ARYA INSTITUTE OF ENGINEERING & TECHNOLOGY, KUKAS, Jaipur

Lecture Notes

Branch : .... Sem. : .... Subject : MEFA

Topic : Basic Economic Concepts Unit: 1 Lecture No. ....

Topics :

Basic Economic Concepts -

Meaning, nature and scope of economics, deductive vs. inductive methods, static and dynamics, Economic problems : scarcity and choice, Circular flow of economic activity, National Income - concepts and measurement.

⇒ Basic Economic Concepts : Meaning of Economics

Economics is a social science that studies the behaviour patterns of human beings. The basic function of economics is to study how individuals, households, organizations, and nations utilize their limited resources to achieve maximum profit.

The study of economics can be divided into two parts, namely microeconomics and macroeconomics. Microeconomics is a branch of economics that examines the market behaviour of individual consumers and organizations. It focus on demand and supply, pricing and output of individual organizations.

On the other hand, macroeconomics analyzes the economy as a whole. It deals with issues related to national income, employment pattern, inflation, recession and economic growth.

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⇛ Meaning Of Economics :
Economics is defined by taking four viewpoints which are explained as follows -

1) Wealth Viewpoint -
According to Adam Smith, economics is a science of wealth. He is regarded as father of economics and wrote a book entitled "An enquiry into the Nature and the Causes Of Wealth of Nations" in 1776. In his book, he stated that the main purpose of all economic activities is to gain maximum wealth as possible.

2) Welfare Viewpoint -
Alfred Marshall, associated the term economics with man and his welfare. He wrote a book "Principles Of Economics" in 1980. In his book he stated that economics is a science of welfare. According to him, "Economics is a study of mankind in the ordinary business of life, it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing."

3) Scarcity Viewpoint -
Lionel Robbins defined economics as a science of scarcity or choice in his book "An Essay on the Nature and Significance of Economic Science" which was published in 1932. According to him "Economics is the science which studies human behaviour as a relationship between ends and

scarce means which have alternative uses." The definition provides three basic features of existence of human beings, namely unlimited wants, limited resources, and alternative uses of limited resources.

4) Growth Viewpoint –
Indicates the modern perspective of economics. The main contributor of this definition was Paul Samuelson. He provided the growth-oriented definition of economics. According to him, "Economics is a study of how men and society choose with or without the use of money, to employ scarce productive use resource which could have alternative uses, to produce various commodities over time and distribute them for consumption, now and in the future among the various people and groups of society." In his definition, he outlined three main aspects, namely human behaviour, allocation of resources, and alternative uses of resources. Therefore, his definition was similar to the definition provided by Robbins.

⇒ Nature Of Economics :

Some economists believed economics as a science, while other believed economics as a social science. Let us now discuss the nature of economics as follow -

- Economics as a Science -

It refers to the scientific nature of economi[cs]. Some economists believed that in economics a problem is solved by adopting a scienti[fic] approach, which involves collecting and analyzi[ng] data and making related laws and theories. Economics is considered as a science because there are similarities between the problem solving process of economics and science.

- Economics as a Social Science -

It implies that economics is a study of behaviour patterns of human beings. The basi[c] function of economics is to study how individu[als], households, organizations, and nations utilize their limited resources to achieve maximu[m] profit. This function of economics is termed maximizing behaviour or optimizing behaviour. In economics, optimizing behaviour refers to sele[c]ting the most profitable alternative from the available alternatives. Therefore, it can be sa[id] that economics is a social science that aim at studying human behaviour with respect to optimal allocation of available resources t[o] achieve maximum profit.

⇒ Scope Of Economics :

In short the scope of economics can be summarized in following points :-

* It studies the man in the ordinary business of life and how he earns his income and how he satisfies his wants.

* It is concerned not with individual actions but with social actions.

* It studies how wealth is produced with limited resources in order to satisfy human wants.

* It learns the problems arising out of multicipility of want and scarcity of resources which satisfy these wants.

* It learns the production, consumption, exchange and distribution.

The continuous growth in the subject matter of economics has led to divergent views about the scope of economics. It includes subject matter of economics, economics is a science or an art, or is it a positive or normative science.

⇒ Deductive Vs. Inductive Methods.

Economic models are the principles underlying the economic reasoning. Such methods are concerned with the scientific explanation of economics and the relation between different economic factors. Mainly there are 2 methods viz. Deductive method and Inductive method.

✶ Deductive Method:

Deductive method is typically known as analytical abstract or a priority technique. Deduction starts and continues from the generic to the specific whereas induction progresses from the specific to the broad. According to Gee Wilson, "By deduction in logic is meant reasoning or inference from the general to the particular or from the universal to the individual. Induction is the process of reasoning from a part to the whole, from particular to general or from the individual to the universal."

⇒ Advantages of Deductive Method :-

i) Absence of bias
ii) Lack of restricted experiments
iii) Efficiency
iv) Universal application
v) Complementary
vi) Prediction
vii) Accuracy
viii) Convenience

☆ Inductive Method :

Inductive method or Inductive reasoning is the widely accepted method in economics for deriving conclusions. As we know, economics is a social science. The only way to study the spending habits of a particular society is to collect the spending data of each individual. After analyzing those data, you can make generalizations about the spending habits of the society. This process is known as inductive reasoning.

⇒ Types of Inductive Method :

There are two types of inductive method, namely experimental method and statistical method.

i) Experimental Method -
This method is helpful to validate the laws or generalizations obtained using the deductive method.

ii) Statistical Method -
Under this method, the researcher collects the statistical data first. Then he or she analyzes the data and makes generalizations.

⇒ Advantages of Inductive Method -

* It can be employed to verify the conclusions of economic theory formulated by the deductive method.
* The findings attained by ~~by~~ inductive reasoning are typically examined based on data.
* The generalizations arrived through this approach tend to be more trustworthy compared to other methods.

⇒ Static and Dynamics Economics :

✲ Static Economics :

The word 'static' has been taken from physical science. It points to a position of complete rest. In other words, by static is meant a position where there is the absence of any movement. But the concept of statics has its different meaning in economics. It does not point to a position of complete rest or no movement.

In economics, the concept of static refers to a situation where there is a movement. But this movement is continuous, certain, regular and constant. Static economics does not deal with the unexpected changes. It studies only the expected economic activities. There are no windfall changes or fluctuations in economic activities. According to Prof Harrod, "An economy in which rates of output are constant is called static."

⇒ Features of Static Economics :

i) No change in the population and its composition.
ii) No change in the quantity of capital.
iii) No change in the technique of production.
iv) No change in the working and organization of industrial units.
v) No change in the habits, tastes and fashion of the people, i.e. the wants of people remain the same.

★ Dynamics Economics :

The concept of dynamics is derived from Physics. It refers to a state where there is a change such as movement. But it has a different meaning in economics. Dynamics refers to that movement which is uncertain, unexpected and irregular.

According to Prof. Harrod, "Economic dynamics is the study of an economy in which rates of output are changing."

⇒ Features of dynamics economics -

i) In a dynamic economy, population grows.
ii) Quantity of capital grows.
iii) Modes of production improve.
iv) Industride institutions undergo changes. Inefficient organizations are replaced by efficient organizations.
v) Habits of the people, fashions and customs changes, as wants of the people increase.

⇒ Scope & Importance of Dynamic Economics -
i) Study of Time Element
ii) Trade cycles
iii) Basis of many economic theories
iv) More flexible approach
v) Realistic approach.

Economic Problems :-

The economic problem - sometimes called the basic or central economic problem - asserts that an economy's finite resources are insufficient to satisfy all human wants and needs. It assumes that human wants are unlimited, but the means to satisfy human wants are limited. Economy problem is the problem of rational management of resources or the problem of optimum utilisation of resources.

Scarcity and Choice :

The Problem of Scarcity -

We live in a world of scarcity. People want and need variety of goods and services. This applies ~~equally~~ to the poor and the rich people. It implies that human wants are unlimited but the means to fulfil them are limited. At any one time, only a limited amount of goods and services can be produced.

This is because the existing supplies of resources are extremely inadequate. These resources are land, labour, capital and entrepreneurship. These factors of production or inputs are used in producing goods and services that are called economic goods which have a piece. These facts explain scarcity as the principal problem of every society and suggest the Law of scarcity, the law states that human wants are virtually unlimited and the resources available to satisfy these wants are limited.

☆ The Problem of Choice -

Since we live in a world of scarcity, a society can produce only a small portion of goods and services that its people want. Therefore, scarcity of resources gives rise to the fundamental economic problem of choice.

A decision to produce one good requires a decision to produce less of some other good. So choice involves sacrifice. Thus every society is faced with the basic problem of deciding what it is willing to sacrifice to produce the goods it wants the most. The sacrifice of the alternative in the production of a good is called the opportunity cost.

⇒ Central Problems of an Economy :

There are few main categories of choices that a society must make

1. What to goods & services produce and in what quantities?
2. How to produce these goods & services?
3. For whom to produce them?
4. How efficiently are the resources being utilized?
5. Is the economy growing?

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✡ Circular flow of Economic Activities :-

The all pervasive economic problem is that of scarcity which is solved by three institutions of an economy, they are household (or individuals), firm and government. They are actively engaged in three economic activities of production, consumption and exchange of goods and services. These three institutions act and react in such a manner that all economic activities move in a circular flow.

⇒ There are two types of economy :

1) Closed Economy -
An economy in which no activity is conducted with outside economies. It is self-sufficient meaning that no imports are brought in and no exports are sent out. The goal is to provide consumers with everything that they need from within the economy's border.

2) Open Economy -
An economy can have transactions with foreign economies, therefore, an economy can spend more than it produces domestically, by importing from abroad or it can spend less. All output is sold domestically, and expenditure is divided into three components - consumption, investment, & government purchases, than it produces and sell the difference to foreign countries.

The Circular flow in a Two-Sector Economy

In a simplified economy with only two types of economic agents (institutions), households or consumers and business firms. The circular flow of economic activity is shown in given figure -

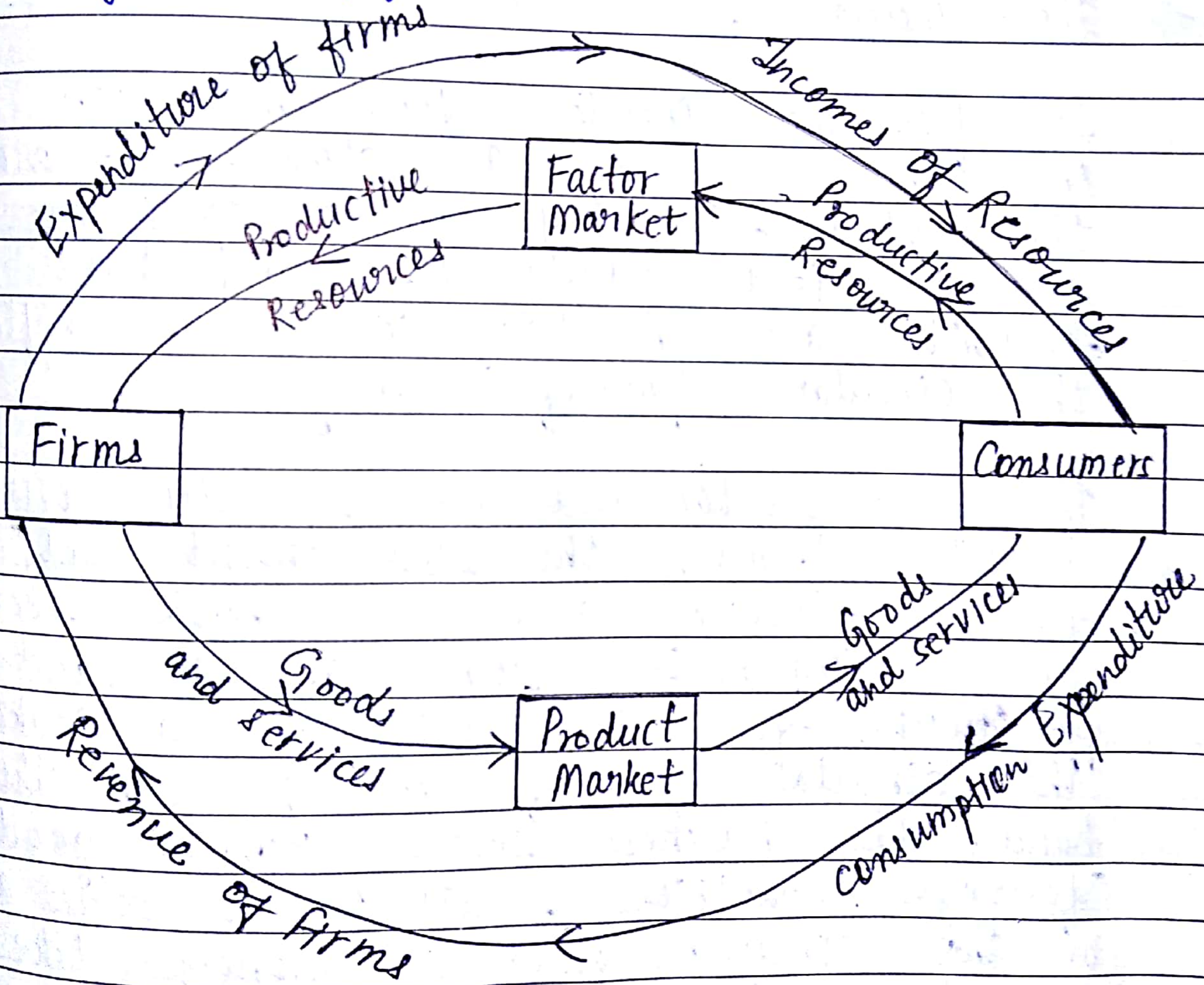

Figure : Circular flow in a Two-Sector Economy

⇒ The Circular flow in a Three-Sector Economy -

The circular flow in a three-sector economy includes consumers, business firms and the Government. For this, we add taxes and government purchases (or expenditure) in our presentation. Taxes are outflows from the circular flow and government purchases are inflows into the circular flow.

⇒ The Circular flow in a Four-Sector Economy -

So far the circular flow has been shown in the case of a closed economy. But the actual economy in an open one, where foreign trade plays an important role. Exports are an injection or inflows into the circular flow of money.

The four sector economy includes consumers, business firms, the Government and the foreign sector. The household sector buys goods imported from abroad and makes payment for them which is a leakage from the circular flow of money. On the other hand, the business sector exports goods to foreign countries & its receipts are an injection in the circular flow of money. Like the business sector, modern governments also export and import goods and services, and lend to and borrow from foreign countries.

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National Income :-

In simple terms, national income is the money value of goods and services produced in an economy within a given period of time.

⇒ **Concept Of National Income :**

In general terms, national income can be defined as the total money value of goods and services produced by a country in a particular period of time. The duration of this period is usually one year.

According to National Committee appointed by the Government of India in 1949, "A national income estimate measures the volume of commodities and services turned out during a given period of time counted without duplication."

⇒ The significance of national income is explained in the following points –

* Reflects the overall performance of an economy.
* Represents the standard of living of people.
* Helps in determining the contribution of different sectors.
* Helps in comparing the standard of living of different countries.
* Helps in determining total consumption, savings and investment in an economy.

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⇒ Measurement of National Income –

National income can be defined by taking three viewpoints, namely production viewpoint, income viewpoint, and expenditure viewpoint. Based on these viewpoints, thre are three different methods of estimating national income which are shown in figure –

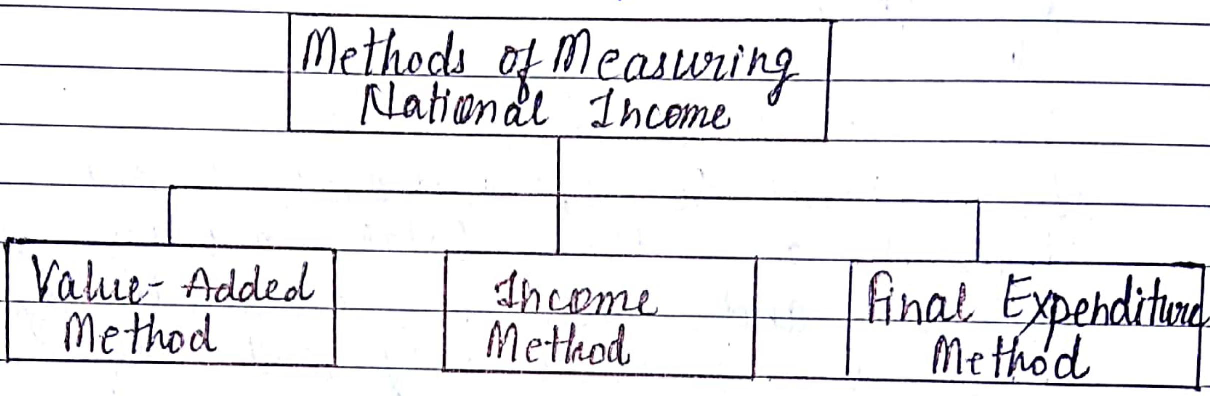

figure: Different Methods of measuring National Income

1) **Value-Added Method :**

The national economy is considered as an aggregate of producing units combining different sectors such as agriculture, mining, manufacturing, trade and commerce ect. The entire national economy is considered as an aggregate of producing units.

2) **Income Method :**

The whole national economy is viewed as a combination of individuals and households owning different kinds of factors of production which they use themselves or sell factor-services to make their livelihood. The national economy is considered as combination of factor-owners and users.

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Final Expenditure Method -
National economy is viewed as a collection of spending units. The national economy may also be viewed as a collection of consuming, saving and investing units (individuals, households and government).

National income comprises a number of inter-related concepts, such as gross national product, gross domestic product, and net national product. These concepts form the basis of understanding the theory of national income. These concepts are as follows-

1) Gross National Product :
Gross National Product (GNP) is defined as the total market value of all final goods and services produced in a country during a specific period of time, usually one year. It measures the output generated by a country's organizations ~~based~~ located domestically or abroad.

2) Gross Domestic Product :
Gross Domestic Product (GDP) refers to the market value of final goods and services produced in a country in a given time period. It includes income earned by foreign players locally minus income earned by national players in abroad.

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3) Net Domestic Product :

Net Domestic Product (NDP) is equal to GDP minus depreciation. GDP indicates the gross availability of final goods, whereas NDP shows the net availability of final goods after deducting depreciation.

NDP = GDP − Depreciation.

4) Net National Product :

Net National Product (NNP) is equal to GNP minus depreciation. It indicates the net output available for the consumption by society where society includes consumers, producers and government. NNP is the actual measure of the national income. If NNP is divided by the population of the country, then it gives per capita income in an economy.

5) Personal Income :

Personal Income can be defined as the sum of income actually received by individuals or households from different sources in an economy during a given period of time.

6) Disposable Income :

Disposable income refers to the part of personal income, which is left after the payment of tax and property tax to government.

It is calculated as–

Disposable Income = Personal Income − Personal Taxes

or Disposable Income = Consumption + Saving