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CRASH COURSE MATERIAL

Business Economics

Chapter 1 – Introduction to Business Economics

By Prof. Shashi Kiran.M



Advait Learning



9353164696 / 8660386382

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Chapter -1

INTRODUCTION TO BUSINESS ECONOMICS

The term 'Economics' owes its origin to the Greek word 'Oiko' (Household) 'nomia' (Management) meaning it is an ART of 'household management'.

The Economics was born with the publication of Adam Smith's book "*An inquiry in to the Nature and Causes of the wealth of the nation*" in the year 1776. Adam Smith is known as the father of Economics. Till 19th Century, economics was known as "political economy"

(Father of Modern Economics –A. Marshall)

These two fundamental facts that

- (i) Human beings have unlimited wants; and
- (ii) The means of satisfying these wants are relatively scarce form the subject matter of Economics.

Economics is, thus, the study of how we work together to transform scarce resources into goods and services to satisfy the most of our infinite wants and how we distribute these goods and services among ourselves.

Meaning of Business Economics

Business Economics is the problem of **rational business decision making**, i.e. selecting an appropriate alternative at right time to achieve organisational goals

Decision Making involves

- Evaluation of feasible alternatives
- Rational Judgement on basic information
- Choice on available productive resources, i.e. Land/Labour/Capital/Organisation
Which are limited and can be employed in alternative uses.
Therefore, more effective alternative must be chosen & less effective alternative must be rejected.

Business Economics is used for rational business decision making which fills the gap between Economic theory & Business practices.

Which integrates economic theory with business practices, it is the process of business decision making through economic tools like Demand, Supply, Cost, Price, Competition, etc.

Definition of Business Economics

Business economics may be defined as the use of economic analysis to make business decision involving the best use of an Organisation's scarce resources.

Joel Dean defines Business Economics in terms of the use of economic analysis in the form of business policies. Business Economics is a component of applied economics as it includes applications involving quantitative techniques such as linear programming, regression analysis, capital budgeting, break even analysis & Cost analysis.

Nature of Business Economics

MICRO ECONOMICS: Micro economics is defined as the study of behaviour of individual decision making units, such as consumers, resource owner and firms. It is also known as Price Theory since its major subject matter deals with the determination of price of commodities and factor. It includes:-

- Product Pricing
- Consumer behaviour
- Factor Pricing
- Behaviour of Firm
- Location of Industry

MACRO ECONOMICS: In macro Economics, we study the economic behaviour of large aggregates such as the overall conditions of the economy such as total production, total consumption, total saving and total investment in it. It includes:-

- National income and output.
- General Price level.
- Balance and price level.
- External value of money.
- Saving and investment.
- Employment and growth.

NATURE OF ECONOMICS

Under this, we generally discuss whether Economics is science or art or both and if it is a science whether it is a positive science or a normative science or both.

Economics – As a science and as an art:

Often a question arises – whether Economics is a science or an art or both.

a) **Economics is a science** : A subject is considered science if it satisfies the below conditions

- A Systematic body of knowledge
- Answers should be measurable
- Answers should be predictable
- There should be tools to measure answers
- Universally Acceptable

Economics satisfies all the above conditions except Universally Acceptable, The end results in economics is not applicable for all the circumstances it will be subjective in nature.

Example: Demand for an Audi car in India & America will not be same, but scientific outcome such as H₂O i.e., Combining 2 atoms of Hydrogen and 1 atom of Oxygen will result to water in any part of an earth.

Hence, “Economics is not a pure science it is a partial science”

- b) **Economics is an art:** Art is nothing but practice of knowledge. Whereas science teaches us to know, art teaches us to do. Unlike science which is theoretical, art is practical. If we analyse Economics, we find that it has the features of an art also. Its various branches, consumption, production and public finance etc. provide practical solutions to various economic problems. It helps in solving various economic problems which we face in our day-to-day life.

Thus, Economics is both a science and an art. It is science in its methodology and art in its application.

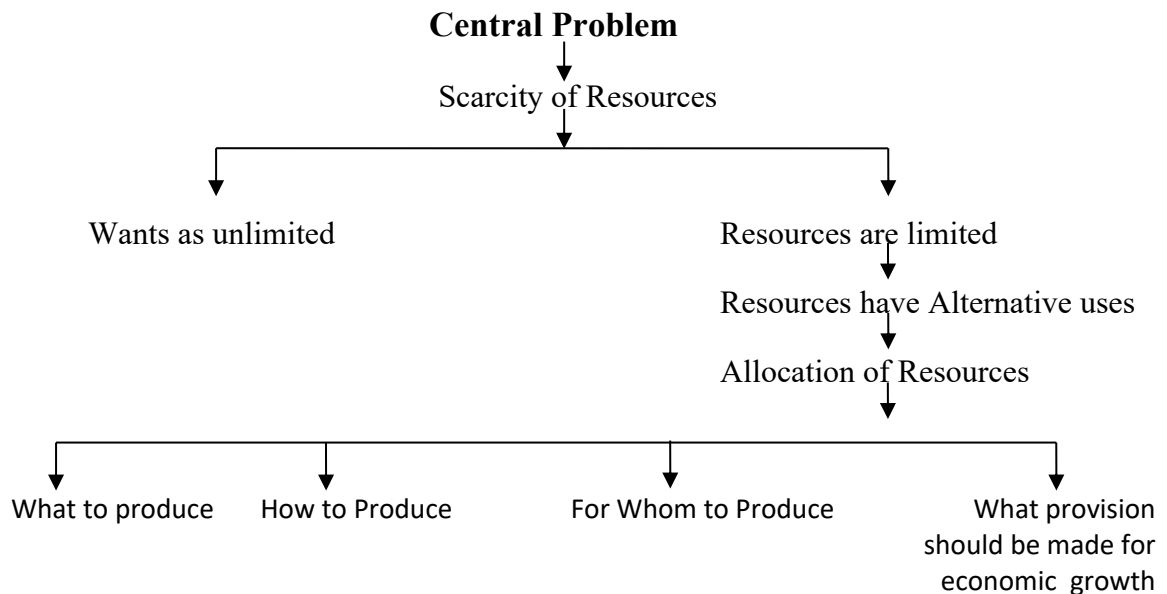
Economics as Positive Science and Economics as Normative Science

Positive Science	Normative Science
<ul style="list-style-type: none"> • It is a systematic body of knowledge which concerns 'WHAT IT IS' • Main objective is to establish Uniformity • It is called as Descriptive science, as it describes the economic problem and never gives suggestions • It does not passes value judgements • Concerned with facts • It explains cause & effect relationship 	<ul style="list-style-type: none"> • It is a systematic body of knowledge which concerns 'WHAT OUGHT TO BE' • Main objectives is to establish Ideals • It is called as Prescriptive science, as it gives suggestions along with describing the economic problem • It passes value judgements • Not concerned with facts • It suggests how things should be

- c) **Pragmatic in approach** – Micro economics is abstract and purely theoretical and analyses economics phenomena under unrealistic assumptions. In contrast, Business Economics is pragmatic in it's approach and it tackles practical problems which the firm faces in the real world.
- d) **Inter disciplinary in nature** – Business Economics is interdisciplinary as it incorporates tools from other disciplines such as mathematics, Management theory, Accounting, Statistics etc.
- e) **Incomplete elements** – such as general price level, income and employment level, government policies, tax and interest rates, industries etc.
- f) **Based on Micro economics** – Business economics is largely based on micro economics. A business manager is largely concerned with the achievements of objectives of his organisation. Since business economics is concerned with the decision making aspects of individual establishments, it heavily relies on micro economics.

CENTRAL ECONOMIC PROBLEM

Human wants are unlimited and productive resources are scarce. An economics without scarcity is not found in the real world. All wants can not be satisfied with the scarce productive resources for the satisfaction of wants, so problem of use of scarce resources arise. This generally called the central economic problems



Problems of Allocation of Resources:-

- (i) **What to produce** - Human wants are unlimited and resources are limited to satisfy human wants. The question arises what goods are to be produced and in what quantity these goods to be produced.
 - (a) Durable / perishable goods
 - (b) Single / Multiple use
 - (c) Superior / Inferior goods
 It is also known as problem of choice making.
- (ii) **How to produce**- This problem is related to the problem of choice of technique for producing a commodity. An economy has to choose between.
 - (a) Labour intensive technique and
 - (b) Capital intensive technique
 The economy has to decide about technique of production on the basis of cost of labour and capital. A labour surplus economy chooses labour intensive technique and a capital surplus economy chooses capital-intensive technique.
- (iii) **For whom to produce** – which determine the distribution of goods among the various individuals like,
 - (a) class of society
 - (b) targeted customers
 - (c) their ability to purchase
 to decide about the share of different people in the national goods and service.
- (iv) **What provision should be made for economic growth:** A society would not like to use all its scarce resources for current consumption only. This is because if it uses all the resources for current consumption and no provision is made for future Production, the societies’ production capacity would not increase. (Sustainable development)

ECONOMIC SYSTEM

Economic system is defined as an arrangement by which the central problems of an economy are solved.

1.1 CAPITALIST ECONOMY

Capitalism is a political economic system based on private property and private profit. This type of system is also called laissez-faire or free market economy.

Main features are:

1. **Private ownership of property/ right to property** : the right of private property means that productive factors such as land, factories, machinery, mines, etc. are under private ownership. The owners of these factors are free to use them in the manner in which they like. The government may, however, put some restrictions for the benefit of the society in general.
2. **Freedom of enterprises. I.e Government interference is zero** : This means that everybody engages in any economic activity he likes. More specifically he is free to set up any firm to produce goods.
3. **Profit motive of production**: In a capitalist economy it is the profit motive which forces or induces people to work and produce, Price mechanism guides production decisions. i.e. manufacturer will only produce those goods which intern has a demand in economy.
4. **Existence of Competition between producers**: Competition prevails among sellers to sell their goods and among buyers to obtain goods to satisfy their wants. Advertisement, price-cutting, discounts, etc. are very common methods of competition in a capitalist economy.
5. **Consumer sovereignty is not restricted.** i.e Choice making ability to a customer is not restricted : this means people in a capitalist economy are free to spend their income as they like. This is known as consumer sovereignty. Consumers are sovereign in the sense producers produce only those goods which consumers wish to buy.
6. **In-equal distribution of Income**: There is generally a wide gap of income between the rich and the poor in the economy which mainly arises due to unequal distribution of property in such economies.

Merits of Capitalist Economy

- (i) Encourages economic activities
- (ii) Maximum efficiency
- (iii) Dynamic economy
- (iv) Rapid economy growth

Demerits of Capitalist economy

- (i) Unequal distribution of income and wealth
- (ii) Business instability
- (iii) Consumer exploitation
- (iv) Misallocation of productive resources

1.2 SOCIALIST ECONOMY

Socialist economy is planned or command economy based on public ownership of property and social welfare motive. Prices are determined by central planning authority. Some of the socialist countries are Hungary, Poland, Yugoslavia, Bulgaria, etc.

Main features are:

1. **Public ownership of property or factors of production :** The first essential characteristic of socialism is that all the important and strategic means of production are State-owned. However, it should not be taken to mean that private enterprise and private property are totally dispensed with in such economies. They do exist; but their relative importance is so insignificant that they can be easily ignored without adversely affecting the model of socialism. There is collective ownership of all means of production. As a result of social ownership, profit-motive and self-interest are not the driving force of economic activity as it is in the case of a market economy/ capitalistic economy. The resources here are used to achieve certain socio-economic objectives.
2. **No freedom of enterprise i.e. Complete role of Govt:** Private enterprises should only follow what CPA instructs, they cannot decide on their own. The right to private property is limited as all property of the country is owned by the state. Hence, No individual can accumulate excessive property as in the case of capitalism.
3. **Social welfare motive:** Social welfare becomes the guiding light in such a system. Since all the enterprises are State-owned, no individual or private profit accrues. In the State enterprises price policy is guided by the aims of social welfare rather than by profit motive.
4. **Planning mechanism guides production :** There is a central authority to set and accomplish socio-economic goals; that is why it is called a centrally planned economy. Major economic decisions, such as what to produce, when and how much to produce, etc., are taken by the central authority. All the basic decisions pertaining to the working and the regulation of the economy in such a system are taken by the Government/ CPA. The Government uses the tools of economic planning as coordinating mechanism as also the one that takes economic decisions. For this purpose, a central authority is set up
5. **No competition:** One of the basic tasks of economic planning is to avoid duplication of efforts and wastage of resources. Since the State has the monopoly of production and investment in socialism, it avoids all sorts of competition and rivalry as between different production units. Recently, of course, some of the socialist countries have been encouraging competition among State-owned enterprises themselves.

6. **Absence of consumer's sovereignty i.e.,** Choice making ability to consumer
Freedom from hunger is guaranteed but consumers' sovereignty gets restricted by selective production of goods by authority, The range of choice is limited by planned production. However, within that range an individual is free to choose what he likes most.
7. **Restriction on freedom of occupation:** The right to work is guaranteed but the choice of occupation gets restricted because these are determined by some authority on the basis of certain socio-economic goals before the nation
8. **Equal distribution of Income:** A relative equality of income is an important feature. Among other things, differences are narrowed down by lack of opportunities to accumulate private capital. Educational and other facilities are enjoyed more or less equally; thus the basic causes of inequalities are removed.

Merits of socialist economy:

- (i) Optimum utilization of resources
- (ii) Satisfaction of consumers need
- (iii) Equal distribution of income and wealth

Demerits of socialist economy:

- (i) Inaccurate calculation of cost
- (ii) Bureaucratic set-up
- (iii) Concentration of power in government hands

1.3 MIXEDECONOMY

All economics are mixed economics, with elements of both market and command. India is a mixed economy.

Main features are:

1. Ownership of property is both by private and public sector.
In mixed economy there is the co-existence of both private and public enterprise ,A sector in which both the government and the private enterprises have equal access, and join hands to produce a commodity, leading to the establishment of joint sectors.
2. **Planned Economy:** a mixed economy is a planned economy, i.e. an economy in which the government has a clear and definite economic plan. Public sector enterprises have to work according to a plan and to achieve the objectives laid down. The government has also to create necessary atmosphere for the private sector to develop on its own. Thus, it must prepare plans of development for both the private and the public sector enterprises. Allocation of resources in a mixed economy should be better since it attempts to combine the productive efficiency of capitalism and distributive justice of socialism.

3. **Balanced Regional Development:** in a mixed economy balanced regional development is expected. Public sector enterprises may be located in the backward regions so as to ensure its development. Further by way of subsidies and other incentives private sector may be lured to establish and develop industries in backward regions.
4. **A Dual System of Pricing exists:** in a mixed economy, a dual system of pricing exists. In private sector, prices of goods and factors of production are determined through the free play of market forces of demand and supply. In public sector, the state determines prices of various products. The state reserves itself the right to keep different prices for public sector units and private sector units. The state may also fix the prices of certain essential commodities which are used by the common man. For example, in India, the prices of essential commodities like diesel, LPG, are fixed by government. Overall planning is done by the State Authority called Planning Commission in countries like India who have adopted mixed economy.
5. There is freedom of enterprise in the private sector but no freedom in the public sector.
6. Private sector produces with profit motive and public sector with welfare motive.
7. In the private sector, price mechanism solves the basic problems whereas in the public sector, the government guides the production decisions.
8. Competition exists but is limited to the private sector.
9. Consumer's sovereignty exists.
10. Freedom of occupation exists.

Merits of Mixed Economy:

1. Mixed economy secures the merits of both capitalism and socialism while avoiding the evils of both.
2. Mixed economy protects individual freedom. Under the system, individuals have the freedom of consumption, choice of occupation, freedom of enterprise and freedom of expression.
3. Price mechanism is allowed to operate under mixed economy.
4. Reducing the inequalities of wealth and class struggle is one of the aims of mixed economy.
5. Economic fluctuations can be avoided due to centrally planned economy.
6. Mixed economy helps under-developed countries to have rapid and balanced economic development.

De-merits of Mixed Economy

1. Mixed Economy is difficult to operate. Balancing and adjusting the public and private sector is often difficult.
2. Excessive controls and heavy taxes are likely to prevail under mixed economy. These will discourage production in the private sector.
3. Mixed economy is described by Schumpeter as "Capitalism in the oxygen tent". According to him it is only a trick of the capitalists to cheat the working class by offering them some temporary advantage like social security, uplift of the depressed classes, etc.

Features of Three Economics System

Features	Capitalism	Socialism	Mixed Economy
1. Ownership of property	Private ownership	Public ownership	Both public and private ownerships.
2. Freedom of enterprise	Exists	No freedom	Freedom in private sector but no freedom in public sector
3. Motive of production	Profit motive	Social welfare	Profit motive in private sector and welfare motive in public sector
4. Who governs production	Price mechanism	Planning mechanism	Both price mechanism and planning mechanism.
5. Competition	Exists	No competition	Exists only in private sector
6. Distribution of income	Very unequal	Quite equal	Considerable inequalities exists
7. Role of government	No role	Complete role	Full role in public sector and limited role in private sector