INTRODUCTION TO ECONOMICS

Economics

- Economics is derived from two Greek words
- Oikos- a house
- Nemein- to manage
- Means “managing an household”

Emphasis	**Significant contribution**
Wealth	Adam Smith
Welfare	Alfred Marshall
Scarcity	Lionel Robbins
growth	Paul Samuelson

Definitions

Adam smith (1723 - 1790),

Father of Economics

- Book “An Inquiry into Nature and Causes of Wealth of Nations” (1776)
- defined economics as the practical science of production and distribution of wealth.

Alfred Marshall (1842 - 1924) wrote a book “Principles of Economics” (1890)

- Welfare definition
- defined “Political Economy” or 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 well being”.

- Lionel Robbins (Scarcity definition)
- book “An Essay on the Nature and Significance of Economic Science” in 1932.
- According to him, “economics is a science which studies human behaviour as a relationship between ends and scarce means which have alternative uses”
- Ends – human wants
- Means – resources with which wants are fulfilled

Prof. Paul Samuelson (Growth definition)

- defined economics as “the study of how men and society choose, with or without the use of money, to employ scarce productive resources which could have alternative uses, to produce various commodities over time, and distribute them for consumption, now and in the future among various people and groups of society”

SCOPE OF ECONOMICS

- Economics - A Science and an Art
- Economics - A Social Science
- Economics is both positive and normative science.

Economics as Science

- Economics is a systematic study of knowledge and facts. All the theories and facts related with both micro and macro economics are systematically collected, classified and analyzed.
- Economics deals with the correlation-ship between cause and effect. For example, supply is a positive function of price, i.e., change in price is cause and change in supply is effect.
- All the laws in economics are also universally accepted, like, law of demand, law of supply, law of diminishing marginal utility etc.
- Theories and laws of economics are based on experiments, like, mixed economy too is an experimental outcome between capitalist and socialist economies.
- Economics has a scale of measurement. According to Prof. Marshall, ‘money’ is used as the measuring rod in economics.

Economics as Art

- Art is the practical application of knowledge for achieving particular goals. Science gives us principles of any discipline however, art turns all these principles into reality. Therefore, considering the activities in economics, it can claimed as an art also, because it gives guidance to the solutions of all the economic problems.

Positive Science

- ??????????
- It only describes what it is
- Positive science does not indicate what is good or what is bad to the society.
- It will simply provide results of economic analysis of a problem.
- A positive statement is based on facts.

Normative science

- It makes distinction between good and bad.
- It prescribes what should be done to promote human welfare.
- A normative statement involves ethical values.
- Policy making

Positive vs Normative

- How much will a new petrol tax raise the price of petrol?
- Will an increase in the minimum wage increase unemployment?
- Why the price of Pop corn is Rs 4.20 ?

- Should there be a new tax on petrol?
- Should there be an increase in the minimum wage?
- What should the price of Pop corn be?

Therefore, economics is a positive as well as normative science.

Introduction to Micro and Macro Economics

- The whole economic theory is broadly divided into two parts – Micro economics and Macro economics.
- These two terms were at first used by Ragner Frisch in 1933. But these two words became popular worldwide and most of the economist using nowadays.
- The term ‘micro’ and ‘macro’ were derived from Greek words ‘Mikros’ and ‘Makros’ meaning ‘small’ and ‘large’ respectively.
- So micro economics deals with the analysis of an individual unit and macro economics with economy as a whole.
- For example, in micro economics we study how price of goods or factors of production are determined. In macro economics we study what are the causes of high or low level of employment.

- So, according to Edwin Mansfield – "Micro economics deals with the economic behaviour of individual units such as consumers, firms, and resource owners; while macro economics deals with behaviour of economic aggregates such as gross national product and the level of employment.
- A. Smith, D.Ricardo, T.R. Malthus, J.S. Mill were mainly of micro economic nature. A. Marshall, A.C. Pigou were of macro – economic nature. But macro economics was developed and popularized only after Keynes in 1936.

Meaning of Micro - economics

- The term micro was originated from Greek word 'Mikros' which means small.
- Hence, microeconomics is concerned on small economic units like as individual consumer, households, firms, industry etc.

Use or Importance of Micro – Economics

The importance of micro – economics can be analyzed on the basis of following headings:

1) <u>Efficient allocation of resources</u>:

- **Microeconomics also concern about how a consumer** and producers allocate available limited resources in various aspects so that the consumer will be able to maximize the level of satisfaction and the producers will be able to maximize output.
- As for example, the consumer will be able to maximize satisfaction.
- **When, $MU_x/P_x = MU_y/P_y$ Or, $MU_x/MU_y = P_x/P_y$**
- **Similarly, the process will be also to maximize output when,**
- **$MP_x/P_x = MP_L/P_L$ Or, $MP_x/MP_L = P_x/P_L$**

Where,

MUx = Marginal utility of commodity x

MUy = Marginal utility of commodity y

Px = Price of commodity x, Py = price of commodity y

MPx = Marginal productivity of capital

MP_L = Marginal productivity **of labor**

Px = price of capital(interest rate), P_L = Price of labor(wage)

2. To understand the working of market economy:

- We know that in case of market economy there is very less role of the government and the market forces i.e. demand and supply are responsible for determining every economic variable.
- Micro economics also believe that in market economy demand and supply play vital role.
- Hence, with the study of microeconomics, we will be able to understand how an economy without the role of government will run.

3. To provide tools for economic policies:

- Microeconomics is highly helpful in the formulation of economic policies that will promote the welfare of the society.
- It gives tool and foundations for analysis of economic policy.
- The economic policy directly affects the economy and which leads to change in allocation of resources.
- Thus, the policy related to tax, loans, price, demand and production etc. are based on the microeconomic analysis.
- The price theory provides analytical tools for economic policies affecting price and production.
- In this way, microeconomics assists private sectors as well as government to make best use of scare resources.

4) **To examine the condition of social and economic welfare**:

- The normative price theory is called welfare economics. Welfare economic studies welfare of the people as producers and consumers.
- It suggests possible ways of improving welfare of people. It helps to avoid waste and bring more social welfare .
- It defines and analysis the rules of economic efficiency or micro economics help in suggesting ways and means of eliminating wastages in order to bring maximum social welfare.

5) **Helpful in international trade** :

- Every economy depends on the economy either for goods, services, technical knowledge or marginal skills.
- Micro economics tells us how two or more than two economy can gain from international trade.
- It is the relative elasticity's of demand and supply between the two countries which are the basis of determining trade .
- More over, the exchange rate determination between the two countries also depends upon the micro economic instruments of demand and supply.

6) Useful in Business Decision -Making:

- It helps business executives in the attainment of maximum production by the given amount of resources.
- With the help of microeconomics, business firm can make decisions in demand analysis, cost analysis and methods of calculating prices.
- The main areas in which microeconomics is helpful in business decision making are:

a) Pricing Policy:

- Microeconomics examines the basic economic policies.
- It analyze the condition of demand, supply, elasticity of demand, consumer behaviour etc. which are the main variables of price determination.
- Thus, with the help of these variables businessman determine the price of product.

b) Optimal allocation of resources:

- Microeconomics studies about the optimum allocation of scarce resources and which helps to the business firm to select efficient and least cost production technique.
- Similarly, it helps to determine what to produced, how to produced and for whom to produced.

c) Optimal production decision:

- Business firm use the various methods and technique of production.
- However, they have continuously faced the problem of appropriate technique and method of production.
- Because, the resources like, labor, capital is limited.
- Microeconomics provides powerful tool for managerial decision making in the solution of such problems and maximization of output in the production process.

d) <u>Demand analysis and forecasting</u>:

- Demand analysis theory can be a source of many useful insights for business decision making.
- The fundamental objective of demand theory is to identify and analyze the basic determinants of consumer needs or wants.
- On the basis of this analysis a businessman forecast a future sales or demand which is essential before making production schedules of employing resources.
- The forecast helps the manager to expand the market and raise profits.

e) <u>Analysis of cost of production</u>:

- Microeconomics analyzes the different types of cost, factors determining cost and way of minimizing the cost of production

➢ On the basis of these analyses business men estimate the cost of production before making the production decision.

Macro –Economics (meaning and definition

❖ The term macro- economics is derived from Greek word " Makros", which means " big".

❖ Hence, macro- economics studies not individual units but all the units combined together or the economy as a whole.

❖ Since it studies the economy in aggregate. It studies national income, national output, general price level, total employment, total savings, total investment and so on.

❖ It is also called "aggregate economics" or the "income theory".

Difference between microeconomics and macroeconomics

Micro and macroeconomics differ as follows

1) <u>Nature of the study of Economic Units</u>:

- **Microeconomics studies the individual or small economic variables of the economy such as individuals consumption, saving investment and income, but macroeconomics deals with aggregates like national income, full employment and price level.**

2) <u>Objectives</u>:

- **Microeconomics studies principles, problems and policies concerning the optimum allocation of resources whereas macroeconomics studies the problems, policies and principles relating to full employment and growth of resources.**

3) <u>Subject Matter</u>:

- **The subject matter of microeconomics deals with the determination of price, consumer's equilibrium, distribution and welfare, etc, whereas the subject matter of macroeconomics studies full employment, price level, national income, trade cycles, etc.**

4) Methodology:

- Micro laws such as the law of demand and the law of supply become valid on assumptions i.e. other things being equal. This method of study is also known as the 'partial equilibrium analysis'.

- In macroeconomics, economic variables are categorized into aggregate units like aggregate demand, aggregate supply, total consumption, price level, total saving, etc.

- The total effect of an economic factor on the economy is taken in to account in macroeconomic analysis. This method of study is called 'general equilibrium analysis'.

5) Components of Equilibrium:

- Microeconomics studies the equilibrium between the forces of market demand and supply. Hence, the basis of microeconomics is the price mechanism.
- On the other hand, macroeconomic analysis deals with the national income output, employment, etc, an such economic variables are determined at the point of equilibrium established between the forces of the whole economy (i.e. aggregate demand and aggregate supply).

6) Static and Dynamic Analysis:

- Microeconomics studies the equilibrium at a particular point of time. It does not explain the time factor. Hence, microeconomics is regarded as the static analysis.

- On the other hand, macroeconomics is based on time lag, rate of change, past and expected value of variables. Hence, macroeconomics is regarded as the dynamic analysis.

7) <u>Solution of Current Issues and Problems</u>:

- The study of microeconomics does not help to solve the important current issues and problems such as decline in national income, hyper inflation, widespread unemployment and so on.
- On the other hand, macroeconomics studies the causes, effects and possible measures for the solution of these issues and problems. Thus, macroeconomics helps to solve these problems.

Wealth

- It refers to those scarce goods which satisfy our wants and which have money value.
- **Characteristics of Wealth**
  - It must possess utility i.e. it must have the power to satisfy a want.
  - It must be limited in supply.
  - Wealth should be transferable
  - It must have money value
  - It may be external. For example, the goodwill of a company is external wealth

  Utility, scarcity and transferability are thus important characteristics of wealth
- **Classification of Wealth**
  - Wealth may be classified into a) personal wealth (individual wealth), b) social wealth (collective wealth), c) national wealth (a + b) and d) cosmopolitan wealth (e.g. ocean).

Goods and Services

- In economics, goods are materials that satisfy human wants and provide utility, for example, to a consumer making a purchase of a satisfying product.

- Services: A type of **economic** activity that is intangible, is not stored and does not result in ownership. A **service** is consumed at the point of sale.

Types of goods:

- **1) Economic goods and Free Goods:**

  Free goods are those goods that exist in such plenty that can be used as much as we like. They are gift of nature and used without payment e.g. Air, sunshine etc. with out payment e.g. Air, sunshine etc

  The economic goods, on the other hand, are scarce and can be had only on payment. They are limited and generally man made and hence those can be available only on payment. In Economics, we are concerned with economic goods. Economic goods mean wealth. Thus there would have been no science of economics if all goods had been free goods. The distinction between free goods and economic roods, of course is not permanent, for instance air is free goods but when we receive it under fan it is economic goods.

- **2) Consumption Goods and Capital Goods:**

  Consumption goods are those which yield, satisfaction directly. They are used by consumer directly to satisfy the wants e.g. food, clothing, etc. (First order goods).

  Capital goods are these goods which help us to produce other goods e.g. machinery, tools etc. They are also termed as second order goods. Similarly some goods especially raw materials are called as intermediate goods. For instance machinery fixed in factory is capital gods but the cotton used as raw material is intermediate goods. Thus, the consumption goods are also referred as consumer's good while capital goods and intermediate goods are termed as producers goods.

- **3) Material Goods and Non - material Goods:**

  Material good are concrete in nature e.g. building, furniture, books etc.

  While different services a human being is using called non material services. E.g. services of teachers, Doctor, advocate etc.

- **4) Transferable and Non Transferable Goods:**

  Most of the material goods can be transferable. Here transferable means change in ownership e.g. land, vehicle etc.

  On the contrary non-transferable goods referred to personal qualities like skill, intelligence etc. which never be transferred.
- 5) **Personal and Impersonal Goods:**

  Personal goods refer to personal qualities of a person and they are non material and exist inside him e.g. skill, intelligence etc. They are also called as internal goods.

  The impersonal goods are generally material goods and not personal goods. For example land furniture, vehicle etc. They are external and lie outside and hence they are also called external goods.

  In short, personal goods indicate "what he is" and impersonal goods" What he has"
- 6) **Private Goods and Public Goods:**

  Private goods refer to individual property e.g. Building land, vehicle etc. which are possessed by an individual.

  The public goods like railway, roads, dams etc. are owned by society. They are common to all and owned by society collectively.
- 7) **Necessities and Luxuries:**
- 8) Intermediate and Final Goods

Types of Demand

- **1. Price demand:**
- Price demand refers to the different quantities of the commodity or service which consumers will purchase at a given time and at given prices, assuming other things remaining the same. It is the price demand with which people are mostly concerned and as such price demand is an important notion in economics. Price demand has inverse relation with the price. As the price of commodity increases its demand falls and as the price decreases, its demand rises.
- **2. Income demand:**
- Income demand refers to the different quantities of a commodity or service which consumers will buy at different levels of income, assuming other things remaining constant. Usually the demand for a commodity increases as the income of a person increases unless the commodity happens to be an inferior product. For example, coarse grain is a cheap or inferior commodity. The demand for such commodities decreases as the income of a person increases. Thus, the demand for inferior or cheap goods is inversely related with the income.
- **3. Cross demand:**
- When the demand for a commodity depends not on its price but on the price of other related commodities, it is called cross demand. Here we take closely connected or related goods which are substitutes for one another.

- **4.Direct demand:**
- Commodities or services which satisfy our wants directly are said to have direct demand. For example, all consumer goods satisfy our wants directly, so they are said to have direct demand.
- **5. Derived demand or Indirect demand:**
- Commodities or services demanded for producing goods which satisfy our wants directly are said to have derived demand. For example, demand for a factor of production (say labor) is a derived demand because labor is demanded to help in the construction of houses which will directly satisfy consumers' demand.
- **6. Joint demand:**
- In finished products as in case of bread, there is need for so many things—the services of the flour mill, oven, fuel, etc. The demand for them is called joint demand. Similarly for the construction of a house we require land, labor, capital, organization and materials like cement, bricks, lime, etc. The demand for them is, thus, called a 'joint demand.'
- **7. Composite demand:**
- A commodity is said to have a composite demand when its use is made in more than one purpose. For example the demand for coal is composite demand as coal has many uses—as fuel for a boiler of a factory, for domestic fuel, for oven for steam-making in railways engine, etc.