Axe №01: The Nature of Economics (DEFINITION & SCOPE OF ECONOMICS)

1- What is Economics? Economics is one of the social sciences. It explains about the economic activities of a man. Any activity which is related to earning or spending of money is called economic activity. Almost all people are engaged in economic activities, because they want to earn money.

The main economic problem is to transform society's resources into consumable commodities by using productive technology. It is a problem because human wants are unlimited and society's resources are limited. So the central task of economics is to decide how much of which commodities are to be produced for the optimum satisfaction of human wants.

1-1) Subject Matter of Economics: In economics, a want is something that is desired.

Want is the starting point of economic activity.

Wants leads to efforts. An effort leads to satisfaction.

Wants ⟶ Efforts ⟶ Satisfaction.

This is the subject matter of economics. This subject matter of economics is divided into four parts.

a) Production;

b) Exchange;

c) Distribution;

d) Consumption.

a) Production: In economics, Production involves the creation of goods and services by using resources. It is a process to change the raw materials into final/finished goods (creation of utility). To produce anything so many factors are essential. All these factors are classified into four categories. They are:

(a) Land

(b) Labour

(c) Capital

(d) Entrepreneurship or Organization Technique and Technology

b) Exchange: It means change of the goods from one person to another person. Once upon a time goods were exchanged for goods. It is called "Barter system" To overcome the Inconveniences in the barter system money was invented. Now the goods are exchanged for money. Price is essential for the exchange of goods for money.

c) Distribution (income): Distribution means sharing of the income among the factors of production. The total income which is generated by selling of these goods and services in the market must be distributed among the factors of production in the form of rent, wages, interest and profits. There are two types of distribution:

● **Micro distribution**: Micro distribution is nothing but pricing of factors of production. It means it explains how the price (rent) per unit of land is determined. In the same way how the price per unit of labour (wage) and capital (profit).

● **Macro distribution**: Macro distribution means sharing of the total national income among the total factors of production. It means we came to know whether the income is distributed properly or not properly among the people in the society. Modern economists extended the subject matter of economics. They added some other concepts to the economics. They are:

(a) Employment;

(b)Income;

(c)Planning and Economic development;

(d)International trade;

d) Consumption: It is an act to use the goods or service to satisfy the wants. In economics, Consumption is typically defined as final purchase by an individual that are not investments of some sort. In other words when you buy food, clothes, airplane tickets, a car, etc., that's consumption. Through consumption the consumer destroys the utility of the commodity. This utility was created by the producer through production. If someone buys a house to live in, that should be defined as consumption. If they buy a house to rent out it to someone else, that should be defined as an investment. Similarly, if they buy a car to drive, that's consumption. If you buy a car to use as a taxi for a business, that could be construed as an investment. In short the reason for the purchase determines whether something is viewed as on investment or as consumption.

2- Definition of Economics: The definitions of economics can be classified into four categories.

(a)Wealth definitions;

(b) Welfare definitions;

(c) Scarcity definitions;

(d) Growth definitions

(a)Wealth definitions: Almost classical economists followed wealth definition. It is mostly associated with **J.B. Say** and **Adam smith**. Adam smith was called "Father of economics". The name of book written by Adam smith is "An enquiry into the nature and causes of Wealth of nations", (1776). Adam Smith delinked the economics from political economy and he explained it in a scientific manner.

● **Definitions:**

- According to J. B. Say, "economics is the study of science of wealth.

- According to Adam Smith, "economics is the science which deals with the wealth".

According to the above definitions:-

- Economics explains how the wealth is produced, consumed, exchanged and distributed.
- According to Adam smith man is an economic man.
- Economics is a science of study of wealth only.
- This definition deals with the causes behind the creation of wealth.
- It only considers material wealth.

● **Criticism:** This definition was criticized by so many philosophers. They are **Carlyle, Ruskin, Walrus, and Dickens** and others. According to critics, economics is a decimal science, bread and butter science, uncompleted science etc. Wealth is of no use unless it satisfies human wants. This definition is not of much importance to man and his welfare.

(b) Welfare definition: This definition was given by **Alfred Marshall**. He was the follower of Adam smith. He wrote a famous book "Principles of economics" (or) "Principles of political economy" in 1870. Definition: "Economics is the study of mankind in 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 material requisites of well being". According to Alfred Marshall's definition, economics is one side study of wealth, on other and more important side is the study of part of man (or) welfare of the man.

● **Main Points:**
- According to this definition, economics is a social science.
- According to this definition, goods are classified into two types (or) categories: Material goods and immaterial goods.
- According to Alfred Marshall, economics is a normal science.
- The top priority is given to man (or) welfare of man, secondary priority is given to wealth.
- Marshall enhanced the status of man from economic man to social man. Economics related only some material goods which promote the human welfare.

● **Criticism:** This definition was criticized by **Lionel Robbins** on the following grounds:
- According to Robbins, welfare definition is incomplete definition.
- According to Robbins, economics must be neutral between ends.
- According to Robbins, economist must be as a describer not a describer.
- Marshall neglected some materials goods which do not promote human welfare, but these goods are also produced; exchanged & consumed. So, they also come under the subject matter of economic Example: Cigarette and alcoholic products.

(c) Scarcity Definition/Robbins definitions: This definition was given by **Lionel Robbins**. He wrote a famous book "an essay on the nature and significance of economic science" (1932).

● **Definitions:** "Economics is a science which studies human behaviour as a relationship between ends and scarce means which have alternative uses".

● **Robbins Main Points:** In the above definition:

- Wants are unlimited.
- Limited resources.
- Alternative uses of limited resources.
- Problem of choice.

● **Merits:**

- According to this definition economics is an analytical science.
- Economic turn into universal science.
- According to Robbins, it is a positive science.
- Neutral between ends.

● **Criticism:**

These definitions were also criticized by so many economists on the following terms:

- It is not a universal science.
- Not applicable to developed countries.
- Not applicable to communist (or) countries.
- It is not applicable to developing countries.
- It is an old wine in a new bottle.
- It also neglected the dynamic concepts.

(d)Growth Definition: This Definition was given by **J.M. Keynes and P.A. Samuelson** in the book written by Samuelson was "Economics - An Introductory Analysis", (1948). In this book he gave a new definition to economics.

● **Definitions**: "Economic is the study of how men and society choose with 'or' without use of money to employ the scarce productive resources that would have alternative uses to produce various commodities over time for distributing them for consumption now or in future among the various persons and groups in the society. It Analyse the costs and benefits of improving pattern or resource [use allocation].

● **P.A. Samuelson Main points:**

- Like the scarcity definition, it also accepts the unlimited wants and limited resource which have alternative uses.
- According to Samuelson, the problem of scarcity of resources not only confined to present but also to the future. It means he introduced the concept of time element.

- He also adopted a dynamic approach to the study of economics considering Economic Growth as an integral part of economics.

- This definition includes Marshall's welfare definition and Robbin's scarcity definition.

3- SCOPE OF ECONOMICS: MICRO AND MACRO ECONOMICS: The term 'Micro' and 'Macro' were introduced by Ragnar Frisch in economics. He is the Prof. of Oslo University in Britain. According to him, economics is studied in two ways i.e., Micro level and Macro level.

(a) Microeconomics: The part of economics whose subject matter of study is **individual units**, i.e. a consumer, a household, a firm, an industry, etc. It analyses the way in which the decisions are taken by the economic agents, concerning the allocation of the resources that are limited in nature. It studies consumer behaviour, product pricing, and firm's behaviour.

(b) Macroeconomics: It is that branch of economics which studies the entire economy, instead of individual units, i.e. level of output, total investment, total savings, total consumption, etc. Basically, it is the study of **aggregates and averages**. It analyses the economic environment as a whole wherein the firms, consumers, households, and governments make decisions. It covers areas like national income, general price level, the balance of trade and balance of payment, level of employment, level of savings and investment.

(c) International economics: is concerned with the study of international trade. It studies the imports and exports between countries and keeps an account of international transactions (payments) between countries. It also studies advantages and disadvantages of international trade and trade restrictions by developing trade policies.

(d) The fundamental difference between micro and macro economics:

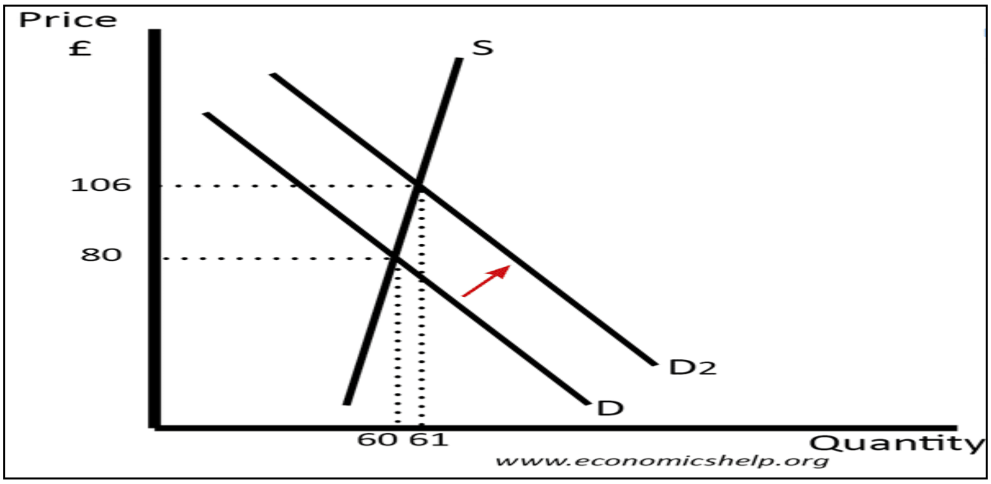
- **Micro economics involves**

- Supply and demand in individual markets.
- Individual consumer behaviour. e.g. Consumer choice theory
- Individual labour markets – e.g. demand for labour, wage determination.
- Externalities arising from production and consumption. e.g. Externalities

- **Macro economics involves**

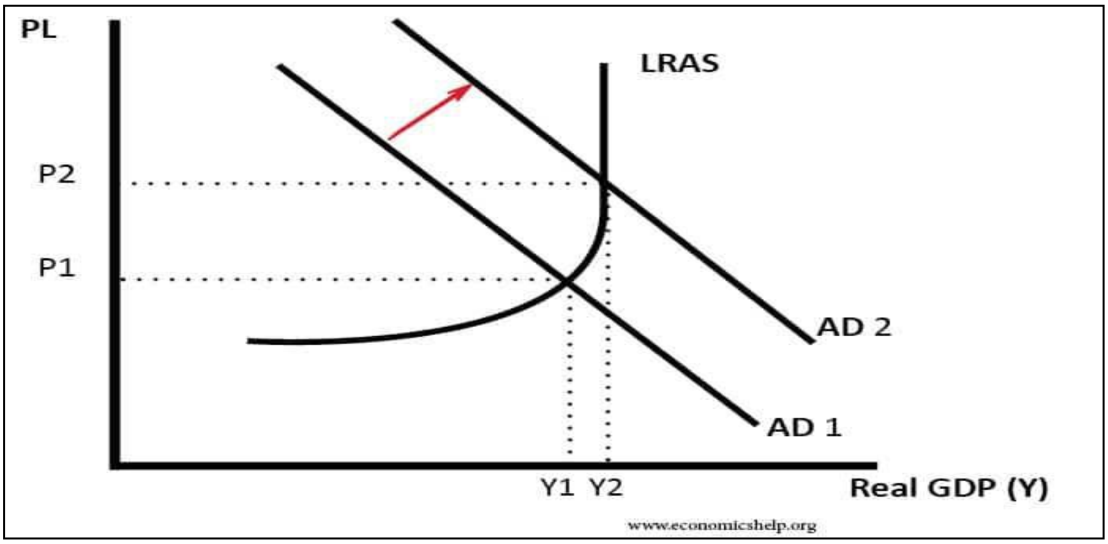
- Monetary / fiscal policy. e.g. what effect does interest rates have on the whole economy?
- Reasons for inflation and unemployment.
- Economic growth
- International trade and globalisation
- Reasons for differences in living standards and economic growth between countries.
- Government borrowing

- **Moving from micro to macro:** If we look at a simple supply and demand diagram for motor cars. Microeconomics is concerned with issues such as the impact of an increase in demand for cars.



This micro economic analysis shows that the increased demand leads to higher price and higher quantity.

● **Macro economic analysis:** This looks at all goods and services produced in the economy.



The macro diagram is looking at real GDP (which is the total amount of output produced in the economy) instead of quantity.

- Instead of the price of a good, we are looking at the overall price level (PL) for the economy. Inflation measures the annual % change in the aggregate price level.

- Instead of just looking at individual demand for cars, we are looking at aggregate demand (AD) total demand in the economy.

- Macro diagrams are based on the same principles as micro diagrams; we just look at Real GDP rather than quantity and Inflation rather than Price Level (PL)

● **The main differences between micro and macro economics:**

- Small segment of economy vs whole aggregate economy.

- Microeconomics works on the principle that markets soon create equilibrium. In macro economics, the economy may be in a state of **disequilibrium** (boom or recession) for a longer period.
- There is little debate about the basic principles of micro-economics. Macro economics is more contentious. There are different schools of macro economics offering different explanations (e.g. Keynesian, Monetarist, Austrian, Real Business cycle e.t.c).
- Macro economics places greater emphasis on empirical data and trying to explain it. Micro economics tends to work from theory first – though this is not always the case.

4- Nature of Economics: Economics is the scientific study of the ownership, use, and exchange of scarce resources – often shortened to the science of scarcity. Economics is regarded as a social science because it uses scientific methods to build theories that can help to explain individuals, groups and organisations behaviour. Economics attempts to explain *economic* behaviour, which arises when scarce resources are exchanged.

In terms of methodology, economists, like other social scientists, are not able to undertake controlled experiments in the way that chemists and biologists are. Hence, economists have to employ different methods, based primarily on observation and deduction and the construction of abstract models. As the social sciences have evolved over the last 100 years, they have become increasingly specialised. This is true for economics, as witnessed by the development of many different strands of investigation including *micro* and *macro* economics, *pure* and *applied* economics, and *industrial* and *financial* economics. What links them all is the attempt to understand how and why exchange takes place, and how exchange creates benefits and costs for the participants.

In studying economics it is important to distinguish two branches of the subject: The first is known as "positive economics", the second as "normative economics".

● **Positive economics**: deals with objective or scientific explanations of the working of the economy. The aim of positive economics is to explain how society makes decisions about consumption, production, and exchange of goods. The purpose of this investigation is twofold:
- To satisfy our curiosity about why the economy works as it does;
- To have some basis for predicting how the economy will respond to changes in circumstances.

● **Normative economics:** is very different. Normative economics offers prescriptions or recommendations based on personal value judgements.