Contents

CHAPTER 1

INTRODUCTION TO ECONOMICS

BASICS OF ECONOMICS

Economics is the science of analyzing the production, distribution and consumption of goods and services. In other words, **what choices people make; how and why they make them when making purchases.**

Scarcity is the basic economic problem that exists because we as humans have unlimited wants that cannot be met by the limited amount of resources our world has. **Any good or service that has a non-zero price is considered scarce.** It will cost you something to consume that good or service. **Without scarcity, there would be no reason to study economics.** People would consume everything they could possibly consume and not have to make choices or trade-offs between goods and services.

The study of economics can be subcategorized into **micro-economics and macro-economics.**

- **Microeconomics** is the study of economics at the individual or business level; how individual people or businesses behave given scarcity and government intervention. Microeconomics includes concepts such as supply and demand, price elasticity, quantity demanded and quantity supplied.
- **Macroeconomics** is the study of the performance and structure of the whole economy rather than individual markets. Macroeconomics includes concepts such as inflation, international trade, unemployment, and national consumption and production.

There are also schools of economic thought. Two of the most common are **Classical and Keynesian.**

- The Classical view believes that free markets are the best way to allocate resources and the government's role should be limited to that of a fair and strict referee.
- In contrast, the Keynesian approach believes that markets don't work well at allocating resources on their own and that governments must step in from time to time and actively reallocates resources efficiently.

TYPES OF ECONOMY

- **In Terms of the Role of State**
  - Capitalism
  - Socialism
  - Mixed Economy
- **In Terms of Per Capita Income**
  - Low-Income
  - Lower – Middle Income
  - Upper – Middle Income
  - High – Income
- **In Terms of the Nature of Economy**
  - Agrarian Economy
  - Industrial Economy
  - Service Economy

IN TERMS OF THE ROLE OF STATE

The most contentious issue that has affected civilized history of mankind is as to how the production process in an economy should be organized. Whether the production should be the sole responsibility of State/Government or should it be left altogether to the private sector?

Every society has to answer three questions which determine the type of economic system:

- What goods and services should be produced in the country?
- How should the goods and services be produced? Should producers use more human labour or more capital (machines) for producing things?
- How should the goods and services be distributed among people?

Based on the answer of these three questions, the economic systems are classified into 3 categories:

CAPITALISTIC ECONOMY

The capitalistic form of economy has its origin in the famous work of **Adam Smith - Wealth of Nations (1776).** He stressed on 'laissez faire' state i.e. non-interference by the government.

The decisions of what to produce, how much to produce and at what price to sell are taken by the market, by the private enterprises in this system with the state having no economic role.

- In a capitalist economy, the market determines prices through the laws of supply and demand.

  For example, when demand for coffee increases, a profit-seeking business will boost prices in order to increase its profit. If, at the same time, society's appetite for tea diminishes, growers will face lower prices and aggregate production will decline. In the long run, some suppliers may even exit the business.
- If labour is cheaper than capital, more labour-intensive methods of production will be used and vice-versa.
- In a capitalist society the goods produced are distributed among people not on the basis of what people need but on the basis of what people can afford and are willing to purchase. This means that a sick person will be able to use the required medicine only if he/she can afford to buy it; if they cannot afford the medicine they will not be able to use it even if they need it urgently.

SOCIALISTIC ECONOMY OR STATE ECONOMY

The socialistic form of economy was rooted in the ideas of historical change proposed by the German philosopher Karl Marx (1818–1883). More specifically, this kind of economic system first came up in the erstwhile USSR after the Bolshevik Revolution (1917) and got its ideal shape in the People's Republic of China (1949).

Under a true socialist system, it's the government's role to determine output and pricing levels. The challenge is synchronizing these decisions with the needs of consumers. A socialist society answers the three questions in a totally different manner:

- In a socialist society the government decides what goods are to be produced in accordance with the needs of society. It is assumed that the government knows what is good for the people of the country and so the desires of individual consumers are not given much importance.
- The government decides how goods are to be produced and how they should be distributed.
- In principle, distribution under socialism is supposed to be based on what people need and not on what they can afford to purchase. Unlike under capitalism, for example, a socialist nation provides free health care to the citizens who need it. Strictly, a socialist society has no private property since everything is owned by the state.

There **are two versions of the state econom**y - in erstwhile USSR known as the socialist economy and in pre-1985 China as the communist economy.

- Socialistic economy emphasized the collective ownership of the means of production (property and assets) and it also ascribed a large role to the state in running the economy,
- Communist economy advocated state ownership of all properties including even labor and absolute power to state in running the economy.

MIXED ECONOMY

It is an economic system that features characteristics of both capitalism and socialism. A mixed economic system allows a level of private economic freedom in the use of capital, but also allows for governments to interfere in economic activities in order to achieve social aims. This type of economic system is less efficient than capitalism, but more efficient than socialism.

Mixed economic systems are not laissez-faire systems: the government is involved in planning the use of resources and can exert control over businesses in the private sector. Governments may seek to redistribute wealth by taxing the private sector, and using funds from taxes to promote social objectives.

Which model was adopted by the Indian Economy?

The leaders of Independent India had to decide the type of economic system most suitable for our nation which would promote the welfare of all rather than a few.

Among the different types of economic systems, socialism appealed to Jawaharlal Nehru the most. However, he was not in favour of the kind of socialism established in the former Soviet Union where all the means of production, i.e. all the factories and farms in the country, were owned by the government. There was no private property. It was not possible in a democracy like India for the government to change the ownership pattern of land and other properties of its citizens in the way that it was done in the former Soviet Union.

The leaders found the answer in an economic system which, in their view, combined the best features of socialism without its drawbacks. **In this view, India would be a socialist society with a strong public sector but also with private property and democracy; the government would plan economy with the private sector being encouraged to be part of the plan effort.**

So, after Independence, India opted for the Mixed Economy. In the process of organising the economy, some basic and important infrastructural economic responsibilities were taken up by the State/Governments (centre and state) and rest of the economic activities was left to private enterprise i.e. the market.

But once the country started the process of economic reforms in early 1990s, the prevailing state-market mix was redefined and a new form of mixed economy began to be practised.

- The redefined mixed economy for India had a declared favour for the market economy.
- Many economic roles which were under complete government monopolies were now opened for participation by the private sector. Examples are many - telecommunication, power, roads, oil and natural gas, etc.
- At the same time, social sector such as education, health care, drinking water, etc were given extra emphasis by the state.

The economic system of India was a mixed economy in pre-1991 years as it is in post-1991 years but the composition of state-market mix has gone for a change.

IN TERMS OF PER CAPITA INCOME

The World Bank classifies economies based on their GNI per capita. The categories are given below:

Categorisation	Per Capita GNI (2016)
Low-Income Economy	\$1,005 or less
Lower Middle-Income Economy	Between \$1,006 and \$3,955
Upper Middle-Income Economy	Between \$3,956 and \$12,235
High-Income Economy	\$12,236 or more

Low- and middle-income economies are usually referred to as developing economies, and the Upper Middle Income and the High Income are referred to as Developed Countries.

India is categorized in the Lower Middle Income Category with per capita GNI of 1680 as per World Bank.

IN TERMS OF THE NATURE OF ECONOMY

Depending upon the shares of the particular sectors in the total production of an economy and the ratio of the dependent population on them for their livelihood, economies are given different names, such as:

Agrarian Economy

An economy is called agrarian if the share of its primary sector is 50 per cent or more in the total output (the GDP) of the economy. At the time of independence, India was such an economy. But now it shows the typical symptom of a service economy with primary sector's contribution falling to almost 18 per cent of its total produce while almost 60 per cent of its population depends on the primary sector for its livelihood. Thus, in monetary terms India is no more an agrarian economy.

Industrial Economy

If the secondary sector contributes 50 per cent or more to the total produce value of an economy, it is an industrial economy. Higher the contribution, higher is the level of industrialisation. Most of the developed economies have crossed this phase once the process of industrialisation saturated.

Service Economy

The economy whose 50 per cent or more produce value comes from the tertiary sector is known as the service economy.

STRUCTURAL COMPOSITION OF ECONOMY

The contribution made by the different sectors of the economy, namely the agricultural sector, the industrial sector and the service sector in the GDP of the country makes up the structural composition of the economy. In some countries, growth in agriculture contributes more to the GDP growth, while in some countries the growth in the service sector contributes more to GDP growth.

Primary Sector

The primary sector involves the extraction of raw materials from the earth. Therefore, this is sometimes known as the Extraction Sector. This extraction results in raw materials and basic foods, such as coal, wood, iron and corn.

Secondary Sector

The secondary sector involves the transformation of raw materials into finished or manufactured goods. This sector is rightly called the manufacturing sector. Since the manufacturing is done by the industries this sector is also called the industrial sector - bread and biscuits, cakes, automobiles, textiles, etc.

Tertiary Sector

The service sector is concerned with the intangible aspect of offering services to consumers and business. It involves retail of the manufactured goods. It also provides services, such as insurance and banking.

Quaternary Sector

The quaternary sector is said to be the intellectual aspect of the economy. It includes education, training, the development of technology and research and development. It is the process which enables entrepreneurs to innovate better manufacturing processes and improve the quality of services offered in the economy. Without this growth of technology and information, economic development would be slow or non-existent.

Structural Transformation of an Indian Economy

Structural transformation in an economy is usually associated with the changes in sectoral composition of output, employment and changes in the rural - urban composition of output and employment.

As a country develops, it undergoes 'structural change'. Usually, with development, the share of agriculture declines and the share of industry become dominant. At higher levels of development, the service sector contributes more to the GDP than the other two sectors. So, in general it follows the below trend as experienced by many developed countries such as US, UK etc. or by developing countries like China etc.

Agriculture (Primary Sector) ⟶ Industry (Secondary Sector) ⟶ Services (Tertiary Sector)

But in the case of India, the structural change is peculiar.

- The share of agriculture in Indian GDP fell from > 40% in the early 1960s to around 17% by the end of the 2000s.
- It is to be noted that the rate of decline in the agricultural share accelerated as the rate of economic growth increased.

- The share of industry as a whole rose from about 20% in 1960 to around 28% in 2009, whereas the share of manufacturing alone disappointingly stayed at around 15% during the entire period, again a sign of sluggish structural transformation.
- By 1990 the share of the service sector was 40.59 per cent, more than that of agriculture or industry, like what we find in developed nations. This phenomenon of growing share of the service sector was accelerated in the post 1991 period.
- Presently, service sector has emerged as the largest and fastest growing sector of the economy with around more than fifty percent contribution to the GDP (at current prices) in 2015 as per Economic Survey 2015-16.
- The distinctive feature of India's growth has been the increasing contribution of service sector to GDP growth. **(Also referred as Growing Tertiarization of Indian Economy)**

The Income Components of GVA and Income and Employment Shares

Sector	CE to GVA	OS & MI to GVA	CFC to GVA	GVA share of the sector	Employment share
			Average 2011-13		2011
Agriculture & Allied	**15.3**	**81.6**	**6.6**	**18.1**	**48.9**
Industry	**35.7**	**49.1**	**14.6**	**31.9**	**24.3**
Mining & Quarrying	23.9	62.5	12.8	3.0	0.5
Manufacturing	23.6	58.4	17.0	17.8	12.6
Electricity, gas & water supply	31.7	36.5	34.1	2.3	0.5
Construction	65.2	29.1	5.1	8.8	10.6
Service sector	**38.9**	**50.0**	**10.4**	**50.0**	**26.9**
Trade, hotels & restaurants	23.5	69.9	5.2	11.4	11.0
Transport, storage & communication	37.9	49.8	15.0	6.6	4.8
Financial, real estate & business services	26.1	61.4	10.8	19.4	2.3
Community, social & personal services	72.7	14.9	12.3	12.7	8.7
Total	**33.6**	**55.5**	**11.1**	**100.0**	**100**

Economic Survey 2015-16

FACTORS OF PRODUCTION

It is an economic term to describe the inputs that are used in the production of goods or services in the attempt to make an economic profit. The factors of production include **land, labor, capital and entrepreneurship**.

Land

- Land is the economic resource encompassing natural resources found within a nation's economy.
- This resource includes timber, land, fisheries, farms and other similar natural resources.
- Land is usually a limited resource for many economies. Example: India has 15% of the global population but only 2.4% of the global land.

Labour

- Labor represents the human capital available to transform raw or national resources into consumer goods.
- Human capital includes all able-bodied individuals capable of working in the nation's economy and providing various services to other individuals or businesses.

- This factor of production is a flexible resource as workers can be allocated to different areas of the economy for producing consumer goods or services.
- Human capital can also be improved through training or educating workers

Capital

- Capital has two economic definitions as a factor of production.
- Capital can represent the monetary resources companies use to purchase natural resources, land and other capital goods.
- Capital also represents the major physical assets individuals and companies use when producing goods or services. These assets include buildings, production facilities, equipment, vehicles and other similar items.

Entrepreneurship

- Entrepreneurship is considered a factor of production because economic resources can exist in an economy and not be transformed into consumer goods.
- Entrepreneurs usually have an idea for creating a valuable good or service and assume the risk involved with transforming economic resources into consumer products.

TYPES OF GOODS

Final Goods

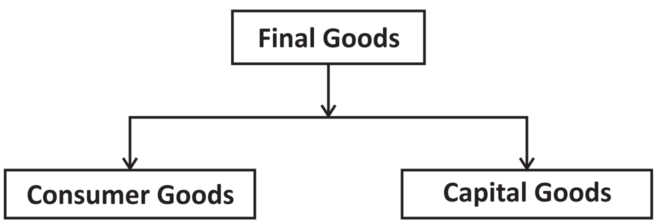
Any good or service purchased by the consumer (Individual or Enterprise) can be for final use or for use in further production. **An item that is meant for final use and will not pass through any more stages of production or transformations is called a final good.**

Why do we call this a final good?

- Once it has been sold, it passes out of the active economic flow.
- It will not undergo any further transformation at the hands of any producer.
- It may, however, undergo transformation by the action of the ultimate purchaser. In fact, many such final goods are transformed during their consumption.

Example: The tea leaves purchased by the consumer are not consumed in that form – they are used to make drinkable tea which is consumed. Similarly, most of the items that enter our kitchen are transformed through the process of cooking. But **cooking at home is not an economic activity** even though the product involved undergoes transformation. Home cooked food is not sold to the market. However if the same cooking or tea brewing was done in a restaurant where the cooked product would be sold to the customers, then the same items such as tea leaves would cease to be final goods and would be counted as inputs to which economic addition takes place. **Thus, it is not in the nature of the good but in the economic nature of its use that a good becomes a final good.**

Final Goods can be distinguished between Consumption Goods and Capital Goods.



Consumer Goods	Capital Goods
• These goods are consumed to satisfy current wants of consumers directly. • For example, food, shirt, shoes, cigarettes, pen, TV set, and radio, etc. are all consumer goods. • Similarly, services rendered to consumers by hotels, retailers, barbers, etc. are consumer services. • Consumption goods sustain the basic objective of an economy, i.e., to sustain the consumption of entire population of the economy. • Consumer goods are further classified into durable and non-durable goods. • Durable goods are those which can be used in consumption again and again over a considerable period of time, e.g., chair, car, fridge, shoes, TV set. • Non-durable goods are like single use goods which are used up by consumers in a single act of consumption, e.g., milk, fruits, matches, cigarettes, coal, etc.	• There are the goods that are of durable character which are used in the production process. • While they make production of other commodities feasible, they themselves don't get transformed in the production process. • These goods form a part of capital, one of the crucial factors of production in which a productive enterprise has invested. • They gradually undergo wear and tear, and thus are repaired or gradually replaced over time.

Intermediate Goods

Of the total production taking place in the economy a large number of products don't end up in final consumption and are not capital goods either. Such goods may be used by other producers as material inputs. **Examples are steel sheets used for making automobiles and copper used for making utensils.** These are intermediate goods, mostly used as raw material or inputs for production of other commodities. These are not final goods.

❑❑❑❑❑