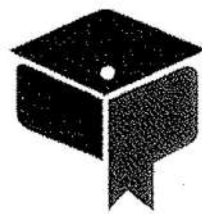

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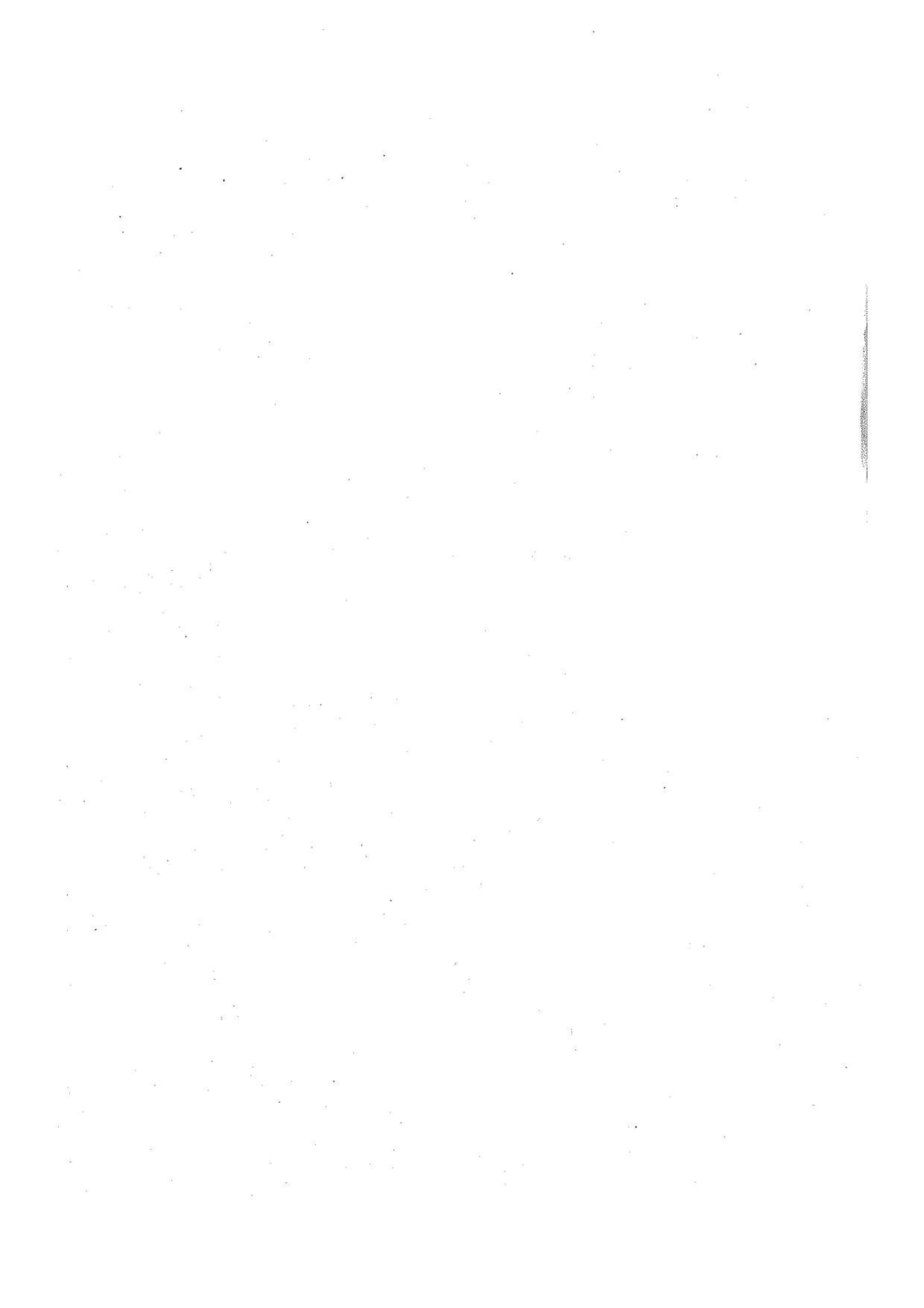

CHAPTER- 1 INTRODUCTION TO ECONOMICS

INTRODUCTION

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

— Lionel Robbins

Economics is the "study of how societies use scarce resources to produce valuable commodities and distribute them among different people."

— Paul. A. Samuelson

Economics is about how the society deals with the problem of scarcity. The scarcity of resources indicates that all wants cannot be satisfied. Hence we have to make choices among innumerable wants. Economics is the study as to how we make choices or how we choose to use resources. Resources include the time and abilities people have, land, buildings, equipment, and know-how of creating useful products and services. In short, economics is the study of labor, land, investments, money, income, and production and of taxes and government expenditures. It helps in solving basic problems of what goods and services to produce, how to produce, and for whom to produce. The supply and demand forces in the market or the price mechanism help society to solve these problems and allocate resources to different economic activities.The act of choosing and resource allocation to the various activities like food production, construction building, production of commodities like clothes, telephones etc. takes place at different levels. A firm has to allocate the available resources for production in the best possible way so as to maximize its sales and profit. Likewise, a consumer spends his income in a manner that most of his needs are met and he derives maximum satisfaction. The study of individual firm or the behaviour of a consumer is the subject matter of Microeconomics. Microeconomics offers detailed treatment of economic behaviour of an individual unit ignoring the relationship of it with the rest of the economy for the sake of simple analysis. Macroeconomics is the explanation of overall interactions in an economy. The working of an economy which is a complex system is explained by economics, it addresses the collective behaviour of economic players like consumers and producers, businesses and industries, governments and countries, and the globe as a whole. Hence, the financial system, public finance, planning and development, different sectors of economy, international economics etc, become important in the study of economics. The objective of the study material is to provide basic knowledge regarding important aspects of an economy and its functioning in general and particularly about Indian economy.

Important Factopedia

demand increases and supply remains the same.

Micro Economics	Micro and Macro Economics Micro means small.Micro economics is the study of particular markets, and segments of the economy.
Macro Economics What is produced and in what quantities?	Macro means large.Macroeconomics is the study of the whole economy. It looks at 'aggregate' variables, such as aggregate demand, national output and inflation Central Problems of an Economy Whether to produce more agricultural goods or industrial products and services.
How are these goods produced?	How much of which of the resources to use. Whether to use more labour or more machines.

For whom are these goods produced?	How should the produce of the economy be distributed among the individuals in the economy?
Maximum Profit	How does a firm decide how much to produce? A firm is a profit maximizer. So, the amount that a firm produces and sells in the market is that which maximizes its profit
Equilibrium	Where market supply equals market demand equilibrium.
equilibrium price	at which equilibrium is reached
equilibrium quantity	quantity bought and sold at equilibrium price.
price will rise	IF demand increases and supply remains the same.
price will fall	If supply increases and demand remains the same
The Centrally Planned Economy	Type of Economy Where the government or the central authority plans all the important activities in the economy.
The Market/ capitalist Economy	Where all the central problems are solved with the help of price mechanism.The basis of price mechanism is that every commodity/ service has a price which is determined with the help of supply and demand.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 that the society wants more of that good and the producers of that good, 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.
Mixed economies	In reality, all economies are mixed economies where some important decisions are taken by the government and the economic activities are by and large conducted through the market.
Substitutes	Substitutes and Complements Goods like tea and coffee are not used together. They are replacements for each other. Since tea is a replacement for coffee, if the price of coffee increases, the consumers can shift to tea. On the other hand, if the price of coffee decreases, the consumption of tea is likely to go down. Thus the demand for a good usually moves in the direction of the price of its replacements.
Complements	Goods that are used, together are called complementary goods. e.g. tea and sugar, pen and ink. Since tea and sugar are used together, an increase in the price of sugar is likely to reduce, the demand for tea, and a decrease in the price of sugar is likely to increase the demand for tea. Hence, the demand for goods moves in the opposite direction of the price of its complementary goods.
Monopoly	Monopoly and Oligopoly When there is a single producer of a particular commodity; no other commodity works as a substitute for this commodity.
Oligopoly	When market of a particular commodity consists of more than one seller but the number of sellers is few
Duopoly	The special case of oligopoly where there are exactly two sellers.
Joint efforts	Four factors of production Production of goods and services is a result of joint efforts of four factors of production
1. Land (i.e. natural resources)	remuneration for which is called rent.
2. Labour	remuneration for which is called wages

3. Capital	remuneration for which is called interest.
4. Entrepreneurship	remuneration of which is profit.

MACROECONOMICS

Macroeconomics is a branch of economics dealing with the overall working of an economy. It deals with all the sectors of the economy, national income, inflation, unemployment, international trade, etc. Generally, the economy of a country is classified into different sectors such as Public Sector, Private Sector, Joint Sector, and Foreign Sector. Public Sector is the sector where everything is managed, controlled and the majority of the stake belongs to the government e.g: Railways; Oil and Natural Gas corporations. Under Private Sector, everything is managed and controlled by private individuals e.g: Infosys, Wipro, etc. In Joint, Sector activities are taken up together by Public and Private sector as a joint venture. The imports and exports of a country; foreign investments, etc., come under the foreign sector.

Classification of Economy

An economy is also classified as Primary, Secondary and Tertiary Sector. Primary Sector constitutes agriculture, mining, fisheries, forestry and other related activities which are considered as primary economic activities. Industrial and manufacturing activities come under secondary sector. Tertiary sector which is also called as Service Sector constitute banking, insurance transportation etc.

ESTIMATING NATIONAL INCOME

Usually while estimating National Income the classification of Primary, Secondary and Tertiary sector is taken into consideration. The National income derived from each of these sectors is calculated.

National Income (NI) or Gross National Product (GNP) is generally defined as the value of the aggregate of final goods and services produced in an economy during a particular period of time which is usually one year.

The national income of a country can be measured by three alternative methods: (i) Product Method (ii) Income Method, and (iii) Expenditure Method.

1. Product Method:

In this method, national income is measured as a flow of goods and services. We calculate money value of all final goods and services produced in an economy during a year. Final goods here refer to those goods which are directly consumed and not used in further production process. Goods which are further used in production process are called intermediate goods. In the value of final goods, value of intermediate goods is already included therefore we do not count value of intermediate goods in national income otherwise there will be double counting of value of goods.

2. Value-Added Product Method Step 1: Gross Domestic Product
Market Price (GDP_{mp}) = Value Added by Primary Sector
- Value Added by Secondary Sector
+ Value Added by Territory sector

Step 2: Net National Product at Factor.
Cost (NNP_{pc})=National Income
-GDP_{mp}
-Depreciation
- Net Indirect Taxes (Indirect
TaxcsSubsidics
- NEIA

2. Income Method:

Under this method, national income is calculated as a flow of factor incomes. There are mostly four factors of production labor, capital, land, and entrepreneurship. Labour gets wages and salaries, capital gets interested, the land gets rent and entrepreneurship gets the benefit as their remuneration. Besides, there are some self-employed persons who employ their own labor and capital such as doctors, advocates, CAs, etc. Their income is called mixed-income. The sum-total of all these factor incomes is called NDP at factor costs.

Income thod
Step 1: Net Domestic Product at Factor COSE (NDP)
-Compensation of employees
+ Operating surplus.
+ Mixed income for self employed person
Setp 2: National Income (NNP_{pc})
- NDP
-Net Factor Income Eamed from Abroad (NFLA)

3. Expenditure Method:

In this method, national income is measured as a flow of expenditure. GDP is sum-total of private consumption expenditure. Government consumption expenditure, gross capital formation (Government and private) and net exports (Export-Import).

Expenditure Method
Setp1: Gross Domistic Product at Market Price (GDP_{mp})
- Private Final Consumtion Expenditure (C)
+ Govt. Final Consumption Expenditure (G)
+ Gross Domestic Capital Formation (2)
+ Net Export (X-M)
Step 2: Net National Product at Factor Cost (NNP_{pc}) National Income=GDP_{mp}
-Depreciation
-NIT (Net indirect Taxes)
+ NFIA

Net National Product (NNP): It is GNP minus depreciation or capital consumption allowances.

NNP=Gross National Product–Depreciation

Depreciation is deducted from GNP to arrive at NNP, since capital stock wears out in the process of production.

Gross Domestic Product (GDP): It relates to the product of the factors of production (land, labour, capital and entrepreneurship) during a year, employed within the political boundary of a country i.e., what is produced within domestic territory. GDP estimated at current year price is called as nominal GDP. GNP is the output produced by the nationals of a country including net return on assets owned abroad, Therefore, GDP = GNP - Net income from abroad or

GNP = GDP + Net income from abroad

Similarly, Net Domestic Product = NNP - net income from abroad.

, GDP = C + G + I + NX

where

- C=consumption;
- G=government spending;
- I=investment; and
- NX=net exports

Real GDP, is the GDP stated in the base-year's price level. The effect of, inflation are the rising prices on GPD level and can thus be adjusted with the help of real GDP. The real GDP reflects the actual growth rate of GDP after adjusted for inflation.

Gross Value Added (GVA) Vs. GDP

Gross value added (GVA) is determined as the value of output less than the value of intermediate consumption. Value-added represents the contribution of labor and capital to the production process. When the value of taxes on products (fewer subsidies on products) is added, the sum of value added for all resident units gives the value of the gross domestic product (GDP). Thus, the Gross Domestic Product (GDP) of any nation represents the sum total of gross value added (GVA) (i.e, without discounting for capital consumption or depreciation) in all the sectors of that economy during the said year after adjusting for taxes and subsidies.

Introduction of GVA at basic prices in India

GDP is estimated by Central Statistical Office (CSO) in India. Under the Fiscal Responsibility and Budget Management Act 2003 and Rules thereunder, the Ministry of Finance utilization the GDP numbers (at current prices) to stubble the fiscal targets. For this intention, the Ministry of Finance makes it's own salient about GDP for the coming two years while specifying future fiscal targets.

In the amendment of National Accounts statistics done by the Central Statistical Organization (CSO) in January 2015, it was decided that sector-wise wise estimates of Gross Value Added (GVA) will now be given at basic prices instead of factor cost. In simple terms, for any commodity, the basic price is the amount receivable by the producer from the purchaser for a unit of a product minus any tax on the product plus any subsidy on the product. However, GVA at basic prices will include production taxes and exclude production subsidies available on the commodity. On the other hand, GVA at factor cost includes no taxes and excludes no subsidies, and GDP at market prices includes both production and product taxes and excludes both production and product subsidies.

The relationship between GVA at Factor Cost and GVA at Basic Prices and GDP at market prices and GVA at basic prices is shown below:

GVA at factor cost + (Production taxes less Production subsidies) = GVA at basic prices

GDP at market prices = GVA at basic prices + Product taxes- Product subsidies

Production taxes or production subsidies are paid or received with regard to production and are freelance of the amount of actual production. Some samples of production taxes are land revenues, stamps and registration fees, and tax on the profession. Some production subsidies embody subsidies to Railways, input subsidies to farmers, subsidies to the village and little industries, body subsidies to firms or cooperatives, etcetera Product taxes or subsidies are paid or received per unit of product. Some examples of product taxes are excise tax, sales tax, service tax, and import and export duties. Product subsidies include food, petroleum, and fertilizer subsidies, interest subsidies given to farmers, households, etcetera through banks.

The concept of GVA at basic prices follows from the United Nation's System of National Accounts (SNA) introduced in 1993 and carried forward in an identical fashion in SNA 2008 as a part of revision of compilation and classification systems. This has been adopted by CSO in its base revision carried out in January 2015.

Personal Income (PI) is defined as the income received by the households before the payment of personal income taxes. From National Income, undivided corporate profit (Ucp), corporate in-

come taxes (CIT) corporate saving (Cs) and social security contribution (SS) made by individual and the transfer payment (TP) are added since they increase the income of individuals.

PI = NI + TP - Ucp - CIT - CS - SS.

Transfer Payments are payments for which no productive activity is made. They are merely transferred of purchasing power from one person or organization to others such as old age pension, lottery, gifts, gambling, unemployment allowance, widow relief and other social security contributions from the government.

Disposable Income (DI) is the income left with the public or what actually gets into public hands, to dispose as it pleases for consumption or saving. It is defined as personal income minus personal income taxes (Tpi).

DI = PI - TpI

Per-Capita Income (pCI) is National Income of a country divided by its total population.

PCI for 2018 = NI of 2018

Almost all the countries of the world take up the task of National Income Accounting, as it indicates the growth level of an economy.

NATIONAL INCOME ACCOUNTING IN INDIA

In India, the National Income Unit of the Central Statistical Organization (CSO) estimates a major part of the National Income by using the production method. Product Method takes into account the value of final goods and services produced in the country. Eg: Agriculture, animal husbandry, forestry, fishing, mining, and factory establishments. The income Method is applied to estimate National Income in other sectors, where the income earned by the people in the form of rent, wages, salaries, interest, and profit are considered. Eg: banking and other services. Through annual estimates of national income, the annual growth rate of an economy can be calculated.

Annual Growth Rate of an economy is the annual percent change of National Income. In other words, the annual growth rate is the percent change in National Income over the previous year. The level of savings and investments determine the amount of fund available for investment in the country. Higher the saving higher will be investment and hence higher growth rate. Usually saving in an economy are derived from government sector, corporate sector and the house hold sector.

Investment is the total amount of capital (money) invested to take up different economic activities. The efficiency of capital or the investment in an economy is calculated with the help of Capital-Output Ratio and Incremental Capital Output Ratio.

Capital-Output Ratio is the ratio which indicates the units of capital needed to produce one unit of output. If the value of capital-output ratio is high (for eg -7: 1) then the efficiency of capital is very low. It means, to produce one unit of output seven units of capital is needed.

Incremental Capital Output Ratio (ICOR) is the number of units of investment needed to generate one unit of additional output in the future. The income level in a country will be high with high investments and high employment level and low unemployment level.

Employment refers to making use of one's labour and getting in return some income. Whereas, unemployment is not making use of one's labour though available, and hence no income. It is the state where supply of labour is excess over the demand for labour.

There could be different types of Unemployment

Under Open Unemployment many persons are left without a job though they are willing to work and are fit both physically and mentally. Agricultural Unemployment can take the form of disguised, under employment or seasonal unemployment. Disguised Unemployment is not easily recognized. More people are employed than the actual requirement. This results in low productivity of the labour For eg: An agricultural plot requires labour of five persons whereas ten persons might be actually working. A person can be said to be under employed if he has a job where his capacities are not utilized fully or which he thinks is not adequate for his purpose. In other words, the job may not be commensurate with his training or qualification. Under Seasonal Unemployment agricultural labourers are employed only during certain seasons like sowing and harvest. In other seasons they are left unemployed. People who are educated to certain levels and are left without job belong to enclosed unemployed class.

Usually there is a trade-off between the unemployment level and inflation in the economy. That is, if the government wants to control inflation, unemployment in the economy increases and vice-versa. But sometimes the economy experiences stagnation or unemployment along with a high rate of inflation. This situation is called as Stagflation. Stagflation is derived from words Stagnation arid Inflation.

Inflation is the continuous rise in the general price

level of the economy. In other words, it is too much of money chasing too few goods. It is usually associated with increased supply of money in the economy. One of the major reasons for inflation is the existence of Black money in the economy. Black Money is the money which is not accounted for. It is the unaccounted or illegitimate transactions of production, consumption and investment. It runs parallel with the accounted economy, hence also referred as parallel economy. The Black Money can be in the form of money, gold, precious stones, land and building assets.

The generation of black money can be due to:

- High rates of taxation where people try to evade taxes and hence do not disclose their actual income.
- The unofficial market for foreign exchange dealing in illicit transactions like smuggling of goods, under invoicing of exports and over invoicing of imports lead to accumulation of unaccounted foreign exchange balances and there by increased dealings in hawala market.
- The Regime of Quantitative Restrictions like controls, permits, quotas, licenses (Permit Raj) etc has also contributed to the generation of black money.
- The other reasons could be Transactions in Real Estate Property, Donations to political parties, Inflation and weaknesses in the enforcement of tax laws.

High levels of inflation lead to certain drastic effects in the economy like high cost of living, lowered standard of life etc. Hence, government tries to control inflation in an economy. Monetary Measures are taken up where credit is controlled by controlling the supply of credit in the economy. It is taken up by Reserve Bank of India. Inflation is also controlled through demonetization of currency of higher denominations. It is usually adopted when there is abundance of black money in the economy.

To control inflation Fiscal Measures are adopted by way of reduction in unnecessary government expenditure, increase in taxes, and increase in savings where the government should float public loans carrying high rates of interest, start saving schemes with prize money, or lottery for long periods, etc. It should also introduce compulsory provident fund, provident fund-cum-pension schemes etc compulsorily. By way of Surplus Budget as Deficit financing is an inflationary budget policy. Therefore at inflationary periods government should give up deficit financing and go for surplus budgeting that is having more revenues and spending less. The government should stop repayment of public debt and postpone it to some future date till inflationary pressures are controlled within the economy. Instead, it should borrow more to reduce money supply in the country.

The inflation rate in the economy can be known with the help of movements in the general price level. It is difficult to find out the general movements in prices by examining changes of price in individual commodities. In a market economy price changes

are common depending on the demand for and supply of goods and services. Therefore, the concept of General Price level is used to find out the overall impact of individual price movements. The general price level can be known through Price Index and gives an idea as to whether there is price stability or not in the economy. Price Stability is the relative stability in the general price level in an economy and not the stability of individual prices or fixed prices.

The general price level is measured by a statistical tool called as Price Index. Price Index is the weighted average of prices of selected goods and services. The weights are assigned to each commodity based on their relative importance in the group of commodities that have been selected. In common terms, the group of commodities is referred as Basket of goods. Two main types of price indices in an economy are Consumer Price Index and Wholesale Price Index.

Consumer Price Index (CPI) is the most widely used price indices. Consumer Price indices measure the general movements of prices of a representative basket of goods and services. Based on the survey of the spending patterns of consumers, goods and services are included in the basket and relative weights are assigned according to their relative importance. The relative importance is found out through the proportion of expenditure incurred on each item. That is, goods and services that account for larger portions of the total expenditure of consumers are assigned greater weights.

Wholesale Price Index (WPI) indicates the general price level with reference to Wholesale Prices. WPI is developed for various groups of commodities like primary articles (consumer), fuel and power, manufactured products and also in general for all type of commodities. There will be movements in the general price level as per the fluctuations in the economic activities.

Business Cycle or Economic Cycle or Trade Cycle refers to the periodic fluctuations in the economy over a period of time. It involves periods of rela-

tively rapid growth of output (recovery and prosperity) alternating with periods of relative decline or stagnation (contraction or recession).

These fluctuations have serious implications on Business community as they have to face drastic effects during recession (decline in economic activity, deflation) and depression. They should be ready to cope with the effects of depression. Deflation is the continuous fall in the general price of the economy. Money supply during deflationary periods will be usually low in the economy. Continuous existence of deflation leads to Depression, the stage of lowest economic activity. Production, Price Level, Income, Profits etc., will be lowest. But during the period of recovery and prosperity (rapid expansion of economic activity, inflation) the business community reaps high profits due to increasing price levels in the economy.

Poverty is the condition of people or social phenomenon where there is lack of even basic necessities of life like food, shelter and clothing. People stricken with poverty are deprived of facilities like health, education, employment etc.

Apart from poverty estimates, there are other indicators which indicate the quality and the st[illegible] dard of living of the population like Demogr[illegible]hic Indicators including Gender Empowerment [illegible]ea-sure and Human Development Index.

DEMOGRAPHIC INDICATOR[illegible] INCLUDE

Infant Mortality Rate (IMR) is the num[illegible]er of infants who die per 1000 live births.

Maternal Mortality Rate (MMR) is the number of mothers who die at the time of delivery per 1000 live births

Life Expectancy at Birth or longevity is the expected life span of the population in years, from birth to death.

Literacy Rate (Percentage of population who are able to read and write).

Sex Ratio is the number of females per 1000 males.

Gender Empowerment Measure (GEM) - In 1995 the United Nations Development Program (UNDP) introduced a new index to quantify the economic and political position of women relative to men in a given society. It identifies the percentage of women occupying administrative and managerial posts, working in professional and technical occupations and holding seats in parliament, as well as their level of earned income relative to men.

Human Development Index (HDI)

The UNDP has been using the index on human development since 1990, with the publication of First Human Development Report.

The HDI is a composite index of three social indicators namely life expectancy or longevity, adult literacy rate, years of schooling and real GDP per capita.

Important Factopedia

Key economic indicators- GVA & GDP at Constant prices (Base year 2011-12)

Issued	Monthly
Issued by	The Central Statistics Office (CSO) (Ministry of Statistics and Program Implementation).CSO also releases Quarterly Estimates of National Income/GDP at constant price (Base 2011-12).
Gross Domestic Product (GDP)	Market value of all final goods and services taking place within the domestic economy during a year.Or GDP at market price = Gross Value Added (GVA) at basic price + Indirect tax- Subsidies
Gross National Product (GNP)	GDPAdd: Income earned by the domestic factors of production employed in the rest of the world. (i.e. Indians or Indian companies abroad).Less: Income earned by the factors of production of the rest of the world employed in the domestic economy. (i.e. profit earned by MNCs in India e.g. Google, IBM). Hence, GNP = GDP + Net factor income from abroad.
[illegible]ation-al [illegible]roduct (NN[illegible]	NNP = GNP – Depreciation.
NN[illegible]t factor [illegible]st or National Income	All above variables are evaluated at market prices. But market price includes indirect taxes. Indirect taxes accrue to the government.National Income = NNP at market prices – Indirect taxes + Subsidies

ECONOMIC POLICY

Before discussing economic policy and its criteria, it is important to understand what is economic policy?

Actions taken by a government to influence its economy are termed economic policy.

In India, the perfect example of economic policy is planning and the resulting five-year plans. India used a mixed economy where both the public sector and private sector would play an important role in the economy. Thus, our industrial policy resolution, 1948 and later 1956, revolved around that philosophy. The second five-year plan was centered around industrialization and the country opened 4 steel plans in collaboration with foreign countries. In 1965, India embarked on a green revolution that resulted in improving the agriculture sector tremendously. At the same time, it solved the prob-