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The Institute of Chartered Accountants of India

BUSINESS ECONOMICS & BUSINESS AND COMMERCIAL KNOWLEDGE

SIERRA INNOVATIONS
Private Limited

CONTENTS

Business & commercial Knowledge

BASIC CONCEPTS OF ECONOMICS

Introduction -
Economics is a social science devoted to the study of how people and societies get what they need and want. Or, in more formal language, economics is the study of how societies divide and use their resources to produce goods and services and of how those goods and services are then distributed and consumed.

Defination of Economics
There are four defination of Economics -

✓ Wealth Defination :
Adam Smith defined "Economics as a science which inquired into the nature and cause of wealth of Nations".

✓ Welfare Defination :
According to Alfred Marshall "Economics is the study of man in the ordinary business of life." It examines how a person gets his income and how he invests it.

✓ Scarcity Defination :
This defination was put forward by Robbins. According to him " Economics is a science

which studies human behaviour as a relationship between ends and scarce means which have alternative uses.

✓ Growth Oriented Defination:

This defination was introduced by Paul. A. Samuelson According to the defination "Economics is the study of how man and society choose with or without the use of money to employ the scarce productive resources, which have alter-native uses, to produce various commodities over time and distributing them for consumption, now or in the future among various person or groups in society."

Scope of Economics –

Traditional Approach –

- Economics is a social science.
- It studies man's behaviour as a rational social being.
- It considered as a science of wealth in relation to human welfare.
- Earning and spending of income was considered to be end of all economic activities.
- Wealth was considered as a means to an end – the end being human welfare.

Modern Approach -

- The scope of Economics lies in analyzing economic problems and suggesting policy measures.
- It seeks to explain what the problem is and how it tends to be solved. In modern time it is both a positive and a normative science.
- Economists of today deal economic issues not merely as they are but also as they should be.
- Welfare economics and growth economics are more normative than positive.

Types of Economics -

Micro Economics　　　　Macro Economics

Micro Economics -

✓ Micro economics studies the economic behaviour of individual economic units.

✓ The study of economic behaviour of the households, firms and industries from the subject-matter of micro economics.

✓ It examines whether resources are efficiently allocated and spells out the conditions for the optimal allocation of resources so as to maximize the output and social welfare.

✓ Micro- economics is concerned with the theories of product pricing, factor pricing and economic welfare.

Macro Economics -

✓ Macro economics deals with the functioning of the economy as a whole.

✓ It deals with the broad economic issues, such as full employment or unemployment, capacity or under capacity production, a low or high rate of growth, inflation or deflation.

✓ It is the theory of national income, employment, aggregate consumption, savings and investment, general price level and economic growth.

Nature of Economics

➤ Economics as science -

- Economics is a systematic body of knowledge as it explains cause and effect relationship between various variables such as price, demand, supply, money supply, production national income, employment, etc.

- This is the traditional deduction method where economic theories are deduced by logical reasoning.
- The laws of economics or economic theories are conditional subject to th condition that other things are equal.
- The truth and applicability of economic theories can be supported or challenged by confronting them to the observations of the real world.
- The laws of physical and natural sciences are exact, but economic laws are not that exact and definite.

➤ Economics as a positive science –
- A positive science is that science in which analysis is confined to cause and effect relationship.
- Positive economics is concerned with the facts about the economy.
- It studies the economic phenomena as they exist.
- It finds out the common characteristics of economic events.
- It specifies cause and effect relationship between them.

Central Problem of Economics –

Every economy faces some common problems.

✓ What to produce ?

- A country cannot produce all goods because it has limited resources.
- It has to make a choice between different goods and services.
- Every economy has to decide what goods and services should be produced.

✓ How to produce ?

- As an economy decides to produce certain goods, it faces the problem to decide how these goods will be produced.
- The problem arises because of unavailability of some resources.
- It also involves the choice of technique of production.
- A country may produce by labour intensive methods or by capital intensive methods of production, depending upon its stock or man power.

✓ For whom to produce ?

- Goods and services are produced for

people who have the means to pay for them.

- A country may produce mass consumption goods at a large scale or goods for upper classes.
- All it depends upon the policies of the government as well as private producing units.

✓ There are three broad classifications based on their mode of production, exchange, distribution and the role which their governments plays in economic activity.

These are :-

- Capitalist Economy
- Socialist Economy
- Mixed Economy.

Capitalist Economy

- It is an economic system in which all means of production are owned and controlled by private individuals for profit.
- In short, private property is the mainstay of capitalism and profit motive is its driving force. Decisions of consumers and businesses determine economic activity.

- Ideally, the government has a limited role in the management of the economic affairs under this system.
- Some examples of a capitalist economy may include U.S., U.K., Germany, Japan, Mexico, singapore, etc. However many of them are not pure form of capitalism but show some features of being a capitalist economy.

Socialist Economy -

- In this economy, the material means of production i.e., factories, capital, mines etc. are owned by the whole community represented by the state.
- All members are entitled to get benefit from the fruits of such socialised planned production on the basis of equal rights.
- A socialist economy is also called as "Command Economy" or a "Centrally planned Economy". Here, the resources are allocated according to the commands of a central planning authority and therefore, market forces have 0 role in the allocation of resources.
- Under a socialist economy, production and distribution of goods are aimed at maximizing the welfare of the community as a whole.

The Mixed Economy -

- The mixed economy system depends on both markets and governments for allocation of resources.
- In fact, every economy in the real world makes use of both markets and governments and therefore, is mixed economy in its nature.
- In a mixed economy, the aim is to develop a system which tries to include the best features of both the controlled economy and the market economy while excluding the demerits of both.
- It appreciates the advantages of private enterprise and private property with their emphasis on self-interest and profit motive. Vast economic development of England, the USA etc. is due to private enterprise.
- At the same time, it is noticed that private property, profit motive and self-interest of the market economy may not promote the interests of the community as a whole and as such, the Government should remove these defects of private enterprise. For this purpose, the Government itself must run important and selected industries and eliminate the free play of profit motive and self-interest. Private enterprise which

has its own significance is also allowed to play a positive role in a mixed economy.

Few Fundamental Concepts -

✓ Wealth and Welfare -

- Welfare means the satisfaction or the well-being enjoyed by society.
- Social welfare depends on the wealth of the nation.
- In general, wealth gives rise to welfare, although they are not same.
- If wealth of society increases, but the distribution among the citizens of the country is very unequal, this inequality may create social jealousy and tension.

✓ Money -

- Anything which is widely accepted in exchange for goods, or in settling debts.
- In Barter system, goods were used as medium of exchange.
- When some commodity is used as a medium of exchange by custom, it is called customary money, (example, the rupee notes and coins).

✓ Markets –

- A system by which the buyers and sellers of a commodity can come into touch with each other (directly or indirectly).
- In Economics, a market for a commodity is a system.
- Here, the buyers and the sellers establish contact with each other directly or indirectly.
- They have a view to purchasing and selling the commodity.

✓ Investment –

- Investment means an increase in the capital stock.
- For a country, as a whole, investment is the increase in the total capital stock of the country.
- For an individual, investment is the increase in the capital stock owned by him.

✓ Production –

- Production means "creation of utility".
- It also refers to creation of goods (or performance of services) for the purpose of selling them in the market.
- Production must be for the purpose of

selling the produced goods (or, services) in the market.

✓ Consumption -
- By consumption, we mean satisfaction of wants.
- It is because we have wants that we consume various goods and services.
- Thus, consumption is defined as the satisfaction of human wants through the use of goods and services.

✓ Saving -
- Saving is defined as income minus consumption.
- Whatever is left in the hands of an individual after meeting consumption expenditure is the individual's savings.

✓ Income -
The income of a person means the net inflow of money (or purchasing power) of this person over a certain period.

✓ Consumer Surplus -
- The excess satisfaction or utility that a

consumer can enjoy from the purchase of a thing when the price that he actually pays is less than the price he was willing to pay for it.

- It is the difference between individual demand price and market price.

✓ Capital -

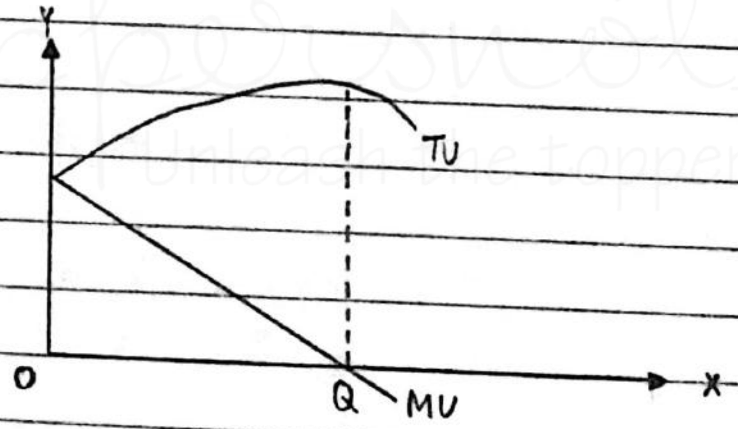
- In a fundamental sense, capital consists of any produced thing that can enhance a person's power to perform economically useful work. Capital is an input in the production process.
- It refers to financial resources available for use.
- Capital is different from money.

✓ Utility -

- Utility, or usefulness, is the ability of something to satisfy needs or wants.
- Utility is an important concept in economics because it represents satisfaction experienced by the consumer of a good.
- Utility is a representation of preferences over some set of goods and services.

✓ Law of Diminishing Marginal Utility –

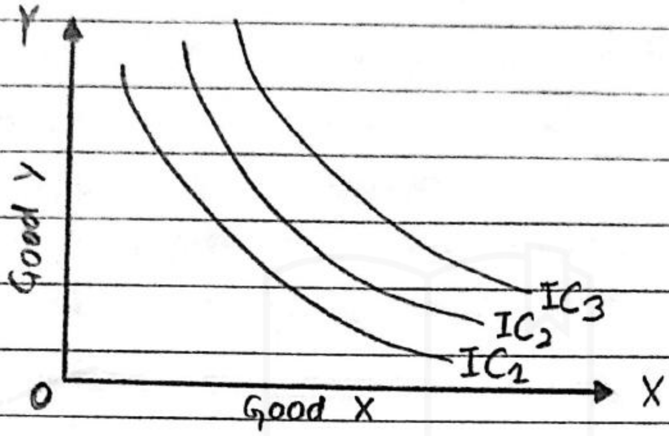
- This law is a fundamental law of Economics. It relates to a man's behaviour as a consumer.
- The law states that a man gets more units of a commodity, marginal utility from each successive unit will go on falling till it becomes zero or negative.
- Marginal utility means the additional utility obtained from one particular unit of a commodity.



✓ Indifference Curves –

An indifference curve is a curve which represents all those combinations of two goods which give same satisfaction to the consumer. Since all the combinations on an indifference curve give equal satisfaction to the consumer, the consumer is indifferent among them.

In other words, since all the combinations provide the same level of satisfaction the consumer prefers them equally and does not mind which combination he gets.



- An indifference map represents a collection of many indifference curves where each curve represents a certain level of satisfaction. In short, a set of indifference curve is called an indifference map.

✓ Production Posibility Curve (PPC) -

- In economics, a production - possibility curve (PPC), is also called a production-possibility frontier (PPF), production - possibility boundary or product transformation curve.
- It is a graph that compares the production rates of two commodities that use the same fixed total of the factors of production.