needs of

daily life are basic requirements for survival. In recent years we have seen a perceived shift of certain items from wants to needs eg. – mobile phones, vehicles, etc. etc.

A need is something that is necessary for an organism to live a healthy life. Needs are distinguished from wants in that, in the case of a need, a deficiency causes a clear adverse outcome: a dysfunction or death.

Needs can be objective and physical, such as the need for food, or psychological and subjective, such as the need for self-esteem.

There are also needs of a social or societal nature. Needs and wants are a matter of interest in, and form a common substrate for, the fields of Philosophy, Biology, Psychology, Social Science, Economics and Politics.

Utility : In economics, utility is a measure of preferences over some set of goods and services. The concept is an important underpinning of rational choice theory in economics and game theory, because it represents satisfaction experienced by the consumer of a good. A good is something that satisfies human wants. Since one cannot directly measure benefit, satisfaction or happiness from a good or service, economists instead have devised ways of representing and measuring utility in terms of economic choices that can be measured. Economists have attempted to perfect highly abstract methods of comparing utilities by observing and calculating economic choices. In the simplest sense, economists consider utility to be revealed in people's willingness to pay different amounts for different goods.

Applications : Utility is usually applied by economists in such constructs as the indifference curve, which plot the combination of commodities that an individual or a society would accept to maintain a given level of satisfaction. Utility and indifference curves are used by economists to understand the underpinnings of demand curves, which are half of the supply and demand analysis that is used to analyze the workings of goods markets.

Individual utility and social utility can be construed as the value of a utility function and a social welfare function respectively. When coupled with production or commodity constraints, under some assumptions these functions can be used to analyze Pareto efficiency, such as illustrated by Edgeworth boxes in contract curves. Such efficiency is a central concept in welfare economics.

In finance, utility is applied to generate an individual's price for an asset called the indifference price. Utility functions are also related to risk measures, with the most common example being the entropic risk measure.

Scarcity : The fundamental economic problem facing all societies. Essentially it is how to satisfy *unlimited wants* with *limited resources*. This is the issue that plagues all government and peoples.

Economic View of Needs and Wants : The economic view of needs and wants utilizes the fictional concept of the economic man, who acts rationally to maximize his potential to consume goods and services that offer him the highest degree of utility or satisfaction. Our economic man's quest is limitless. While your needs may eventually

be satisfied for a while, according to economic theory, wants never are.

For example, a one-bedroom apartment fulfills your needs and wants for housing, but once you get married, you want a townhouse. The want changes to a three-bedroom house when the first kid comes along. Then you decide you want a house with a few extra bedrooms, and a pool wouldn't be bad either, even though the original house fulfills your need for family housing.

Ethical Considerations : The economic perspective of needs and wants raises some ethical concerns. One concern is that consumers are subject to undue persuasion from a consumer culture that makes it difficult for them to determine their true needs and wants, rather than

artificially manufactured needs and wants. A great example of a manufactured want is the pet rock, which served no utilitarian purpose.

Another concern is the idea of consumer lock-in, where our society requires individuals to obtain more and more income and consumption to meet fundamental needs. For example, once upon a time, people functioned perfectly fine without personal automobiles, computers, and cell phones, but now most people view these items as essential needs. All these 'needs' add up.

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Revealed preference : It was recognized that utility could not be measured or observed directly, so instead economists devised a way to infer underlying relative utilities from observed choice. These 'revealed preferences', as they were named by Paul Samuelson, were revealed e.g. in people's willingness to pay:

Utility is taken to be correlative to Desire or Want. It has been already argued that desires cannot be measured directly, but only indirectly, by the outward phenomena to which they give rise: and that in those cases with which economics is chiefly concerned the measure is found in the price which a person is willing to pay for the fulfillment or satisfaction of his desire.

Utility functions : There has been some controversy over the question whether the utility of a commodity can be

measured or not. At one time, it was assumed that the consumer was able to say exactly how much utility he got from the commodity. The economists who made this assumption belonged to the 'cardinalist school' of economics. Today utility functions, expressing utility as a function of the amounts of the various goods consumed, are treated as either *cardinal* or *ordinal*, depending on whether they are or are not interpreted as providing more information than simply the rank ordering of preferences over bundles of goods, such as information on the strength of preferences.

Cardinal utility : When cardinal utility is used, the magnitude of utility differences is treated as an ethically or behaviourally significant quantity. For example, suppose a cup of orange juice has utility of 120 utils, a cup of tea has a utility of 80 utils, and a cup of water has a utility of 40 utils. With cardinal utility, it can be concluded that the cup of orange juice is better than the cup of tea by exactly the same amount by which the cup of tea is better than the cup of water. One cannot conclude, however, that the cup of tea is two thirds as good as the cup of juice, because this conclusion would depend not only on magnitudes of utility differences, but also on the "zero" of utility.

Neoclassical economics has largely retreated from using cardinal utility functions as the basis of economic behaviour. A notable exception is in the context of analyzing choice under conditions of risk.

Sometimes cardinal utility is used to aggregate utilities across persons, to create a social welfare function. The argument against this is that interpersonal comparisons of utility are meaningless because there is no simple way to interpret how different people value consumption bundles.

Ordinal utility : When ordinal utilities are used, differences in utils (values taken on by the utility function) are treated as ethically or behaviourally meaningless: the utility index encodes a full behavioural ordering between members of a choice set, but tells nothing about the related *strength of preferences*. In the above example, it would only be possible to say that juice is preferred to tea to water, but no more.

Marginal Utility : Marginal utility is the additional satisfaction a consumer gains from consuming one more unit of a good or service. Marginal utility is an important economic concept because economists use it to determine how much of an item a consumer will buy. Positive marginal utility is when the consumption of an additional item increases the total utility. Negative marginal utility is when the consumption of an additional item decreases the total utility.

Economists use the concept of marginal utility to measure happiness and pleasure, and how that affects consumer decision making. They have also identified the law of diminishing marginal utility, which means that the first unit of consumption of a good or service has more utility than the next units of consumption.

Example of Marginal Utility : The following example can demonstrate the concept of marginal utility. Imagine that a person has four bottles of water and purchases a fifth bottle of water. Next, imagine that a second person has 50 bottles of water and purchases one more bottle of water. The first person buying the fifth bottle of water will get far more utility from that fifth bottle of water because of its proportion to the total. This fifth bottle increases the total water by 25%. The second person gains far less utility from purchasing a 51st bottle of water, precisely because its proportion to the total is so low. This 51st bottle of water increases the total water by only 2%. As a person purchases more and more of a product, the marginal utility to the buyer gets lower and lower, until it reaches a point where the buyer has zero need for any additional units of the good or service. At that point, the marginal utility of the next unit equals zero.

Factors of Production / Resources - These are those elements that a nation has at its disposal to deal with the issue of scarcity. How efficiently these are used determine the measure of success a nation has. They are -

Land - natural resources, etc.

Capital - investment

Labour - the work force; size, education, quality, work ethic.

Entrepreneurs - inventive and risk taking spirit. This is a rather new addition to a traditional list.

The “**Basic Economic Questions**” - These are the questions all nations must ask when dealing with scarcity and efficiently allocating their resources.

What to produce? / How much to produce? / When to produce? / How to produce? / For whom to produce?

Wealth is the abundance of valuable resources or valuable material possessions. An individual, community, region or country that possesses an abundance of such possessions or resources to the benefit of the common good is known as wealthy.

Meaning of wealth is context-dependent. At the most general level, economists may define wealth as “anything of value” that captures both the subjective nature of the idea and the idea that it is not a fixed or static concept.

The United Nations definition of *inclusive wealth* is a monetary measure which includes the sum of natural, human, and physical assets. Natural capital includes land, forests, energy resources, and minerals. Human capital is the population's education and skills. Physical (or "manufactured") capital includes such things as machinery, buildings, and infrastructure.

Adam Smith, in his seminal work *The Wealth of Nations*, described wealth as "the annual produce of the land and labour of the society". This "produce" is, at its simplest, that which satisfies human needs and wants of utility. In popular usage, wealth can be described as an abundance of items of economic value, or the state of controlling or possessing such items, usually in the form of money, real estate and personal property. An individual who is considered wealthy, affluent, or rich is someone who has accumulated substantial wealth relative to others in their society or reference group.

In economics, net worth refers to the value of assets owned minus the value of liabilities owed at a point in time. Wealth can be categorized into three principal categories: personal property, including homes or automobiles; monetary savings, such as the accumulation of past income; and the capital wealth of income producing assets, including real estate, stocks, bonds,

and businesses. All these delineations make wealth an especially important part of social stratification. Wealth provides a type of individual safety net of protection against an unforeseen decline in one's living standard in the event of job loss or other emergency and can be transformed into home ownership, business ownership, or even a college education.

Wealth has been defined as a collection of things limited in supply, transferable, and useful in satisfying human desires. Scarcity is a fundamental factor for wealth. When a desirable or valuable commodity (transferable good or skill) is abundantly available to everyone, the owner of the commodity will possess no potential for wealth. When a valuable or desirable commodity is in scarce supply, the owner of the commodity will possess great potential for wealth.

'Wealth' refers to some *accumulation* of resources (net asset value), whether abundant or not. 'Richness' refers to

an *abundance* of such resources (income or flow). A wealthy individual, community, or nation thus has more accumulated resources (capital) than a poor one. The opposite of wealth is destitution. The opposite of richness is poverty.

The term implies a social contract on establishing and maintaining ownership in relation to such items which can be invoked with little or no effort and expense on the part of the owner. The concept of wealth is relative and not only varies between societies, but varies between different sections or regions in the same society. A personal net worth of US \$10,000 in most parts of the United States would certainly not place a person among the wealthiest citizens of that locale. However, such an amount would constitute an extraordinary amount of wealth in impoverished developing countries.

Concepts of wealth also vary across time. Modern labor-saving inventions and the development of the sciences have vastly

improved the standard of living in modern societies for even the poorest of people. This comparative wealth across time is also applicable to the future; given this trend of human advancement, it is possible that the standard of living that the wealthiest enjoy today will be considered impoverished by future generations.

Industrialization emphasized the role of technology. Many jobs were automated. Machines replaced some workers while other workers became more specialized. Labour specialization became critical to economic success. However, physical capital, as it came to be known, consisting of both the natural capital and the infrastructural capital, became the focus of the *analysis of wealth*.

Adam Smith saw wealth creation as the combination of materials, labour, land, and technology in such a way as to capture a profit (excess above the cost of production). The

theories of David Ricardo, John Locke, John Stuart Mill, in the 18th century and 19th century built on these views of wealth that we now call classical economics.

Production is a process of combining various material inputs and immaterial inputs (plans, know-how) in order to convert them to value added output for consumption. It is the act of creating a good or service which has value and contributes to the utility of individuals.

Economic well-being is created in a production process, meaning all economic activities that aim directly or indirectly to satisfy human wants and needs. The degree to which the needs are satisfied is often accepted as a measure of economic well-being. In production there are two features which explain increasing economic well-being. They are improving quality-price-ratio of goods and services and increasing incomes from growing and more efficient market production.

The most important forms of production are -

- Market production
- Public production
- Household production

In order to understand the origin of the economic well-being, we must understand these three production processes. All of them produce commodities which have value and contribute to well-being of individuals.

The satisfaction of needs originates from the use of the commodities which are produced. The need satisfaction increases when the quality-price-ratio of the commodities improves and more satisfaction is achieved at less cost. Improving the quality-price-ratio of commodities is to a producer an essential way to improve the competitiveness of products but this kind of gains distributed to customers cannot be measured with production data. Improving the

competitiveness of products means often to the producer lower product prices and therefore losses in incomes which are to compensated with the growth of sales volume.

Economic well-being also increases due to the growth of incomes that are gained from the growing and more efficient market production. Market production is the only production form which creates and distributes incomes to stakeholders. Public production and household production are financed by the incomes generated in market production. Thus market production has a double role in creating well-being, i.e. the role of producing goods and services and the role of creating income. Because of this double role market production is the “primus motor” of economic well-being and therefore here under review.

Stakeholders of production are persons, groups or organizations with an interest in a producing company. Economic well-being

originates in efficient production and it is distributed through the interaction between the company's stakeholders. The stakeholders of companies are economic actors which have an economic interest in a company. Based on the similarities of their interests, stakeholders can be classified into three groups in order to differentiate their interests and mutual relations. The three groups are as follows -

- Customers
- Suppliers
- Producers

Consumption in economics, the use of goods and services by households. Consumption is distinct from consumption expenditure, which is the purchase of goods and services for use by households. Consumption differs from consumption expenditure primarily because durable goods, such as automobiles, generate an expenditure mainly in the period when

they are purchased, but they generate “consumption services” (for example, an automobile provides transportation services) until they are replaced or scrapped.

Neoclassical (mainstream) economists generally consider consumption to be the final purpose of economic activity, and thus the level of consumption per person is viewed as a central measure of an economy’s productive success.

Income : Top three concepts of income are -

1. Accounting Income
2. Economic Income
3. Capital Maintenance Income

1. Accounting income, often referred to as business income or conventional income is measured in accordance with generally accepted accounting principles. The profit and loss account or income statement determines the net income or operating

performance of a business enterprise for some particular period of time. Income is determined by following income statement approach, i.e., by comparing sales revenue and costs related to the sales revenue.

$$\text{Net Income} = \text{Revenue} - \text{Expenses}$$

2. Economic Income : is the way for companies to account for changes in the value of a given asset in the market. It generally recognizes unrealized gains, in addition to recognizing realized gains.

A change in market value rather than cash received is the perfect example of an economic income. Economic income or loss recognizes all gains and losses whether realized or unrealized. This differs from accounting income which only recognizes realized gains ie. gains resulting from an actual business transaction. This defines the difference of accounting earnings vs economic earnings.

3. Capital maintenance is an accounting concept based on the principle that income is only recognized after capital has been maintained or there has been a full recovery of costs. Capital maintenance has been reached if the amount of a company's capital at the end of a period is unchanged from that at the beginning of the period, with any excess amount treated as profit.

Saving is income not spent, or deferred consumption. Methods of saving include putting money aside in, for example, a deposit account, a pension account, an investment fund, or as cash. Saving also involves reducing expenditures, such as recurring costs. In terms of personal finance, saving generally specifies low-risk preservation of money, as in a deposit account, versus investment, wherein risk is a lot higher; in economics more broadly, it refers to any income not used for immediate consumption.

Saving is closely related to physical investment, in that the former provides a source of funds for the latter. By not using income to buy consumer goods and services, it is possible for resources to instead be invested by being used to produce fixed capital, such as factories and machinery. Saving can therefore be vital to increase the amount of fixed capital available, which contributes to economic growth.

However, increased saving does not always correspond to increased investment. If savings are not deposited into a financial intermediary such as a bank, there is no chance for those savings to be recycled as investment by business. This means that saving may increase without increasing investment, possibly causing a short-fall of demand (a pile-up of inventories, a cut-back of production, employment, and income, and thus a recession) rather than to economic growth. In the short term, if saving falls below investment, it can lead to a

growth of aggregate demand and an economic boom. In the long term if saving falls below investment it eventually reduces investment and detracts from future growth. Future growth is made possible by foregoing present consumption to increase investment. However savings not deposited into a financial intermediary amount to an (interest-free) loan to the government or central bank, who can recycle this loan.

In a primitive agricultural economy savings might take the form of holding back the best of the corn harvest as seed corn for the next planting season. If the whole crop were consumed the economy would convert to hunting and gathering the next season.

In economics, saving is defined as income minus consumption. The rate at which people do this is called the marginal propensity to save or average propensity to save. The rate of saving is directly related to both the interest rate and investment, largely by way of the capital markets.

Investment : An investment is an asset or item acquired with the goal of generating income or appreciation. In an economic sense, an investment is the purchase of goods that are not consumed today but are used in the future to create wealth. In finance, an investment is a monetary asset purchased with the idea that the asset will provide income in the future or will later be sold at a higher price for a profit.

The term "investment" can refer to any mechanism used for generating future income. In the financial sense, this includes the purchase of bonds, stocks or real estate property. Additionally, a constructed building or other facility used to produce goods can be seen as an investment. The production of goods required to produce other goods may also be seen as investing.

Taking an action in the hopes of raising future revenue can also be considered an investment. For example, when choosing to

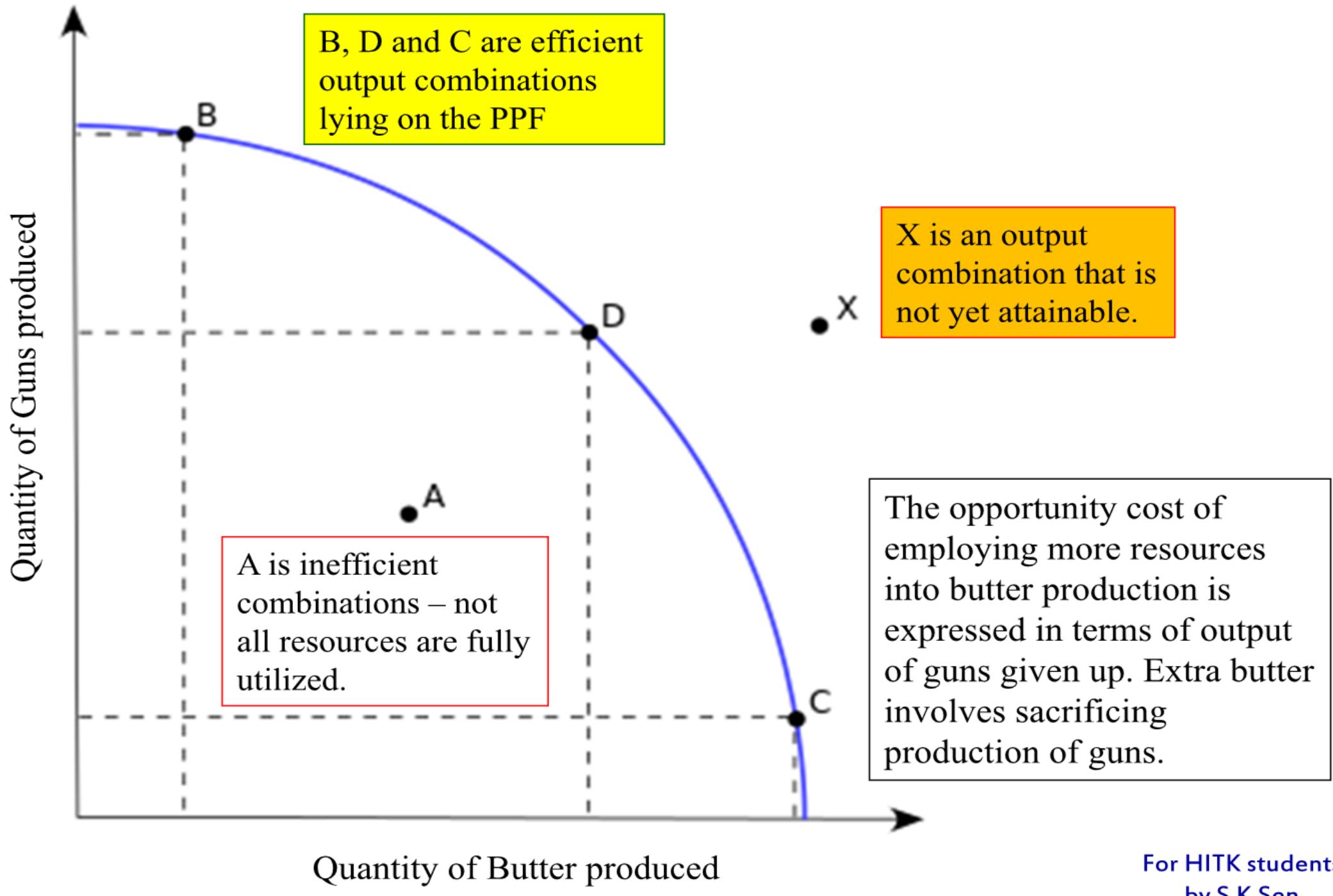
pursue additional education, the goal is often to increase knowledge and improve skills in the hopes of ultimately producing more income.

Economic growth can be encouraged through the use of sound investments at the business level. When a company constructs or acquires a new piece of production equipment in order to raise the total output of goods within the facility, the increased production can cause the nation's gross domestic product (GDP) to rise. This allows the economy to grow through increased production based on the previous equipment investment.

Opportunity Cost - The cost of an economic decision. The classic example is “guns or butter.” What should a nation produce; butter, a need, or guns, a want? What is the cost of either decision? If we choose the guns the cost is the butter. If we choose butter, the cost is the guns. Nations must always deal with the questions faced by opportunity cost. It is a matter of choices. Resources are limited thus we cannot meet every need or want.

Refer Production Possibility Frontier (PPF) curve to understand the mechanism.

Production Possibility Frontier (PPF)



The production-possibility frontier (PPF) is an expository figure for representing scarcity, cost, and efficiency. In the simplest case an economy can produce just two goods (say “guns” and “butter”). The PPF is a table or graph (in previous slide) showing the different quantity combinations of the two goods producible with a given technology and total factor inputs, which limit feasible total output. Each point on the curve shows potential total output for the economy, which is the maximum feasible output of one good, given a feasible output quantity of the other good.

Scarcity is represented in the figure by people being willing but unable in the aggregate to consume beyond the PPF (such as at X) and by the negative slope of the curve. If production of one good increases along the curve, production of the other good decreases, an inverse

relationship. This is because increasing output of one good requires transferring inputs to it from production of the other good, decreasing the latter.

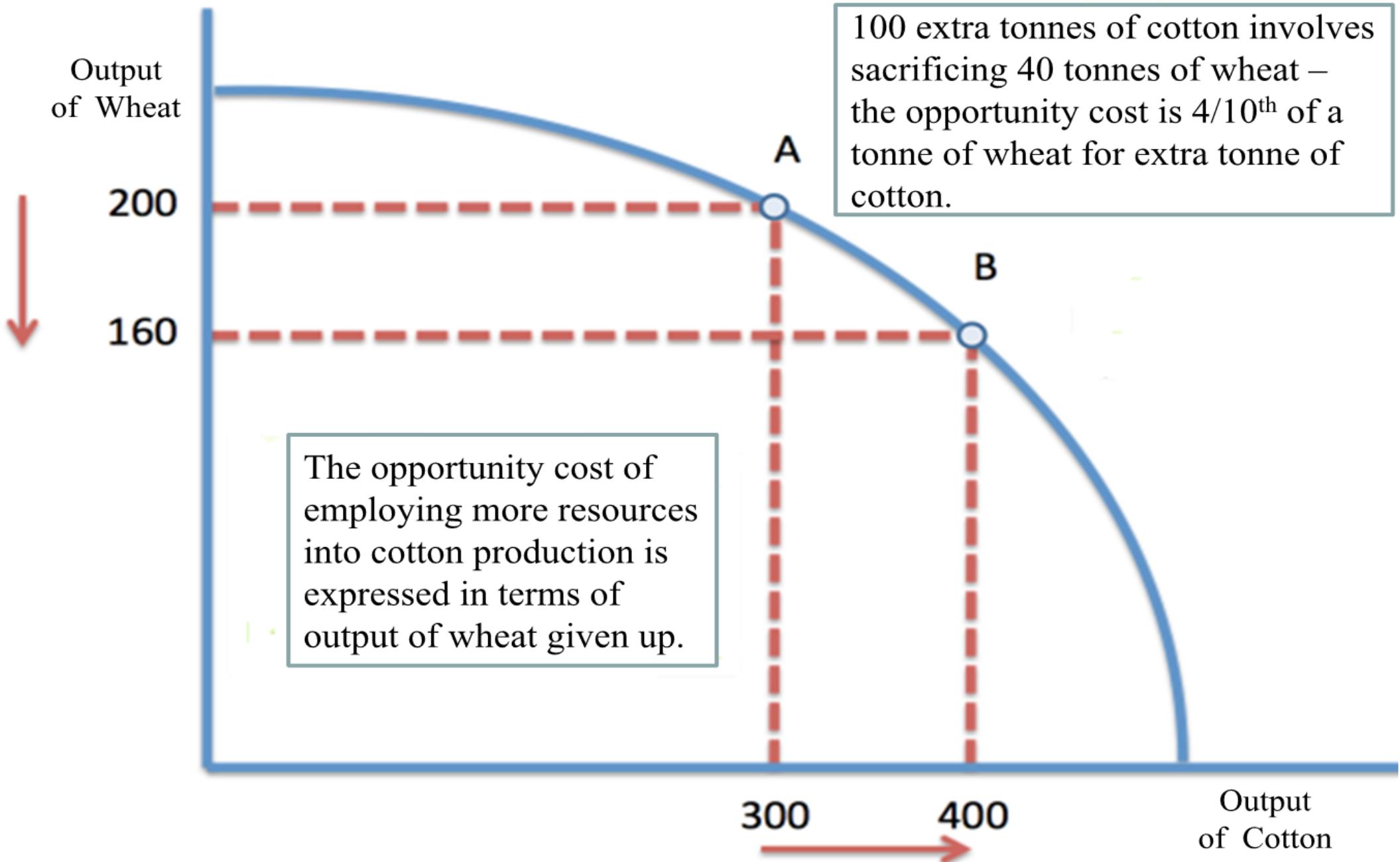
The slope of the curve at a point on it gives the trade-off between the two goods. It measures what an additional unit of one good costs in units forgone of the other good, an example of a real opportunity cost. Thus, if one more Gun costs 100 units of butter, the opportunity cost of one Gun is 100 Butter. Along the PPF, scarcity implies that choosing more of one good in the aggregate entails doing with less of the other good. Still, in a market economy, movement along the curve may indicate that the choice of the increased output is anticipated to be worth the cost to the agents.

By construction, each point on the curve shows productive efficiency in maximizing output for given total inputs. A point inside the curve (as at A), is feasible but represents production inefficiency (wasteful use of inputs), in that output of one or both goods could increase by moving in a northeast direction to a point on the curve. Examples cited of such inefficiency include high unemployment during a business-cycle recession or economic organization of a country that discourages full use of resources. Being on the curve might still not fully satisfy allocative efficiency (also called Pareto efficiency) if it does not produce a mix of goods that consumers prefer over other points.

Much applied economics in public policy is concerned with determining how the efficiency of an economy can be improved. Recognizing the reality of scarcity and then

figuring out how to organize society for the most efficient use of resources has been described as the “essence of economics”, where the subject “makes its unique contribution.”

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