PART A

INTRODUCTORY MICROECONOMICS

1 INTRODUCTION TO MICROECONOMICS

WHAT ECONOMICS IS ALL ABOUT?

Economics is about economizing; that is, about choice among alternative uses of scarce resources. Choices are made by millions of individuals, businesses, and government units. Economics examines how these choices add up to an economic system, and how this system operates. (L.G. Reynolds)

Scarcity is central to economic theory. Economic analysis is fundamentally about the maximization of something (leisure time, wealth, health, happiness—all commonly reduced to the concept of utility) subject to constraints. These constraints—or scarcity—inevitably define a trade-off. For example, one can have more money by working harder, but less time (there are only so many hours in a day, so time is scarce). One can have more apples only at the expense of, say, fewer grapes (you only have so much land on which to grow food—land is scarce). Adam Smith considered, for example, the trade-off between time, or convenience, and money. He discussed how a person could live near town, and pay more for rent of his home, or live farther away and pay less, "paying the difference out of his convenience".

Economics as a subject came into being with the publication of very popular book in 1776, "An Enquiry into the Nature and Causes of Wealth of Nations", written by Prof. Adam Smith. At that time it was called Political economy, which remained operational at least up to the middle part of the 19th century. It is since then that the economists developed tools and principles using inductive and deductive reasoning. In fact, the 'Wealth of Nations' is a landmark in the history of economic thought that separated economics from other social sciences.

The word 'Economics' was derived from the Greek words 'Oikos' (a house) and 'Nemein' (to manage), which meant managing a household, using the limited money or resources a household has.

Let us explain a few important definitions frequently referred to in the economic theory.

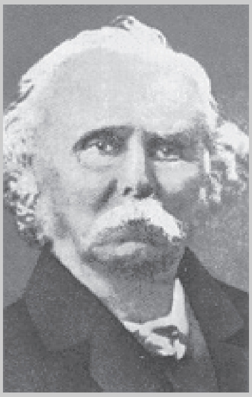
Adam Smith (June 5, 1723-July 17, 1790) was a Scottish political economist and moral philosopher. His 'Inquiry into the Nature and Causes of Wealth of Nations' was one of the earliest attempts to study the historical development of industry and commerce in Europe. That work helped to create the modern academic discipline of Economics and provided one of the best-known intellectual rationales for free trade and capitalism.

At the age of about fifteen, Smith proceeded to the University of Glasgow, studying moral philosophy under "the never-to-be-forgotten" (as Smith called him) Francis Hutcheson. In 1740 he entered the Balliol College of the University of Oxford, but as William Robert Scott has said, "the Oxford of his time gave little if any help towards what was to be his lifework," and he left the university in 1746. In 1748 he began delivering public lectures in Edinburgh under the patronage of Lord Kames. Some of these dealt with rhetoric and *belles-lettres*, but later he took up the subject of "the progress of opulence," and it was then, in his middle or late 20s, that he first expounded the economic philosophy of "the obvious and simple system of natural liberty" which he was later to proclaim to the world in his *Inquiry into the Nature and Causes of the Wealth of Nations*.

Wealth Definition

The early economists like J.E. Cairnes, J.B.Say, and F.A.Walker have defined economics as a science of wealth. Adam Smith, who is also regarded as father of economics, stated that economics is a science concerned with the nature and causes of wealth of nations. That is, economics deal with the question as to how to acquire more and more wealth by a nation. J.S.Mill opined that it is the practical science dealing with the production and distribution of wealth. The American economist F.A.Walker says that economics is that body of knowledge, which relates to wealth. Thus, all these definitions relate to wealth.

However, the above definitions have been criticized on various grounds. As a result, economists like Marshall, Robbins and Samuelson have put forward more comprehensive and scientific definitions. Emphasis has been gradually shifted from wealth to man. As Marshall puts, it is *"on the one side a study of wealth; and on the other, and more important side, a part of the study of man."*



Alfred Marshall (July 26, 1842- July 13, 1924), born in Bermondsey, London, England, became one of the most influential economists of his time. His book, *Principles of Political Economy* (1890) brought together the theories of supply and demand, of marginal utility and of the costs of production into a coherent whole. It became the dominant economic textbook in England for a long period.

Marshall grew up in the London suburb and was educated at the Merchant Taylor's School and St. John's College, Cambridge, where he demonstrated an aptitude in mathematics. Although he wanted early on, at the behest of his father, to become a clergyman, his success at Cambridge University led him to take an academic career. He became a professor in 1868 specializing in political economy. He desired to improve the mathematical rigor of economics and transform it into a more scientific profession. In the 1870s he wrote a small number of tracts on international trade and the problems of protectionism. In 1879, many of these works were compiled together into a work entitled *The Pure Theory of Foreign Trade: The Pure Theory of Domestic Values.* Marshall began work on his seminal work, the Principles of Economics, in 1881, and he spent much of the next decade at work on the treatise. His most important legacy was creating a respected, academic, scientifically-founded profession for economists in the future that set the tone of the field for the remainder of the twentieth century. Marshall's influence on codifying economic thought is difficult to deny. He was the first to rigorously attach price determination to supply and demand functions; modern economists owe the linkage between price shifts and curve shifts to Marshall. Marshall was an important part of the "marginalist revolution;" the idea that consumers attempt to equal prices to their marginal utility was another contribution of his. The price elasticity of demand was presented by Marshall as an extension of these ideas. Economic welfare, divided into producer surplus and consumer surplus, was contributed by Marshall, and indeed, the two are sometimes described eponymously as 'Marshallian surplus.' He used this idea of surplus to rigorously analyze the effect of taxes and price shifts on market welfare. Marshall also identified quasi-rents.

Welfare Definition

Thus according to Marshall, economics not only analysis the aspect of how to acquire wealth but also how to utilize this wealth for obtaining material gains of human life. In fact, wealth has no meaning in itself unless it is used to purchase all those things which are required for our sustenance as well as for the comforts necessary for life. Marshall, thus, opined that wealth is a means to achieve certain ends.

In other words, economics is not a science of wealth but a science of man primarily. It may be called as the science which studies human welfare. Economics is concerned with those activities, which relates to wealth not for its own sake, but for the sake of human welfare that it promotes. According to Cannan, *"The aim of political economy is the explanation of the general causes on which the material welfare of human beings depends."* Marshall in his book, "Principles of Economics", published in 1890, describes economics as, *"the study of mankind in the ordinary business of life; it examines that part of the individual and social action which is most closely connected with the attainment and with the use of the material requisites of well being".*

On examining the Marshall's definition, we find that he has put emphasis on the following four points:

(*a*) Economics is not only the study of wealth but also the study of human beings. Wealth is required for promoting human welfare.

(*b*) Economics deals with ordinary men who are influenced by all natural instincts such as love, affection and fellow feelings and not merely motivated by the desire of acquiring maximum wealth for its own sake. Wealth in itself is meaningless unless it is utilized for obtaining material things of life.

(*c*) Economics is a social science. It does not study isolated individuals but all individuals living in a society. Its aim is to contribute solutions to many social problems.

(*d*) Economics only studies 'material requisites of well being'. That is, it studies the causes of material gain or welfare. It ignores non-material aspects of human life.

This definition has also been criticized on the ground that it only confines its study to the material welfare. Non-material aspects of human life are not taken into consideration. Further, as Robbins said the science of economics studies several activities, that hardly promotes welfare. The activities of producing intoxicants, for instance, do not promote welfare; but it is an economic activity.

Lionel Charles Robbins (1898-1984) was a British economist of the 20th century who proposed one of the early contemporary definitions of economics, "Economics is a science which studies human behavior as a relationship between ends and scarce means which have alternative uses."

Robbins's early essays were very combative in spirit, stressing the subjectivist theory of value beyond what Anglo-Saxon economics had been used to. His famous work on costs (1930, 1934) helped bring Wieser's "alternative cost" theorem of supply to England (which was opposed to Marshall's "real cost" theory of supply). It was his 1932 Essay on the Nature and Significance of Economic Science where Robbins made his Continental credentials clear. Redefining the scope of economics to be "the science which studies human behavior as a relationship between scarce means which have alternative uses".

Scarcity Definition

Lionel Robbins challenged the traditional view of the nature of economic science. His book, "Nature and Significance of Economic Science", published in 1932 gave a new idea of thinking about what economics is. He called all the earlier definitions as classificatory and unscientific. According to him, *"Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses."* This definition focused its attention on a particular aspect of human behaviour, that is, behaviour associated with the utilization of scarce resources to achieve unlimited ends (wants). Robbins definition, thus, laid emphasis on the following points:

(*a*) 'Ends' are the wants, which every human being desires to satisfy. Want is an effective desire for a thing, which can be satisfied by making an effort for obtaining it. We have unlimited wants and as one want gets satisfied another arises. For instance, one may have the desire to buy a car or a flat. Once the car or the flat is purchased, the person wishes to buy a more spacious and designable car and the list of his wants does not stop here but goes on one after another. As human wants are unlimited, we have to make a choice between the most urgent want and less urgent wants. Thus the problem of choice arises. That is why economics is also called as a science of choice. If wants had been limited, they would have been satisfied and there would have been no economic problem.

(*b*) 'Means 'or resources are limited. Means are required to be used for the satisfaction of various wants. For instance, money is an important means to satisfy many of our wants. As stated, means are scarce (short in supply in relation to demand) and as such these are to be used optimally. In other words, scarce or limited means/resources are to be economized. We should not make waste of the limited resources but utilize them very judiciously to get the maximum satisfaction.

(*c*) Robbins also said that, the scarce means have alternative uses. It means that a commodity or resource can be put to different uses. Hence, the demand in the aggregate for that commodity or resource is almost insatiable. For instance, if we have a hundred rupee note, we can use it either to purchase a book or a fashionable clothe. We may use it in other unlimited ways as we like.

Let us now turn our attention to the definitions put forward by modern economists. J.M.Keynes defined economics as the study of the management of scarce resources and of the determination of income and employment in the economy. Thus his study centered on the causes of economic fluctuations to see how economic stability could be established. According to F. Benham, economics is, *"a study of the factors affecting the size, distribution and stability of a country's national income."* Recently, economic growth and development has taken an important place in the study of economics. Prof. Samuelson has given a growth oriented definition of economics. According to him, economics is the study and use of scarce productive resources overtime and distribute these for present and future consumption.

In short, economics is a social science concerned with the use of scarce resources in an optimum manner and in attainment of desired level of income, output, employment and economic growth.

SUBJECT MATTER OF ECONOMICS

The subject matter of economics is divided into two categories–microeconomics and macroeconomics. Microeconomics, which deals with individual agents, such as households and businesses, and macroeconomics, which considers the economy as a whole, in which case it considers aggregate supply and demand for money, capital and commodities. Aspects receiving particular attention in economics are resource allocation, production, distribution, trade, and competition. Economics may in principle be (and increasingly is) applied to any problem that involves choice under scarcity or determining economic value.

The term ‘Micro’ and ‘Macro’ economics have been coined by Prof. Ragnar Frisch of Oslo University during 1920’s. The word micro means a millionth part. In Greek mickros means small. Thus microeconomics deals with a small part of the whole economy. For example, if we study the price of a particular commodity instead of studying the general price level in the economy, we actually are studying microeconomics. Precisely, microeconomics studies the behaviour of individual units of an economy such as consumers, firms, and industry etc. Therefore, it is the study of a particular unit rather than all units combined together. Microeconomics is called Price theory, which explains the composition, or allocation of total production.

In short, microeconomics is the study of the economic behaviour of individual consumers, firms, and industries and the distribution of production and income among them. It considers individuals both as suppliers of labour and capital and as the ultimate consumers of the final product. On the other hand, it analyses firms both as suppliers of products and as consumers of labour and capital.

Microeconomics seeks to analyze the market form or other types of mechanisms that establish relative prices amongst goods and services and/or allocates society’s resources amongst their many alternative uses. In microeconomics, we study the following:

1. Theory of product pricing, which includes-
   (*a*) Theory of consumer behaviour.
   (*b*) Theory of production and costs.
2. Theory of factor pricing, which constitutes-
   (*a*) Theory of wages.
   (*b*) Theory of rent.
   (*c*) Theory of interest.
   (*d*) Theory of profits.
3. Theory of economic welfare.

Microeconomics has occupied a very important place in the study of economic theory. In fact, it is the stepping–stone to economic theory. It has both theoretical and practical implications. Important points of its significance are mentioned as under:

1. Microeconomics is of great help in the efficient management of the limited resources available in a country.
2. Microeconomics is helpful in understanding the working of free enterprise economy where there is no central control.

3. Microeconomics is utilized to explain the gains from international trade, balance of payments disequilibrium and determination of foreign exchange rate.
4. It explains how through market mechanism goods and services produced in the community are distributed.
5. It helps in the formulation of economic policies, which are meant for promoting efficiency in production, and welfare of the people.
6. Microeconomics is the basis of welfare economics.
7. Microeconomics is used for constructing economic models for better understanding of the actual economic phenomena.

Despite the fact that it has so many benefits, it also suffers from certain defects or limitations. These are:

1. It is not capable of explaining the functioning of an economy as a whole.
2. It assumes full employment; which is rare in real life.
3. It cannot be used for solving the problem relating to public finance, monetary and fiscal policy etc.

Positive and Normative Economics

While discussing the scope of economics, we also think of whether economics is a positive or normative science. A positive science describes 'what is' and normative science explains 'what ought to be'. Thus a positive science describes a situation as it is, whereas normative science analysis the situation and suggests/comments on wrongness or rightness of a thing/state. For example, 'population in India is rising', is a positive statement and 'Rising population is an obstacle in the way of development' is a normative statement.

Classical economists consider economics as a positive science. They declined any comment about wrongness or rightness of an economic situation. Robbins also supported the classical view and stated that economics is not concerned with the desirability or otherwise of 'ends'. Therefore, the task of an economist is not to condemn or advocate but to explore and explain. However, economics should not be treated as only positive science. It should be allowed to pass moral judgments of an economic situation. It is, therefore, considered both positive and normative science. Thus, Economics is the social science that studies the allocation of scarce resources to satisfy unlimited wants. This involves analyzing the production, distribution, trade and consumption of goods and services. Economics is said to be positive when it attempts to explain the consequences of different choices given a set of assumptions or a set of observations, and normative when it prescribes that a certain action should be taken.

Questions for Review

1. Define economics as given by L. Robbins.
2. Who is regarded as the father of economics?
3. Who coined the terms—micro and macroeconomics?
4. Name the book written by Adam Smith.

5. 'Economics is a science of choice'—explain.

6. "Economics is a science which studies human behaviour as a relationship between ends and scarce means which have alternative uses." Explain.

7. Give the meaning of the term opportunity cost.

8. How is the study of microeconomics significant?

9. What is the scope of microeconomics?

10. What do you mean by marginal rate of transformation?

11. What is the basic problem of an economy?

12. What do you mean by the terms 'ends' and 'means'?

13. Define want.

14. What is the meaning of economizing of resources? Why is there a need for economizing resources?

16. What do you understand by Micro Economics?

17. What specific problem of an economy is studied in welfare economics?

18. Give the definition of a scarce resource.

19. What is meant by scarcity in economics?

20. Define an economy.

21. State Marshall's definition of Economics.

22. "Economics enquires into the nature and causes of wealth of nations". Who gave this definition of economics? What does it imply?

23. What is economics about? (NCERT)

24. Explain how scarcity and choice go together. (NCERT)

25. "Economics is about making choices in the presence of scarcity." Explain. (NCERT)

26. What are the main features of Marshall's Definition of economics?

27. "Scarce means have alternative uses."—Explain.

28. Name the Economist who coined the terms micro and macro.

29. Write five importances of micro economics.

30. Mention three shortcomings of microeconomic theory.

31. What do you understand by positive and normative economics?

32. Is economics a positive science?