Economics: An Introduction

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"Economy has frequently nothing whatever to do with the amount of money being spent, but with the wisdom used in spending it."

-- Henry Ford

1.1 Meaning of Economy

- Human being is a bundle of wants. In order to satisfy their wants, people earn livelihood, and in its pursuit **engage in production** of various goods and services.
- Production of goods and services, in turn, requires coordination among different **factors of production** (Land, Labour, Capital, and Entrepreneurship) to produce the desired output.
- Since the list of goods and services that any individual needs is so large, no individual in society, to begin with, has all the things he/she needs. This necessitates **adoption of division of labour** and a system of **mutual exchanges**.
- In this way the activities related to earning of livelihood, production, consumption, and exchange becomes very essential in satisfaction of human wants.
- In order to perform all these activities there is a need of some kind of system, organisation, or structure, which we call **economy**.

An Economy is a system comprising **inter-related activities** of production, distribution, consumption, and exchange of goods and services, for **satisfaction of human wants**, through efficient allocation of **scarce** resources.

1.2 Central Problems of Economy: Meaning and Nature

- Human wants are **unlimited**, however, the resources to meet those wants are **limited** or **scarce**.
- This scarcity of means in relation to wants gives rise to the **'problem of choice'**.
- The scarce resources of an economy have competing usages, and thus, every society has to decide on which wants are to be fulfilled and how much resources are to be allocated among different wants.
- For this, every society has to make choices and it is this necessity of choice which gives birth to **'economic problem'**.

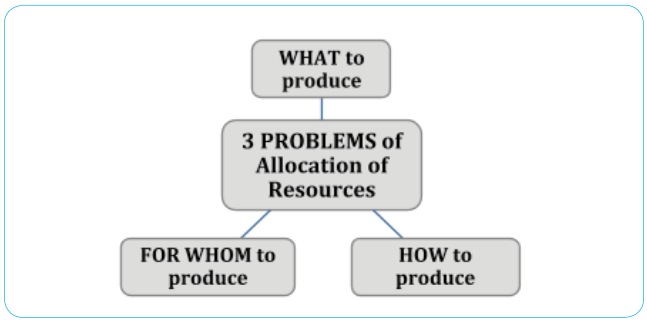
In other words, the **problem of choice** arising from the use of **limited means** (scarce resources, with competing uses) in **satisfaction of varying ends** (unlimited wants, having different priorities) is known as **economic problem**.

- The **three major problems** faced by an economy are:
  1. Problem of **Allocation** of Resources
  2. Problem of **Utilization** of Resources
  3. Problem of **Growth** of Resources

- It is to be noted that **central problems are universal in nature** and faced by all countries whether socialist, capitalist, or mixed economy, developed or underdeveloped economy, small or large economy.

1.2.1 Problem of Allocation of Resources

It further can be categorized into three other basic economic problems:



A. What goods and services shall be produced and in what quantities?

- For example, choice between consumption goods and capital goods, civil goods and military goods, mass-goods and luxury goods, private goods and public goods, agriculture goods and industrial goods etc.
- Every society can face problem of choice but with **different priorities**.
- In less developed economies the choice may be between production of food crops and manufacture of bicycles.
- In advanced economies the choice may be between building more shopping malls or producing more cars.

B. How shall goods and services be produced?

- For example, choice between labour intensive and capital intensive techniques.
- If goods and services are produced by employing more of labour and less of capital, it is known as **labour intensive** method of production.
- If goods and services are produced by employing more of capital (machinery etc.), it is called capital **intensive method** of production.

C. For whom goods and services are to be produced?

- It refers to the decision of how the total produce (or income/wealth) of the economy is **distributed among various individuals and factors of production**.
- For example, whether or not to ensure a minimum amount of consumption for everyone in the economy. Whether or not elementary education and basic health services should be available freely for everyone in the economy. Whose needs are to be addressed, the poorer people or the richer people?

1.2.2 Problem of Full Utilisation of Resources

Resources are scarce; hence, they must be used judiciously to give the maximum output.

- **Optimum utilization** of resources has the following implications:
  - All resources must be utilized, and
  - Resources must be used efficiently
- If these scarce resources remain **unutilized** or **under-utilised**, it is a wastage of such resources.
- For example, educated but unemployed people ie. resources are available but are not used. Growing only one crop in agricultural field in a year, ie. sub optimal use of the available resources.

1.2.3 Problem of Growth of Resources

With the growth of resources like land, capital and technology over a period of time, the problem of scarcity can be addressed.

- Growth of resources is a **prerequisite** for the growth of an economy.
- It will increase the standard of living of people and making a country developed from underdeveloped.
- This is the reason why all developed countries have availability of advanced technologies.

1.3 Economics: The Discipline

1.3.1 Defining Economics

- The term 'Economics' is derived from two Greek words *oikos* and *nemein*, meaning the rule/law or management of the household/family.
- Though there has not been a consensus among economists on an all-encompassing definition of economics, the following working definition of economics has been broadly accepted.

Economics can be defined as a **social science** concerned with how individuals, governments, firms

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and nations **make choices** regarding allocation of scarce resources among competing uses, to produce and distribute goods and services in satisfaction of unlimited human wants.

- **Thus, in a nutshell, economics studies the following:**
  - How individuals, firms, government, and other organisations within a society **make choices** and how these choices determine society's use of its resources.
  - How societies use scarce resources to **produce** valuable commodities and **distribute** them among different people.
- **Economics is a social science** because it enables a study into social behaviour of economic agents engaged in economic activities and helps analyse and understand social problems arising from interactions among them.
- Economics, thus, provides a logical way to look at problems, drawing upon history, philosophy and mathematics to solve issues such as how families, businesses and government can make sound financial decisions, how countries can reduce their unemployment rates, how to handle inflation etc.

1.4 Branches of Economics

Traditionally, the subject matter of economics has been studied under two broad branches:

1. Microeconomics
2. Macroeconomics

1.4.1 Microeconomics

- The word "micro" means very small. So, microeconomics implies study of economics at a **very small level**.
- In a society, comprising of many individuals collectively, every single individual makes just a small part. So, the economic decisions taken by a single individual become the subject matter of microeconomics.
- Thus, **Microeconomics** is the study of **individual actors'** behaviour (such as individual consumers, households and firms) in decision making and allocation of resources.
- It studies what **choices** people make, what **factors** influence their choices and **how** their decisions affect the markets by affecting the price, the supply, and the demand.
- For example, microeconomics examines how a company could maximize its production and capacity so that it could lower prices and better compete in its industry.

1.4.2 Macroeconomics

- The word "**macro**" means **very large**. So, the economic decisions taken at the level of the **economy as whole** are subject matter of macroeconomics.
- Thus, **Macroeconomics** is the branch of economics that studies the behaviour and performance of an economy as a whole. It is not concerned with analysis of individual units.
- It focuses on the **aggregate changes** in the economy such as total national income and output, total employment, aggregate demand and supply, balance of payment, general price level, aggregate investment and expenditure, money supply etc.
- For example, Macroeconomics analyses how an increase or decrease in net exports affects a nation's capital account, or how GDP would be affected by the unemployment rate.
- Government and corporations use macroeconomic models to help in formulating of economic policies and strategies.

1.4.3 Interdependence of Microeconomics & Macroeconomics

- The behaviour of a particular firm or consumer is dependent on the state of national and global economy. The prosperity and well-being of individual economic units can be ensured only when the performance of the whole economy is excellent.
- Similarly, every macroeconomic problem requires micro economic analysis for addressing the root cause of the issue.
- For example, increase in the taxes by the government are a macroeconomic decision but their impact on savings of an individual firm is microeconomic analysis.

1.5 Organization of Economic Activities

- Even though the **basic economic (central) problems** are fundamental and common to all the economies,

different economic systems try to solve them differently, and organise their economies accordingly.

- Organizing an economy means the way in which the means of production and distribution of goods are organized, such as under capitalism or socialism.
- Most economic activity in countries around the world **exists on a spectrum** that ranges from a pure free market economy to an extreme centrally planned (command) economy.

1.5.1 Capitalist or Market Economy

- A Capitalist economy (or market economy) is an economic system in which means of production are **privately owned** and economic activities are guided by **self-interest** and **profit motive**.
- The central problems in a capitalist economy are solved by **price mechanism**, that is, free market forces of demand and supply decide what is to be produced and in what quantities.
- The principle of market economy dictates that producers and sellers of goods and services will offer the highest possible price that consumers are willing to pay for goods or services. When the level of supply meets the level of demand, a **natural economic equilibrium** is achieved.
- **For instance**
  - If the buyers demand more of a certain good, the price of that good will rise.
  - This will send a signal to the producer of that good to the effect that the society as a whole wants more of that good than is currently being produced.
  - The producers of the good, in turn, are likely to increase their production.
  - In this way, prices of goods and services send important information to all the individuals across the market and help achieve coordination in a market system.
- **Competition** is present among producers, which keeps prices fair and ensures efficient production and supply.
- The government plays a **limited role** in a market economy, but performs a **regulatory function** to ensure fair play and less monopoly.
- The capitalistic form of economy has its origin in the famous work of Adam Smith, ***An Inquiry into Nature and Causes of Wealth of Nations*** (1776). Adam Smith propounded an economic system characterised by absence of government interference or '*Laissez Faire*'. According to him the **'invisible hand'** of the 'market forces' (price mechanism) will bring a state of equilibrium to the economy and a general well-being to the countrymen.

1.5.2 Centrally Planned or Command Economy

- In a centrally planned economy, all the means of production are owned and controlled by the **government** or a central authority, with the objective of **maximization of social welfare** rather than maximization of individual profit.
- The government takes **all important economic decisions** regarding production, exchange, distribution, and consumption of goods and services, keeping in view the general welfare of the society as a whole.
- The central problems under this economic system are solved by a central planning authority, the State, through the **mechanism of planning**.
- A centrally planned economic system has been more visible in socialist and communist economies of erstwhile USSR and China.
- Proposed and popularised by German Philosopher **Karl Marx**, it came in response to failure of capitalist market economy to ensure **distributive justice** and welfare to all the sections of society.

1.5.3 Mixed Economy

- A mixed economy is a system in which **both private and public sectors co-exist** and both operate under **general guidance** of an economic planning.
- The solution of central problems in a mixed economy is a **joint responsibility** of price mechanism and planning process. Here, the planning is not centralized planning but democratic planning.
- There is a certain level of economic freedom so that the private sector can decide the use of capital and seek profits.
- It simultaneously allows the government to intervene in some economic activities and industries. Some essential industries, such as national defense, public transportation, and package delivery, are partially publicly owned.
- Through providing public goods and collecting taxes, the government can create more social welfare.

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- Government uses its various policies e.g. licensing policy, taxation policy, price policy, monetary policy and fiscal policy to control and regulate the private sector
- The Great Depression of 1930s brought to fore a complete failure of 'invisible hand' of free market to self-correct itself, consequently, resulting in large scale unemployment, declining demand, wiping out of hard earned incomes, and massively failing economies.
- A new approach was needed which came in the famous work, ***The General Theory of Employment, Interest and Money*** (1936) by the British economist, **John Maynard Keynes**.
- The key plank of Keynesian economics was the assertion that aggregate demand—measured as the sum of spending by households, businesses, and the government—was the most important driving force in an economy.
- Keynes further asserted that free markets have no self-balancing mechanisms that can ensure full employment. Hence, to overcome the **weaknesses of market economy** government intervention through public policies was considered desirable in order to achieve full employment and price stability.
- In reality, all economies are mixed economies. The only difference is in terms of the extent of the role of the government in deciding the course of economic activities.

1.5.4 The Indian Case

- India, post-independence, opted for a **mixed economic model** after having assessed the merits of each system.
- However, Indian economy was inflicted with multitude of problems – poverty, unemployment, food shortage, inequality, stagnating agriculture and near absent industrial sector. Given the extreme fragility of economy, a need was felt for **direct state intervention**.
- Therefore, though a small private sector existed, State became omnipresent in all spheres of Indian economy, micromanaging sectoral activities and controlling and directing their outcomes towards accomplishment of planned developmental goals.
- As India embarked upon the path of **economic reforms (1991)**, Liberalisation, Privatisation, Globalisation (LPG) became the key words. The prevailing state-market mix was redefined and a new form of mixed economy began to be practised.
- The **New Economic Policy** envisioned an economy where private sector was given a substantial role and the State transformed from being a 'market regulator to a facilitator'.
- In fact, sectors such as power, telecommunication, defence, roads, natural gas and petroleum etc. that were once government monopolies, have were opened for private sector participation.
- The current call for **'maximum governance, minimum government'** bears a testimony to changing role of the government from that of 'rowing' to 'steering' the economy.

1.6 Sectors of Economy

1.6.1 Primary Sector

- It includes economic activities which involves **direct use of natural resources** – Agriculture, Animal Husbandry, Fishing, Forestry, Mining & Quarrying
- The primary sector utilizes the natural resources and produces raw materials and basic goods which may be used by the industries or by the end-users.
- It also serves as a basic sector assisting the growth of the secondary and tertiary sectors.
- Agriculture is the most important sector of India, providing employment to about 45% of the population.

1.6.2 Secondary Sector

- The Secondary sector consists of the **industrial sector** that includes manufacturing, electricity, fuel, and construction of finished goods and tangible products.
- The secondary sector performs the vital role of catering to the needs of potential consumers of the nation by providing finished manufactured goods.
- Availability of desired skilled manpower, necessary products and processes, and capital engineering has immensely contributed to India becoming a manufacturing hub at the global level.

1.6.3 Tertiary sector

- The tertiary sector is intangible in nature and is also known as the **services sector**.
- This sector consists of provision of services such as education, medical, hotel, insurance, transportation,

IT/ITeS, tourism, real estate and finance needed by the consumers.

- The services sector has been the **growth engine** for India's development, contributing nearly 55% the country's GDP.

1.6.4. Quaternary Sector

- The quaternary sector is said to be the **intellectual aspect** of the economy.
- It is also known as the **knowledge economy** – this is the component of the economy based on human capital – IT, knowledge and education.
- Quaternary sector includes education, training, development of technology, and research and development.
- It is primarily related to the service sector, but also is related to the high tech component of manufacturing.
- It enables entrepreneurs to innovate better manufacturing processes and improve the quality of services offered in the economy.
- Without this growth of technology and information, economic development would be slow or non-existent.

1.6.5 Quinary Sector

- The quinary sector is the part of the economy where the **highest-level of decisions** are made.
- This sector includes top executives or officials in fields such as government, science, universities, nonprofits, health care, culture, and the media.
- It may also include police and fire departments, which are public services as opposed to for-profit enterprises.

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