MODULE 1
BASIC PRINCIPLES OF ECONOMICS

Economics is a ‘behavioural science’ that studies the choices people make as they cope with scarcity. The English term ‘Economics’ is derived from the Greek word ‘Oikonomia’. Its meaning is ‘household management’. Economics was first read in ancient Greece. Aristotle, the Greek Philosopher termed Economics as a science of ‘household management’.

Definitional Framework of Economics

Economics has been defined in various ways over time, reflecting different schools of thought and focuses. Major definitions of economics include:

(l) The wealth definition

(II) The welfare definition

(III) The scarcity definition

(IV) The growth definition.

1. The Wealth Definition:

The wealth definition treats economics as a 'science of wealth’. It was propounded by **Adam Smith** in his book **An Enquiry into the Nature and Causes of Wealth of Nations, published in 1776.**

As per this definition, 'economics is primarily concerned with the nature and causes of wealth of nations’. This definition emphasizes the importance of understanding how wealth is generated and accumulated within a nation and what factors contribute to economic growth and prosperity of nations.

2. The Welfare Definition

The welfare definition treats economics as a 'science of man and his material welfare. It was propounded by **Alfred Marshall** in his book **Principles of Economics,** published in **1890**.

As per this definition, 'economics is a study of mankind in the ordinary business of life. On the one hand, it is a study of wealth and on the other and the more important side, it is a study of man and his welfare.'

The welfare definition of economics represents a significant expansion of the discipline's scope, emphasizing that economic activities should ultimately enhance human well. It highlights the importance of high considering the broader impacts of economic policies and our decisions on the welfare of the individuals and society.

3. The Scarcity Definition:

The scarcity definition treats economics as a **'science of scarcity and choice’**. It was propounded by **Lionnel Robbins** in his work **Nature and Significance of Economic Science, published in 1932.** Robbins has challenged the traditional/ materialistic definitions of economics and has expressed it in terms of 'scarcity' and 'choice.'

As per this definition,economics is a science which studies human behavior as a relationship between ends and scarce means which have alternative uses. It emphasized the central role of scarcity and choice in economic analysis.The definition remains a fundamental concept in economic theory and practice as it defined economics as 'making choices in the presence of scarcity.'

4. The Growth Definition:

The growth definition of economics treats economics as a **'science of economic growth and development.'** It was chiefly associated with **Paul A. Samuelson** as seen in his book **Foundations of Economic Analysis, published in the year 1947.** As per this definition, 'economics is a social science concerned with proper use and allocation of scarce resources for achievement and maintenance of growth with stability'.

The definition examines how an economy expands its capacity to produce goods and services, leading to higher levels of income, employment, and overall wealth. It involves studying the factors that contribute to growth, the theories that explain how growth occurs, and the policies that can enhance growth.

Amartya Sen emphasized the 'human' and 'well-being' aspect of economics. He defined economics as a study of how people use their resources to achieve a better well-being and enhancement of human capabilities, simply abbreviated as 'development.' How can people attain 'development' is the central idea in Sen's economics.

Summarize:

- Economics is a study of how individuals, firms, and societies allocate the scarce resources so as to satisfy their unlimited wants and needs.
- Economics is the analysis of how people make choices under conditions of scarcity and the implications of these choices for the use of resources.
- Economics is the examination of how different economic agents interact in markets and the outcomes of these interactions for the production, distribution, and consumption of goods and services.
- Economics is the understanding of the phenomena and policies that affect the overall economic stability, growth and development of nations.

Each definition of economics over different spans of time emphasizes different aspects of economic activity, from individual decision-making and market dynamics to broader societal and ethical considerations.

Why Study Economics? (Importance of studying economics:

Studying economics is essential for several reasons, as it provides valuable insights into how societies allocate scarce resources, make decisions, and interact in markets. Economics is about making choices.

Studying economics gives an insight into the nature of the problems, helps us understand how the world works and make us astute participants in the economy. There are several reasons to study economics as:

1. It helps to learn a way of thinking for optimization,
2. It helps to understand the economic indicators,
3. It helps to understand the market dynamics,
4. It helps to make informed decisions,
5. It helps to understand the society,
6. It helps to understand and analyze public policies,
7. It helps to develop the skills of critical thinking and problem-solving,
8. It helps to improve the quality of life by contributing to economic well-being and sustainability,
9. It helps to understand the global affairs, and
10. It helps ultimately to be an informed citizen.

Basic Principles of Economics

The study of economics has many facets, but is unified by several central ideas and principles. The basic principles of economics provide a foundational understanding of how economies function and how economic agents make decision.

The major principles of economics that can be applied in many of life's situations may be split up into three broad categories

(i) How people make decisions,
(ii) How people interact,
(iii) How the economy as a whole works.

1. How People Make Decisions?

People make decisions based on their rational behavior and seeking to maximize their well-being or utility given the constraints and preferences. The behaviour of the economy reflects the behaviour of the individuals who make up the economy, the axiom 'how people make decisions' enlists four basic principles regarding individual decision-making as:

(a) People face trade-offs,
(b)The cost of something is what you give up to get it,
(c) Rational people think at the margin
(d) People respond to incentives.

(a) People face trade-offs

The study of economics starts by acknowledging life's trade-offs. When people are grouped into societies, they face different kinds of trade-offs.

Trade-offs refers to the situations where, in order to gain something, another thing must be given up. In the real life, people are facing different trade- offs between different parameters. Proper understanding of the trade-offs is essential for making more efficient and informed economic decisions at all levels.

One of the classic examples for trade-off is the trade-off between 'guns and butter. The more a society spends on its national defense (guns) to protect its nation from foreign aggressors, the less it can spend on consumer goods (butter).

Another prominent example for trade-off is the trade-off between 'efficiency and equality.' Efficiency implies a situation where the society can attain maximum benefits from its scarce resources. Equality implies a situation where the economic prosperity or benefits are distributed uniformity among the members of the society.

(b) The cost of something is what you give up to get it:

People face trade-offs, making decisions requires comparing the costs and benefits of alternative situations or courses of action. The cost of something is always what we give up to get that item. When making any decision, the decision makers should be aware of what we are giving up for obtaining something.

(c)Rational people think at the margin:

We normally assume that people are rational. Rational people are those people who systematically and purposefully do their best as to achieve their objectives. Decisions are normally taken on the basis of considering almost all available information. Rational people often make decisions by comparing the 'marginal benefits' and 'marginal costs' situations. A rational decision maker normally takes an action only if the marginal benefit of the action exceeds its marginal cost.

Decision making based on 'marginal thinking' is very important. Consider the classic example of **'water-diamond paradox'** which addresses why water is so cheap (even if it is very essential for life's survival) and why diamond is very expensive (even it is not much essential for life's survival). The reason is that though water is very essential for survival the marginal benefit of an extra cup is small because it is plentiful.

d)People respond to incentives:

Incentives are something that induces people to act. It refers to the rewards and penalties that motivate behaviour. Incentives play a pivotal role in decision making of individuals and that of the society. When price of a particular commodity increases in the market, people decide to lower its consumption. At the same time, when price of a particular commodity increases in the market, its producers decide to hire more workers to increase the production of that commodity. That is, a higher price in the market provides an incentive for the buyers to consume less and an incentive for the sellers to produce more. Incentives are everywhere. Policymakers are also very much influenced by the incentives. Whenever they fail to consider how the policies affect the incentives, they often end up facing unintended consequences.

II)How People Interact?

The behavior of the economy reflects the interactions of the individuals living in the society, the axiom 'how people interact' enlists three basic principles of decision-making as: **(a) trade can make everyone better-off,**

(b) markets are usually a good way to organize economic activities, and

(c) governments can sometimes improve market outcomes.

(a) Trade can make everyone better-off:

No country has the potential to produce all the commodities they want. The basic reason for different nations entering into trade is that no nation has the capacity to produce by itself all the commodities and services that are required by its people According to McConnel, "international trade is a means by which nations can specialize, increase the productivity of their resources and thereby realize a larger output than otherwise" It permits producers in each nation to take the advantage of specialization and efficiencies of large-scale operations. Trade allows countries to specialize what they do best and to enjoy a greater variety of goods and services.

The basic foundations for why nations engage in international trade and how it will mutually benefit the countries may be illustrated as follows:

Non-availability of specific factor endowments

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Differences in relative factor prices

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Differences in relative costs

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Differences in comparative advantage

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International division of labor

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International specialization in production and export

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Gainful international trade

(b). Markets are usually a good way to organize economic activity:

Markets are usually a good way to organize economic activities due to their efficiency, flexibility, and ability to promote innovation and consumer choice. Markets can efficiently allocate resources, provide signals for production and consumption, and promote innovation and growth when it is go functioning well.

Prices and self-interest are the most pivotal components influencing economic decision making. In any market buyers look at the price when determining 'how much to demand' and the sellers on the other hand look at the price when deciding 'how much to supply' . As a result of the interactions and decisions that the buyers and sellers make, market prices reflect both the value of a good to the society and the cost to the society of making that good as well.

Adam Smith believed the participants of the market economy are motivated by their own **'self-interest'** and there exists an "**invisible hand**' in the marketplace that guides the 'self-interest' so as to promote the overall well-being of the economy.

(c) **Governments can sometimes improve market outcomes**

If the 'invisible hands' bring everything in good order in the market, there will be no need for any government or public intervention and the economy is operating on the principle of 'laissez-faire' . The proper role and scope of the government and its intervention in economic activities arises when and only when the market fails.

Market failure is a situation where the market fails to produce an efficient and equitable allocation and distribution of resources. When we study economics, we will become better judge of when a government policy is justifiable and when it is not simply on the basis of realizing efficiency and equality.

3. How the Economy as a Whole Works?

Understanding how the economy as a whole works involves examining various interconnected factors that exist in the economy. The economy functions as a dynamic system shaped by the interactions of so many stakeholders such as individuals, businesses, governments, and international entities, all driven by the pursuit of economic goals such as growth, stability, and prosperity. The economy as a whole, is a vast and intricate system that involves production, distribution, and consumption of goods and services within a society.

In this there are three prominent principles such as:

a) **A country's standard of living depends on its ability to produce goods and services**
b) **Price rise when the government prints too much money.**
c) **Society faces a short run tradeoff between inflation and unemployment.**

a)A country's standard of living depends on its ability to produce goods and services:

Standards of living typically refer to the overall level of prosperity and well-being enjoyed by the individuals within a society. It implies the level of comfort, wealth, material goods, and the necessities available to individuals or groups in a particular region.

It includes various factors that contribute to the overall well-being and quality of life of the people of a country. A country's ability to produce goods and services efficiently and effectively is a foundational element of its standard of living. It is a fundamental driver of the standard of living as it provides the material foundation upon which people build their lives.

The level of production influences income levels, employment opportunities, access to goods and services, infrastructure quality, investment, innovation, and the overall well-being of its citizens.

Productivity implies the quantity of goods and services produced by each unit of its factor inputs. **Productive** capacity means the maximum level of output an economy can produce by using all its available resources.

Public policies in these areas may aim to improve of access, affordability, and quality of services to enhance overall standards of living. For example, in societies with lower standards of living, policymakers may focus on addressing immediate needs such as food assistance, housing subsidies, and unemployment benefits.

(b) Prices rise when the government prints too much money:

The statement prices rise when the government prints too much money reflects a simplified understanding of the potential consequences of excessive **'monetary expansion'** in an economy. When the government prints too much money, it injects additional money into the economy. With more money circulating in the economy, consumers and businesses have additional purchasing power which will lead to an increase in the aggregate demand and a decrease in the value of money in the economy.

A continuous rise in price level as a result of an increase in money supply and the consequent fall in the value of money is called 'inflation'.

While the policy of 'monetary expansion' simply on the basis of increasing the quantity of money can stimulate economic activity and support growth, it also carries the risk of inflation. Inflation comes about when there is a sustained increase in the supply of money.

Central banks and governments typically aim to strike a balance between stimulating economic growth and controlling inflation through monetary and fiscal policies.

c). Society faces a short-run trade-off between inflation and unemployment:

Economists believe that the society faces a basic trade-off between inflation and unemployment in the short-run. Such a relationship between inflation and unemployment is popularized by **A.W. Phillips** through the **'Phillips curve have analysis'**. Based on the data of the United Kingdom, Phillips observed that 'there exists a stable, inverse and non-linear relationship between rate of change of inflation and rate of change of unemployment in the short-run. It suggests that when inflation is low, unemployment tends to be high, and when inflation is high, unemployment tends to be low.

Expansionary monetary policies aimed at reducing unemployment may lead to higher inflation in the short-run. The logic behind the short-run effects of 'monetary expansions' is summed up as follows:

- Increasing the quantity of money in the economy stimulates the overall level of spending and thus the aggregate demand for goods and services.
- Higher aggregate demand will lead to an increase in the prices and at the same time, encourages the firms to hire more workers and produce a larger quantity of goods and services.

Conversely, contractionary monetary policies designed to curb inflation may result in higher unemployment in the short-run, The logic behind the short-run effects of 'monetary contractions' is summed up as follows:

- Decreasing the quantity of money in the economy reduces the overall level of spending and thus the aggregate demand for goods and services.
- Lower aggregate demand will lead to a decrease in the prices and at the same time, prompts the firms to reduce the number of workers and produce a lesser quantity of goods and services.
- Reducing workers means an increase in the existing stock of unemployment in the economy.

Short-run relationship between inflation and unemployment forms an integral part of the analysis of 'business cycles'.

Business cycle is the irregular and unpredictable fluctuations in the economic activities. The Phillips curve relationship may not hold true in the long-run and over time, the economy can adjust to new equilibrium levels of inflation and unemployment. Policymakers must carefully consider both inflation and unemployment when formulating economic policies to achieve their dual objectives of price stability and full employment.

Basic Principles of Economics		
1.	**How people make decisions?**	
	(i)	People face trade-offs
	(ii)	The cost of something is what you give
	(iii)	Rational people think at the margin
	(iv)	People respond to incentives
2.	**How people interact?**	
	(v)	Trade can make everyone better-off
	(vi)	Markets are usually a good way to organise economic activity
	(vii)	Governments can sometimes improve market outcomes
3.	**How the economy as a whole works?**	
	(viii)	A country's standard of living depends on its ability to produce goods and services
	(ix)	Prices rise when the government prints too much money
	(x)	Society faces a short-run trade-off between inflation and unemployment