CHAPTER 1
INTRODUCTION TO MICRO ECONOMICS

Fundamental Premise of Economics: - Individuals are capable of establishing goals and acting in a manner consistent with achievement of those goals

Definition: - Different definitions of Economics are given by different economists, which can be classified as follows;

Economics as a science of wealth (By Adam Smith);
Economics as a science of material well-being (By Prof. Alfred Marshall);
Economics as a science of choice making (By Lionel Robbins);
Economics as a science of dynamic growth and development (By Paul .A. Samuelson).

1**. Economics as a Science of Wealth**: - In 1776 Adam Smith's book, *"An Enquiry In To the Nature and Causes of Wealth of the Nation"* published. As the name of the book suggests, Adam Smith defined economics as *an enquiry in to the nature and causes of the generation of the wealth of a nation*.

J.B.Say also defined economics as *a science which deals with wealth.*

Salient Features: - Following the salient features of this definition;

1. **Adam Smith's definition tries to increase the prosperity of the nation**: - Adam Smith defines the economics as a subject, which encourages the people to procure more and more wealth. He believed that if every body tries to earn more and more wealth it will lead to the prosperity of the nation.
2. **View of economic man**: - Adam Smith believed that the only motivation before mankind is to maximize his profit.

Criticism: - Smith's definition is criticized on following grounds: -

1. **Exploitation of labour**: - Adam Smith's definition encourages the selfishness in the society. The rich peoples tried to earn wealth at the cost of poor people. This leads to exploitation of labour by capitalists during the industrial revolution in England.
2. **Wrong view of economic man**: - Adam Smith's view that the man is purely motivated by the wealth was also found to be wrong. Though wealth is important for human being he also has a humanitarian aspect to his nature.
3. **It narrows the scope of economics**: - Adam smith's definition narrows the scope of economics by defining it as a study of wealth.

Adam Smith's definition increases the selfishness n the society. Critics condemn it as Gospel of Mammon and Dismal Science. This definition comes to an end towards the end of 17th century.

2. **Economics as a Science of Material Well-Being**: - Alfred Marshall rehabilitated the image of economics by shifting the emphasis from wealth to welfare. In his book *"Economics of Welfare",* Marshall says, *"it is on the one side a study of wealth but on the other and more important side a part of the study of man."*

This reveals that the man is more important than the wealth. Though wealth is important, man is more important because the wealth generated for the material welfare of the human being.

In his book "Principles of Economics" Prof. Alfred Marshall defined … "Economics is a study of mankind in the 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 the material requisite of well being."

A.C. Pigou gives another important definition under this group. According to him, *"The range of our inquiry becomes restricted to that part of social welfare that can be brought directly or indirectly into relation with measuring rod of money."*

Salient Features: - The salient features are ~

1. **Economics is a social science**: - According to Marshall Economics studies only the activities of human beings living in the society. Hence, it is asocial science.
2. **Economics deals only with economic aspect of life**: - According to Marshall Economics studies only the "economic activities" of a man i.e. the attainment and use of material requisites. It studies only that part of human behavior, which can be measured in terms of money.
3. **Science of welfare**: - According to Marshall Economics tells us how to produce consumer goods to maximize human welfare.

Criticism: - The welfare definitions are criticized on the following grounds: ~

(1.) **Only material things are considered**: - Marshall includes only material things in the study of economics and ignores the services that are also a crucial part of economic activity. However, the services are immaterial but they still play a vital role to promote human welfare. Robbins held the view that those services that have some exchange value must also be included in the study of economics.

(2.) **It narrows the scope of economics**: - Marshall had included only social humans in the study of economics. He has ignored those who live outside the society and by doing so; he has narrowed the scope of economics.
(3.) **This definition makes the study of economics subjective**: - By using the term welfare meaning well being i.e.; all those activities which lead to human satisfaction Marshall has made the study of economics subjective. Different people may think differently about different goods as far as welfare is concerned.
(4.) **It creates confusion**: - By including production and consumption of only those goods, which can be measured in terms money, Marshall has created confusion. Since the same activity at one point of time be measured in terms of money and at another time without money.
(5.) **Marshall's definition is highly classificated**: - Marshall classified the activities of human being in ordinary and unordinary, social and nonsocial, monetary and nonmonetary.

3. **Economics as a Science of Choice Making**: - Lionel Robbins in his book named *'Nature and Significance of Economic Science' published in 1932*, defined economics as follows: -

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

The following are the important aspects of definition given by Robbins-
(1) **Human wants are unlimited**: - The wants of human beings are unlimited; if one want is satisfied another want crops up. One has to choose between more urgent and less urgent want. That is why the economics is a science of choice making.
(2) **The means to satisfy wants are limited**: - There is a scarcity of resources in relation to their requirements to satisfy wants.
(3) **The scarce means are capable of being put to alternative uses**: - Although resources to satisfy unlimited ends are limited, they can be put to alternative uses.
(4) **Economics is a positive science**: - According to Robbins, economics is a positive science. The economics is *neutral between ends*.

Criticism: -
(1). Robbins has considered the problem of scarcity of resources but some times problem also arise because of abundance of resources. Robbins has not given any solution to this problem.
(2). Though Robbins does not use the word welfare in his definition but it is implied in it since optimization of gains is aimed to increase welfare.
(3). Robbins talks of allocation of resources' but without a growth of resources human wants in the future will not be fulfilled. Robbins has totally ignored this aspect.
(4). Robbins has enlarged the scope of economics too much by including in it all problems where choice is concerned.

4. **Economics as a Science of Dynamic Growth and Development**: - Noble laureate Prof. Paul. A. Samuelson has defined economics as follows: -
"Economics is the study of how men and society choose with or without the use of money to employ scarce productive resources which could have alternative uses to produce various commodities over a period of time and distribute them for consumption now and in the future amongst various people and groups in society."

Salient Features: -
1. Samuelson agrees with Robbins that economics should deal with scarce resources and unlimited ends. So that it optimizes the gains.
2. Samuelson however argues that the resources are not static and they can be made to grow over time through exploration, exploitation and development.
3. According to Samuelson the growth of resources is necessary since not only the present wants of human beings should be considered but also the increasing wants of increasing number of people should be taken in to consideration.
4. Like Robbins Samuelson includes all activities in economics whether they can be measured in terms of money or not or whether they lead to material welfare or not.

Best General Definition of Economics: -It is the study of Individual and social choice in the face of scarcity.

Economics -- Science or Art

Economics as a science: -
Economics is a science because it uses scientific methods in its researches and investigations.
As every science economics also has a unit of measurement that is money; the economist can measure the individual and business motives with the use of this measuring rod of money.
Though the economics has an inability to predict the future course of events as accurately as accurately as the laws of the physical sciences like physics and chemistry can. But for this reason the scientific nature of economics can not be denied. The reason for this lack of accuracy is that economics deals with highly complex and variable forces. It deals with men who have freedom of will and there is no guarantee that they will act in a preconceived manner.
Economics as an art: -
Economics is an art too. Economics as a science make laws, rules and doctrines and as an art it tell how to use these laws rules and doctrines for the maximum satisfaction of human beings.

Economics- Positive Science or Normative Science

The old *English Classical School of Economics* held that Economics was purely a positive science while the *Historical School of Germany* held the contrary view that the economics is a normative science.
Economics as a positive science: -
Economics as a positive science is concerned with the criteria of, 'what is?' And not to the criteria of 'what ought to be?'
Economics must study things as they are.
Economics must be neutral between ends.
Economics does not discuss the moral rightness or wrongness of the thing.
An economist should not give value judgments or ethical advices.
Economics as a normative science: -
Economics as a normative science is concerned with the criteria of 'what ought to be?'
It has no objection to discussing the moral rightness or wrongness of the thing.
An economist is also a human and lives in the same society and knows that the rules framed by him are used for this society so he can not abstain himself from giving value judgments.
Conclusion: -Economics is both positive as well as normative science.

Methods of Economic Study

Since Economics is a science, it also adopts certain methods for the discovery and formulation of its laws and principles. There are two methods
1. **Deductive Method**: - The deductive method is also known as the analytical, abstract, and a priori method. This method descends from general to particular. Under deductive method conclusions are drawn on the basis of certain fundamental truths. Law of demand and law of supply are based on deduction.
Steps or stages of Deduction: -
(1). Perception of problem.
(2). Making assumptions.
(3). Formulating hypothesis.
(4). Testing or verifying the hypothesis.
2. **Inductive Method**: - The inductive method is also known as historical, empirical or posteriori method. This method mounts from particular to general. Induction is a process in which facts are collected, arranged and then general conclusions are drawn.
Steps or stages of Induction: -
(1). Perception of the problem.
(2). Collection, classification and analysis of data using appropriate statistical technique.
(3). Finding out the reason of relationship existing.
(4). Setting up rules and general laws.

Micro Economic And Macro Economic Analysis: - The economic theory is divided under two heads: Microeconomics and Macroeconomics. These terms were first used by Prof. Ragnar Frisch of Oslo University.
Micro Economics: - Microeconomics deals with a small part or a small component of the national economy of a country.
Microeconomics may be defined as that branch of economic analysis which studies the economic behavior of the individual unit, may be a person, a particular household, or a particular firm. It is a study of one particular unit rather than all the units combined together. In microeconomics we examine *the trees not the forest*. Since microeconomics splits up the entire economy into smaller parts for the purpose of intensive study, it is sometimes referred to as the *Slicing Method*.

Scope of Microeconomics: - In microeconomics we study:-
Theory of product with its two constituents, namely, the theory of consumer's behavior and the theory of production and costs.
Theory of factor pricing with its four constituent, namely, the theories of wages, rent, interest and profit.
Theory of Economic Welfare.

Microeconomics is sometimes referred to as *Price Theory*, the reason being that prices are the main part of microeconomics.

Macro Economics: - Macroeconomics is concerned with the economic activity in the large.

Macroeconomics may be defined as that branch of economic analysis which studies the behavior of not one particular unit, but of all the units combined together. Macroeconomics is the study of aggregates; hence, it is also called Aggregative Economics.

It is the study of the overall conditions of an economy, say, total production, total consumption, total savings, and total investment.

Scope/field of Macroeconomics: - In macroeconomics we study: -
Theory of Income, Output and Employment with its two constituents, namely, the theory of consumption function and the theory of investment function.
Theory of Prices with its constituents of theory of inflation, deflation and reflation.
Theory of economic growth.

Interdependence of Microeconomics and Macroeconomics: - Microeconomics and Macroeconomics are complementary to each other. In fact, they are so interdependent that neither approach is complete without the other. In the words of Prof. Samuelson, "*There is really no opposition between microeconomics and macroeconomics. Both are absolutely vital. You are less than half educated if you understand the one while being ignorant of the other*.

Central Problems of Economics

There central problems of an economy arise from two basic facts, namely, the multiplicity of ends and the scarcity of means.

Every economy has to face three problems:-

1. What to Produce: - The economy has to take a fundamental decision that what goods and services are to be produced and in what quantity with the limited resources at its disposal.

2. How to Produce: - This is the problem of what type of technique is to be adopted for production; an economy may choose between labour intensive technique (use of more labour than capital) and capital intensive technique (use of more capital than labour).

3. For Whom to Produce: - The third decision to be taken by an economy is : How to distribute the commodities and services among the different sections of the society?

Types of Economies and How They Solve Their Central Economic problems

There are three types of economies:-

1. Capitalist Economy (Free Economy or Market Economy): - A capitalist economy uses the impersonal forces of the market demand and supply or the price mechanism to solve its central problems.

The basic features of a capitalistic economy are as follows:-

5. There is a right of private property. The factors of production are (land, machineries etc.) under private ownership.
6. There is a freedom of work; every person is free to choose an engage in an economic activity he likes.
7. The profit motive is most important in the capitalist economy
8. The consumer is the sovereign in a capitalistic economy. A consumer can spend his income where he likes.
9. There exists inequalities of income, some peoples are rich and others are poor. This leads to class struggle.

Ex.: - Britain; U.S.A.

2. Socialist Economy (Controlled Economy): - A socialist economy solves their central economic problem through Central Planning Authority (Central Planning Commission).

The main features of Socialist Economy are: -

1. The factors of production are collectively owned by the society. These are used by Government in order to maximize the welfare of the society.
2. The right of work is guaranteed by the Government but the choice of occupation is restricted.
3. Since the factors of production are owned by the society (Govt.) the profit motive has no longer importance, These are used to achieve socio-economical objectives.

4. Only those goods are produced which are selected by the society, hence the consumers' sovereignty is restricted.

5. There exists an economical equality.

Ex.: - China and erstwhile U.S.S.R.

Now a days no country is purely socialist.

3. Mixed Economy: -In a mixed economy a system is developed which tries to include the best features of both capitalist economy and the capitalist economy. It solves the economic problems through both price mechanism and central planning.

The main features of Socialist Economy are: -

1. A dual system of pricing exists
2. State regulates the prices of essential commodities.

Ex.: - India.