INTRODUCTION OF ECONOMICS

Economics

The term *economics* is derived from the ancient Greek word *oikonomia,* which means "management of a household".

Adam Smith defined economics "as the study of the nature and causes of the generation of wealth of a nation". The subject matter of economics has been divided into two parts: Microeconomics and Macroeconomics. These terms were first coined and used by **Ragnar Frisch** and have now been adopted by economists all over the world.

Microeconomics

Microeconomics occupies a vital place in economics and it has theoretical and practical importance.

It is microeconomics that tells us how a free-market economy with its millions of consumers and producers works to decide about the allocation of productive resources among thousands of goods and services.

Microeconomics analysis is also usefully applied to the various applied branches of economics such as Public Finance and International Economics.

Macroeconomics

Macroeconomics analyses the behaviour of the whole economic system in totality or entirety, such as total employment, national product or income, the general price level in the economy. Therefore, macroeconomics is also known as **"aggregative economics".**

Microeconomics vs Macroeconomics

In short, macroeconomics studies the functioning of the economy as a whole and microeconomics analyses the behaviour of individual components like industries, firms and households.

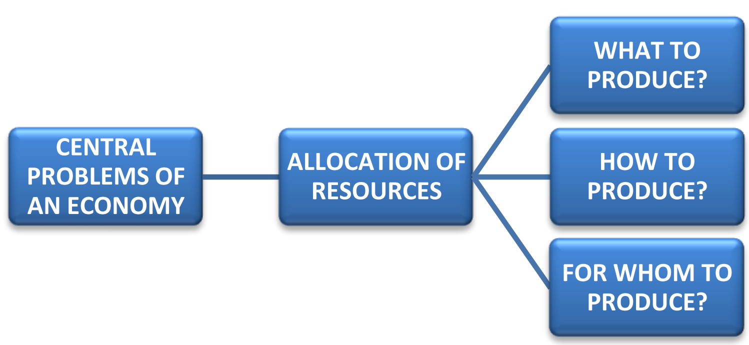
Thus, microeconomics deals with the theory of the firm and the behaviour and problems of individuals and firms. It is concerned with pricing theory, demand concepts and theories of market structure.

Macroeconomics is concerned with such economic variables as the aggregate output of an economy, the extent to which the resources are employed, the level and determination of national income, balance of payments, etc.

Central problems of an economy

To put it simply, **choice problem** is the central problem of an economy. Scarcity of resources having alternative uses in relation to demand for them gives rise to choice problem. Every society has to decide how much each of the resources is to be used in the production of different goods and services. Thus, **allocation of resources** is the fundamental problem. Related to it are the following three central problems faced by every economy:

(i) What to produce
(ii) How to produce
(iii) For whom to produce



(i) What to produce and in what quantity

It is the problem of choosing which commodities should be produced and in what quantities. Food or clothes? More food and less clothes or *vice versa*? Wheat or sugarcane? More butter or more tanks? In case of more tanks, some resources will have to be diverted from butter, but the economy cannot have more tanks and more butter at the same time. Society has to choose between consumer goods (e.g., clothes, shoes, sugar, wheat) and producer goods (e.g., tools, machines, trucks); between necessity goods and luxury goods. Besides, all goods cannot be produced as the resources are limited. Here, the guiding principle is to allocate resources in a *way that generates maximum aggregate utility.*

(ii) How to produce

It is the problem of choosing the method or technique of production. This arises because a commodity can be produced in more than one method: more labour and less capital or *vice versa* (i.e. labour-intensive technique or capital-intensive technique); large-scale production or small-scale production. For instance, a given amount of wheat can be produced either by using more land and less capital (manure, seeds, tubewell, etc.) or less land and more capital. Similarly, a given quantity of clothes can be manufactured by combining factors of production in different proportions, making it capital- intensive or labour-intensive. The guiding principle in such cases is to adopt those techniques which **involve the least possible cost** to produce per unit of commodity. At macro level the most efficient technical method is the one which uses the least amount of scarce resources.

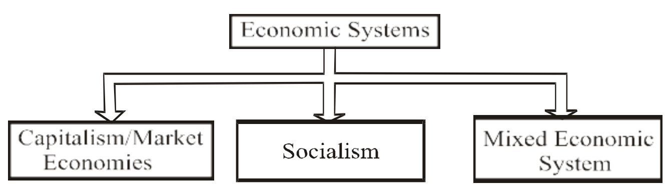
(iii) For whom to produce

It is the problem of distribution of income among factors of production which help in production. Who will consume the goods and services produced? A few rich and many poor or *vice versa*. Goods and services are produced especially for the people who can purchase them. And purchasing power depends upon their income, which, in turn, depends mainly on the distribution of income from output among factors of production which help to produce it.

It may be noted that the above problems are not separate or independent of each other, but are the different forms of the same basic problem, namely, to make a choice among alternative uses of scarce resources to obtain maximum satisfaction.

Economic Systems

An economy refers to an organisation through which people earn their living. An economic system refers to those norms and rules or institutions which direct an economy.



Invisible Hand in Capitalism or Market Economy

Capitalism is a system in which economic relations are directed through the principle of free play of market forces. Which is why capitalism is often characterised as 'market economy'. Producers and consumers are free to exercise their choices. There is no central authority to direct the economy. Instead, the economy is self-driven through an invisible hand or through the free play of the forces of market demand and market supply.

Characteristic Features of Capitalism

1. **Private Property:** In market economies people have the right to hold and use private property in any

manner they like. This right of the people is protected by the government. All means of production, namely, machines, tool, land, mines, etc., are owned privately. Capitalists are free to hold and expand their capital to any extent. They also enjoy the freedom to buy or sell any property. They can enter into any contract in respect of their property. On the death of a person, his property passes on to his successors. Freedom of the people to use their private property is subject to the law of the land.

2. **Price Mechanism:** Price mechanism is the principal guiding mechanism that guides the producers and consumers in their decision-making. Price mechanism refers to relative price structure determined by the interaction of the forces of demand and supply without any external interference. **Price mechanism helps producers to decide what to produce and how much to produce, how to produce and for whom to produce.**

3. **Freedom of Enterprise:** Every individual is free to use his means of production in any manner he likes. He may set up any business or industry of any size at any time and place. In other words, an entrepreneur can take independent decisions with regard to what, where and how much to produce.

4. **Competition and Cooperation:** Because of freedom of enterprise there are a large number of producers of almost every commodity. These producers compete with one another. Buyers compete with one another in order to buy a given product. In the factor market, workers compete for jobs. On the other hand, there is cooperation. It is through the cooperation of workers (or through their cooperative efforts) that inputs are converted into outputs, resulting in value addition.

5. **Profit Motive:** The desire to earn profit is the chief motive of undertaking production activity. Every value-addition activity is prompted by profit. Entrepreneurs engage themselves in those enterprises which are likely to yield maximum profits.

6. **Sovereignty of the Consumer:** Under market economies, consumer is a sovereign. The entire production structure is oriented to fulfil consumers' demands.

7. **Labour as a Commodity:** Like any other commodity, labour is bought and sold in the factor market. Labour becomes a commodity because people, deprived of the means of production, are unable to make use of their own labour; they are compelled to sell their labour to earn their livelihood.

8. **Self-interest:** In market economies, self-interest is the principal guiding force. By self-interest we mean the urge to maximise personal welfare.

Central Planning in Socialism or Command Economies

These are economies in which resources (or means of production) are collectively owned by the society as a whole, and there is a central authority to decide about the allocation of resources with a view to achieving maximum social welfare along with equitable distribution of income. In such economies, the state plays the central role in directing all economic activities in a manner such that all members of the community get equal opportunities of participating in the process of growth and enjoying the fruits thereof.

Characteristic Features of Command Economies

1. **Social or Collective Ownership:** All means of production are socially owned. No individual can keep capital at will in the form of machines, factory premises, etc. Government represents the society under this system and uses the means of production as it deems fit.

2. **Central Planning Authority:** Under this economic system, government appoints a central planning authority to decide about what to produce, how much to produce, how to produce and for whom to produce. It undertakes detailed survey of the country's available physical and human resources and formulates an exhaustive plan for achieving the set objectives.

3. **Set Objectives:** It is not a purposeless economy; rather it has set objectives before it. These objectives are fully endorsed by the society and efforts are made to achieve them according to plans. The social and economic objectives relate to rapid industrialisation, high standard of living, full employment and social equity.

4. **Economic Planning:** Economic planning is of central significance in command economies. Objectives are comprehensively considered and specified in the light of the given resource power of the nation. Efficient allocation of the scarce means to alternative uses is taken as the supreme goal, and efficiency is defined not in terms of maximisation of profits but in terms of maximisation of social welfare.

5. **Government Control:** Plans are formulated and enforced strictly under government control. The central planning authority formulates the plan and forwards it to the government for implementation. Every economic activity, i.e., exchange, distribution, consumption, investment, prices, and foreign trade is fully controlled by the government.

A Critical Mix in Mixed Economies

These are economies where market forces (or the forces of supply and demand) are free to operate but not without 'watch and ward' by the state or some central authorities. Unlike communism, it is not a consciously created system focusing on equality and social justice. Also, unlike free economies, it is not a spontaneous economic order where all economic decisions are taken in pursuit of self-interest. Instead, a mixed economy is a midway between command economies and free economies. It is an economy in which the choice is not between self-interest or social interest but between 'how much of self-interest' and 'how much of social interest'. Both self- interest and social interest are simultaneously pursued.

Characteristic Features of Mixed Economies

1. **Co-existence of the Private and the Public Sectors:** The most important feature of a mixed economy is that under it both public and private sectors work hand in hand. Industries of national importance like basic industries, arms and ammunition industries, power generation, etc. are set up in the public sector. Consumer goods industries, small industries, agriculture, etc., are left in the domain of the private sector. It is like a PPC model (Private Public Co-operation model) which serves as the undercurrent of growth and development.

2. **Directive Planning and Government Control:** It is the endeavour of the government to launch democratic plans with a view to giving the desired direction to the process of growth and development. These plans aim at progressive development of both public and private sectors.

3. **Private Property and Economic Equality:** Under mixed economy, people are free to acquire private property. But, in the interest of equitable distribution of wealth and income in the country, the government adopts suitable measures to combat concentration of wealth in the hands of a few people. Government imposes various taxes on richer sections of the society (of course, on progressive basis) and offers subsidy to poorer sections of the society with a view to promoting equity and social justice.

4. **Regulated Price Mechanism:** Under mixed economy, one finds free-play price mechanism but not without government intervention. Prices of goods are by and large determined by market forces, but prices of social goods are fixed by the government. It is a situation of regulated price mechanism.

5. **Profit Motive and Social Welfare:** Production is undertaken not exclusively to maximise profits or to maximise social welfare. Rather, it is a critical mix of both profit maximisation and welfare maximisation, which govern production decisions. Competition is promoted, but concentration (of economic power) is not allowed.

Positive and Normative Economic Analyses

Positive economic analysis: Positive economic analysis deals with the things ***'as they are'***. It 'studies the actuals' as they are and not what is desirable. It analyses the cause-and- effect relationship involved in the actuals and remains strictly neutral and silent with regard to ends. The ethics of economic decisions are not touched. Examples are: 'India is over- populated' or 'Prices have been rising in India' or 'Increase in real per capita income raises the standard of living of the people'. It may be mentioned that ***Prof. Robbins*** considered economics as purely a positive science.

Normative economic analysis: It deals with things as ***'they ought to be'***. It tells how the economic problems should be solved. In other words, it passes moral judgements expressing good or bad aspects of economic decisions. Thus, Examples of normative economic analysis are: 'Rich people should be taxed more' or 'Free education should be given to the poor' or 'Interest-free loans should be given to the poor farmers'. Needless to mention that ***Marshall*** regarded economics as a normative science which prescribes courses of action that achieve social goals.