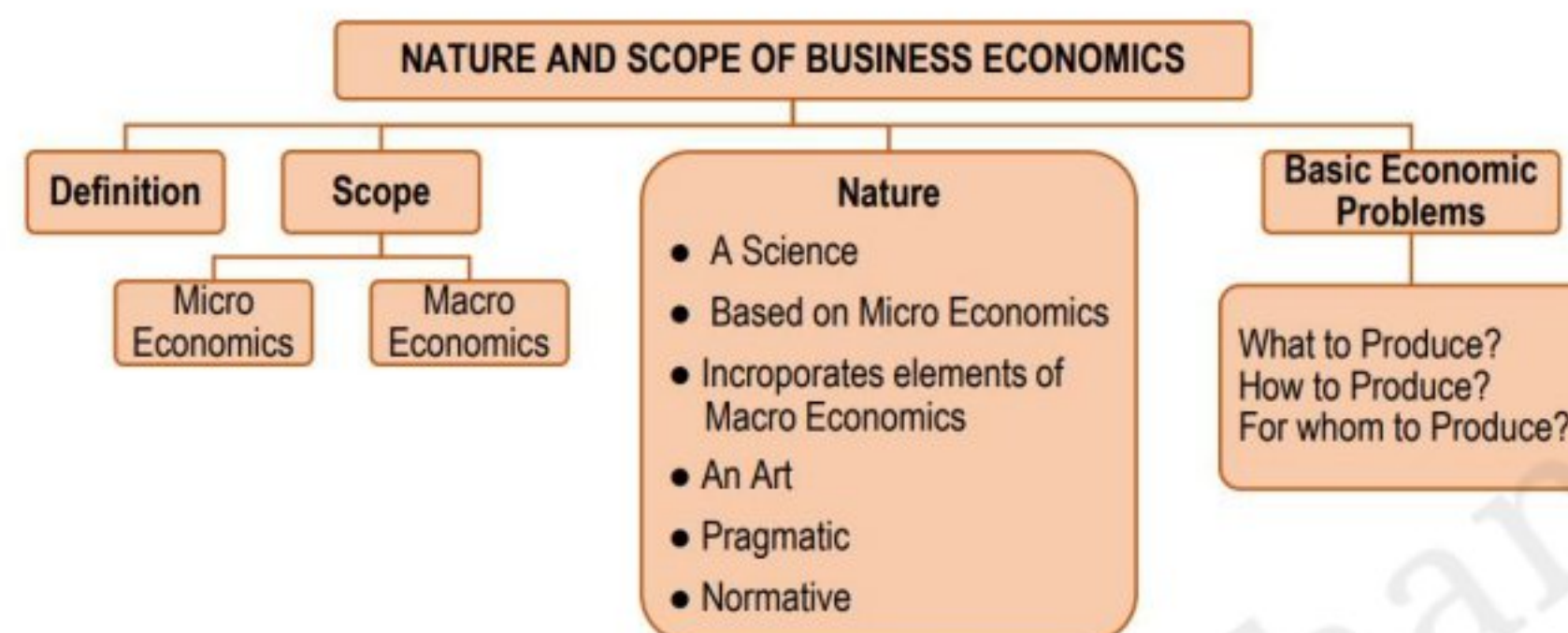


CA Foundation – Business Economics

Chapter 1 – Nature & Scope of Business Economics

CHAPTER OVERVIEW



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Fundamental Facts

Human Beings have
unlimited wants

The means to satisfy these unlimited wants are
relatively scarce



Subject matter of Economics



- We cannot have everything we want with the resources we have, we are forever forced to make choices and therefore, we choose to satisfy only some of our wants leaving many other wants unsatisfied.
- Similar dilemma is faced by **every individual, every society and every country in this world.**

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What is Economics?

Basic Definition

Economics is the study of the **processes** by which the **relatively scarce resources** are allocated to satisfy the **competing unlimited wants** of human beings in a society.



- Of course, the available resources will be efficiently used when they are allocated to their **highest valued uses**.
- Thus, we can say that, Economics is the study of how we work together to transform the scarce resources into goods and services to satisfy the most pressing of our infinite wants and how we distribute these goods and services among ourselves.

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This definition of Economics is the domain of **Modern neo classical micro economic analysis**.

Despite being correct, it is **incomplete** because it brings to our mind the picture of society with:

- Fixed resources, skills and productive capacity
- Deciding on what specific kind of goods and services it ought to produce with the given resources and,
- How they ought to be distributed among the members of the society.

Two of the most important concerns of modern economies are not fully covered by the basic definition. Economics also deals with:



II. Processes by which the productive capacity of the resources are increased

III. Factors which, in the past, have led to sharp fluctuations in the rate of utilizations of resources

II. Economics also deals with the processes by which the productive capacity of the resources are increased.

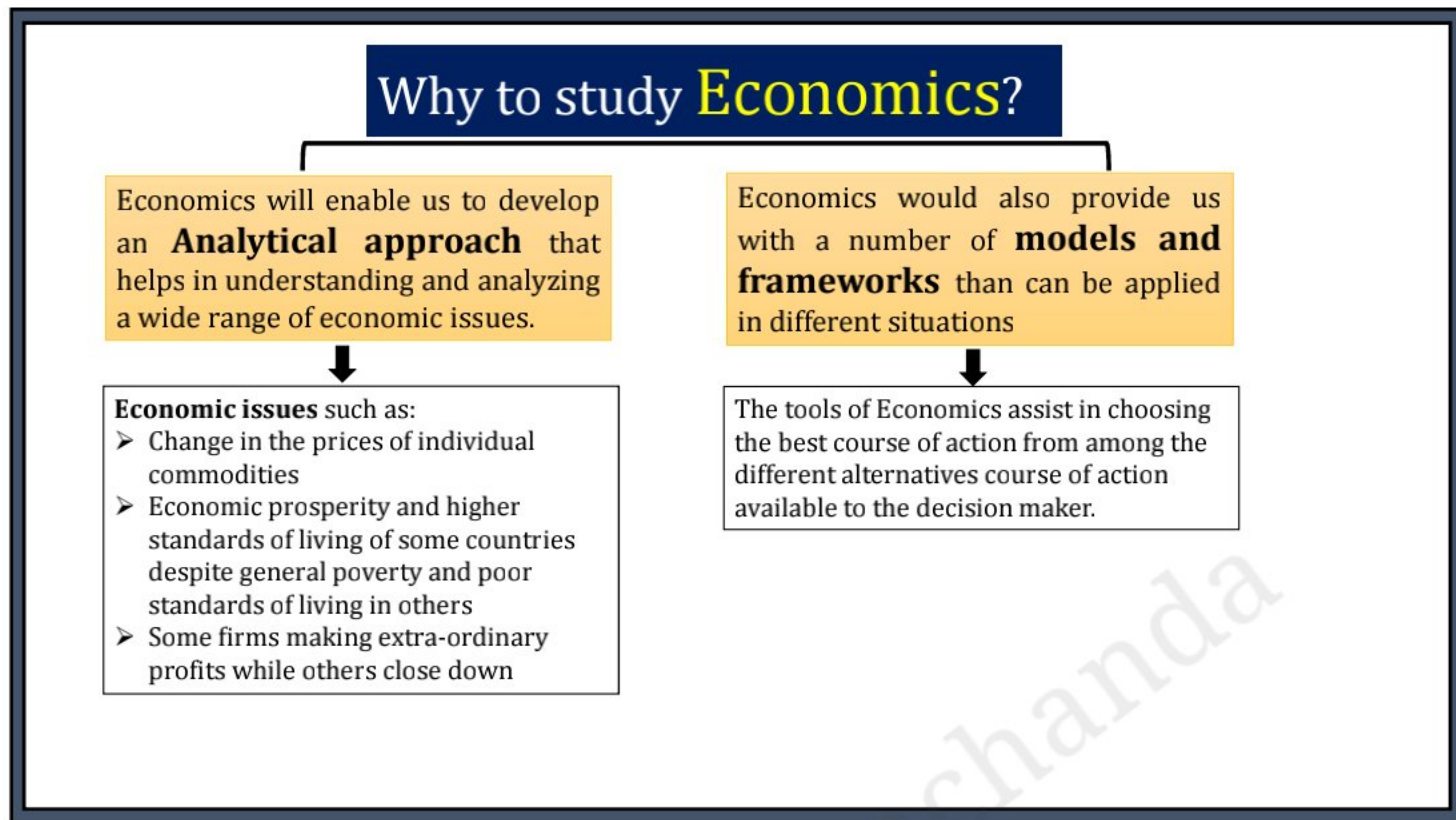
- Population and labour forces have increased
- New sources of raw materials have been discovered
- New and better plant & equipment have been made available on farms and in factories and mines
- Better education and newly acquired skills have raised the productivity of labour force
- New kinds of natural resources have been discovered like alternative sources of energy

III. Economics also deals with the factors, which in the past, have led to sharp fluctuations in the rate of utilization of resources.

- Resulting growth in production and income has not been smooth.
- There have been periods in which output not only failed to grow, but also actually declined sharply (Corona Pandemic 2019).
- During such period, factories, workers and other productive resources have remained idle due to insufficient demand.

Important Points to Remember !!

- The term Economics is derived from the Greek word '**Oikonomia**' which means household.
- Till 19th Century, Economics was known as '**Political Economy**'.
- The book named '**An Inquiry into the nature and causes of the Wealth of Nations**' (1776) usually abbreviated as '**The wealth of Nations**', by **Adam Smith** is considered as the first modern work of Economics.



However,

It is necessary to remember that most economic problems are of **complex nature** and are **affected by several factors**, some of which are rooted in Economics and others in political set up, social norms, etc.

The study of Economics **cannot ensure** that all the problems will be appropriately tackled

But,

It would enable a student to **examine a problem in its right perspective** and would help in **discovering suitable measures** to deal with the same.

Meaning of Business Economics..

Decision Making in Business

- **Decision Making** refers to the process of selecting an appropriate alternative that will provide the most efficient means of attaining a desired end, from two or more alternative courses of action.
- The success & survival of any business depends on sound decisions.



THE FAILURE
OF NANO



together is better

bitter
better



- It involves evaluation of **feasible alternatives**, **rational judgment** on the basis of information and choice of a particular alternative which the decision maker finds as the most suitable.

➤ The question of choice arises because our **productive resources** such as land labour, capital, and management are **limited** and can be employed in alternative uses. Therefore, more efficient alternatives must be chosen and less efficient alternatives must be rejected.

➤ The management of a business unit generally needs to make **strategic, tactical and operational decisions**. A few examples of issues requiring decision making in the context of businesses are illustrated below:

Should our firm be in this business?

Should the firm launch a product, given the highly competitive market environment?

If the firm decided on launching the product, which available technique of production should be used?

From where should the firm procure the necessary inputs and at what prices so as to have competitive edge?

Should the firm make the components or buy them from other firms?

How much should be the optimum output and at what price should the firm sell?

How will the product be placed in the market? Which customer segment should we focus on and how to improve the customer experience? Which marketing strategy should be chosen? How much should be the marketing budget?

How to combat the risks and uncertainties involved?



➤ Decision making on the above as well as similar issues is **not simple** as the economic **environment** in which the firm functions is **highly complex and dynamic**.

➤ The **problem gets aggravated** because, most of the time, decisions are to be taken under conditions of imperfect knowledge and uncertainty.

➤ Decision making therefore, requires that the management be equipped with proper methodology and appropriate analytical tools and techniques.

➤ Business Economics meets these needs of the management by providing a huge corpus of theory and techniques.

➤ Briefly put, **Business economics integrates economic theory with business practice**

Economic Theories

such as *Demand, supply, cost, production, etc.*

Applied in



**Business
Decision Making**

=

**Business
Economics**

Business Economics, also known to as **Managerial Economics**, refers to the integrations of economic theory with business practices.

- In short, we can say that Business Economics is **Applied Economics** that fill the gap between economic theory and business practice.
- Business Economics has close connection with Economic theory (Micro as well as Macro-Economics), Operations Research, Statistics, Mathematics and the Theory of Decision-Making.
- A professional business economist has to **integrate the concept and methods from all these disciplines** in order to understand and analyze practical managerial problems.
- Business Economics is not only valuable to business decision makers, but **also useful for managers of 'not-for-profit' organizations** such as NGO, and voluntary organization.

Business Economics = Managerial Economics = Applied Economics

Definition of Business Economics

- Business Economics may be defined as the **use of economic analysis/theories to make business decisions involving the best use of an organization's scarce resources.**
- **John Dean** defined Business Economics in terms of the use of Economic analysis in the formulation of business policies.

Multiple Choice Questions

- 1) Economists regard decision making as important because:
- a) The resources required to satisfy our unlimited wants and needs are finite, or scarce.
 - b) It is crucial to understand how we can best allocate our scarce resources to satisfy society's unlimited wants and needs
 - c) Resources have alternative uses
 - d) All of the above**
- 2) In economics, we use the term scarcity to mean:
- a) Absolute scarcity and lack of resources in less developed countries
 - b) Relative scarcity i.e., scarcity in relation to the wants of the society**
 - c) Scarcity during times of business failure and natural calamities
 - d) Scarcity caused on account of excessive consumption by the rich
- 3) The managerial economics:
- a) Is applied economics that fills gap between economic theory and business practice**
 - b) Is just a theory concept
 - c) Trains managers how to behave in recessions
 - d) Provides the tools which explains various concepts

Multiple Choice Questions

- 4) The benefit of economic study is:
- a) It ensures that all the problems will be appropriately tackled
 - b) It helps in identifying problems
 - c) It enables to examine a problem in its right perspective**
 - d) It gives exact solutions to every problem
- 5) There is need of economic study because:
- a) The resources are limited
 - b) The wants are unlimited
 - c) The resources are unlimited
 - d) Both a) and b)**
- 6) Consider the following and decide which, if any, economy is without scarcity:
- a) The pre-independent Indian, economy, where most people were farmers
 - b) A mythical economy where everybody is a billionaire
 - c) Any economy where income is distributed equally among its people
 - d) None of the above**

Micro & Macro Economics

Micro Economics:

- Study of the behavior of different **individuals** and **organizations** within an economy.
- Microeconomics examines how the individual units (consumers or firms) make decisions as to how to efficiently allocate their scarce resources.
- Here, the focus is on a number of a small number or group of units rather than all the units combined, and therefore it does not explain what is happening in the wider economic environment
- We mainly study the following in Micro-economics:
 - Product pricing
 - Consumer behavior
 - Factor pricing
 - The economic conditions of a section of people
 - Behavior of firms
 - Location of industry

Macro Economics:

- Study of the overall economic phenomena or the **Economy as a whole, rather than individual parts.**
- In Macro, we study the behavior of the **large economic aggregates** such as, the overall levels of output and employment, total consumption, total savings and total import-export, etc.
- It analyses the overall economic environment in which the firms, governments and households operate and make decisions.
- A few areas that come under Macro Economics are:
 - National Income & National output
 - The general price level and interest rates
 - Balance of trade and balance of payments
 - External value of currency
 - The overall level of savings and investments
 - The Level of employment and rate of economic growth

- **While business economics is basically concerned with Micro Economics**, Macro Economic analysis also has got an important role to play.
- Business firms need a thorough understanding of the macroeconomic environment in which they have to function.

Multiple Choice Questions

7) Mr. Satish hired a business consultant to guide him for growth of his business. The consultant visited his factory and suggested some changes with respect of staff appointment, loan availability and so on. Which approach is that consultant using?

- a) **Micro Economics**
- b) Macro economics
- c) None of the above
- d) Both a and b

8) Which of the following is correct?

- a) Micro economics is important for study of a particular household and a particular firm
- b) Macro economics is important for study of economic conditions of a country
- c) None of above
- d) **Both a and b**

Multiple Choice Questions

9) A study of how increases in the corporate income tax rate will affect the national unemployment rate is an example of:

- a) **Macro-economics**
- b) Descriptive Economics
- c) Micro-economics
- d) Normative economics

10) Macro economics is the study of

- a) All aspects of society
- b) **The national economy and the global economy as a whole**
- c) Big businesses
- d) The decisions of individual businesses and people



Multiple Choice Questions

- 11) Which of the following would be considered a topic of study in Macroeconomics
- The effect of increase in wages on the profitability of cotton industry
 - The effect on steel prices when more steel is imported
 - The effect of an increasing inflation rate on living standards of people in India**
 - The effect of an increase in the price of coffee on the quantity of tea consumed.
- 12) Which of the following is not the subject matter of Business Economics?
- Should our firm be in this business?
 - How much should be produced and what price should be kept?
 - How will the product be placed in the market?
 - How should we decrease unemployment in the economy?**
- 13) Which of the following is not a subject matter of Micro-economics?
- The price of mangoes
 - The cost of producing a fire truck for the fire department of Delhi, India
 - The quantity of mangoes produced for the mangoes market
 - The national economy's annual rate of growth.**

Nature of Business Economics

- Economic theories are **hypothetical and simplistic in character** as they are based on economic models built on simplifying **assumptions**.
- Therefore, usually, there is a gap between the propositions of economic theory and happenings in the real economic world in which the managers make decisions.
- Business Economics enables application of economic logic and analytical tools to bridge the gap between theory and practice.

Nature of Business Economics

Business Economics is a **Science**

Based on **Micro-Economics**

Incorporates elements of **Macro Analysis**

Business Economics is also an **Art**

Use of **Theory of Markets and Private Enterprises**

Pragmatic in Nature

Interdisciplinary in Nature

Normative in Nature



1) Business Economics is a Science:

- Science is a systematized body of knowledge which establishes **cause and effect relationships**.
- Business Economics integrates the tools such as Mathematics, Statistics and Econometrics with Economic Theory to arrive at appropriate strategies for achieving the goal of business enterprises.
- It follows scientific methods and tests the validity of the results

2) Based on Micro Economics:

- Business Economics is based largely on Micro-Economics.
- A business manager is usually concerned about achievement of the predetermined objectives of his organization so as to ensure the long-term survival and profitable functioning of the organization.
- Since Business Economics is concerned more with the **decision making problems of individual establishments**, it relies heavily on Microeconomics

3) Incorporates elements Macro Analysis:

- A business unit does not operate in a vacuum.
- It is affected by the external environment of the economy in which it operates such as income and employment levels in the economy and government policies with respect to taxation, etc. All these are components of Macro economics.

4) Business Economics is an Art:

- As it involves **practical application** of rules and principles for the attainment of set objectives.

5) Use of Theory of Markets & Private Enterprises:

- Business Economics largely uses the theory of markets and private enterprise.
- It uses the theory of the firm and resource allocation in the backdrop of a private enterprise economy.

6) Pragmatic in Nature:

- Micro-Economics is abstract and purely theoretical and analyses economic phenomena under unrealistic assumptions
- In contrast, Business Economics is pragmatic in its approach as it **tackles practical problems** which the firms face in the real world.

7) Interdisciplinary in Nature

- Business Economics is interdisciplinary in nature as it incorporates tools from other disciplines such as Mathematics, Operations Research, Management Theory, Accounting, marketing, Finance, Statistics and Econometrics

8) Normative in Nature

Economic theory has developed along two lines – **Positive & Normative**

Positive or Pure Science:

- Analyses **cause and effect relationship**
- Does not involve any value judgement
- It states '**what is**' of the state of affairs
- It is **descriptive in nature**- describes the economic behavior without prescriptions

Normative Science:

- Involves **value judgements**
- It is **prescriptive** in nature
- It suggests '**what should be**' or '**what ought be**' a particular course of action
- Welfare considerations are embedded in normative science.

- Business Economics is **generally normative** or prescriptive in nature.
- It suggests the **application of economic principles** with regard to policy formulation, decision making and future planning.
- However, firms must thoroughly understand their environment. This requires the study of positive or descriptive economic theory. Thus, **Business Economics combines the essentials of normative and positive economic theory, the emphasis being more on the Normative than Positive.**

Multiple Choice Questions

14) **The difference between positive and normative Economics is:**

- a) Positive Economics explains the performance of the economy while normative Economics finds out the reasons for poor performance
- b) Positive Economics describes the facts of the economy while normative economics involves evaluating whether some of these are good or bad for the welfare of the people.**
- c) Normative Economics describes the facts of the economy while positive Economics involves evaluating whether some of these are good or bad for the welfare of the people.
- d) Positive Economics prescribes while normative Economics describes

15) **Which of the following is a normative economic statement?**

- a) Unemployment rate decreases with industrialization
- b) Economics is a social science that studies human behavior
- c) The minimum wage should be raised to Rs. 200/- a day**
- d) India spends a huge amount of money on national defense



Multiple Choice Questions

16) Ram: My corn harvest this year is poor

Krishan: Don't worry, Price increases will compensate for the fall in quantity supplied

Vinod: Climate effects crop yields. Some years are bad, others are good.

Madhu: The government ought to guarantee that our income will not fall

In this conversation, the normative statement is made by:

- a) Ram
- b) Krishan
- c) Vinod
- d) Madhu**

17) **An example of 'positive' economic analysis would be:**

- a) An analysis of the relationship between the price of food and the quality purchased**
- b) Determining how much income each person should be guaranteed
- c) Determining the 'fair' price for food
- d) Deciding how to distribute the output of the economy

Multiple Choice Questions

18) **Which of the following is normative statement?**

- a) Planned economies allocate resources via government departments
- b) Most transitional economies have experienced problems of falling output and rising prices over the past decade.
- c) There is a greater degree of consumer sovereignty in market economies than planned economies.
- d) Reducing inequality should be a major priority for mixed economies.**

19) **'A government deficit will reduce unemployment and cause an increase in prices' This statement is:**

- a) Positive**
- b) Normative
- c) Both
- d) None of the above

Multiple Choice Questions

18) Normative economics is _____ in nature

- a) Modern
- b) Descriptive
- c) Prescriptive**
- d) None of the above

19) The term economics is derived from Greek work "*Oikonomia*" which means

- a) Household management**
- b) Art of Living
- c) Science of good governance
- d) Law of rational behavior

20) The famous book "Wealth of Nations" was published in

- a) 1776**
- b) 1750
- c) 1850
- d) 1886

Scope of Business Economics

The scope of Business Economics is quite wide. It covers most of the practical problems a manager or a firm faces.

Business Issues

Internal Issues or Operational Issues

- Issues that **arise within the organization** and fall within the purview & **control of management**
- Issues related to choice of Business & its size, product decisions, technology and factor combinations, pricing & sales promotion, financing, inventory, etc. are few examples.

Solved through **Micro Economics**

External Issues or Environmental Issues

- They have significant influence upon the functioning and performance of business
- Business decisions cannot be taken without considering the External factors.
- As the **management of the firm has no control over these factors**, it should fine-tune its policies to minimize their adverse impact

Solved through **Macro Economics**

The following **Micro –Economic Theories** deal with Internal Issues:

1) Demand Analysis & Forecasting:

Demand Analysis:

- It pertains to the behaviour of consumers in the market.
- It studies the nature of consumer preferences and the effect of changes in the determinants of demand such as, price of the commodity, consumers' income, prices of related commodities, consumer tastes and preferences etc.

Demand Forecasting:

- It is the technique of predicting future demand for goods and services on the basis of the past behaviour of factors which affect demand.
- Accurate forecasting is essential for a firm to enable it to produce the required quantities at the right time and to arrange, well in advance, for the various factors of production viz., raw materials, labour, machines, equipment, buildings etc.

10% price decrease krne se demand kitni increase hogi?

Future me demand increase hogi ya decrease?



The following **Micro –Economic Theories** deal with Internal Issues:

2) Production & Cost Analysis

Production Theory:

- It explains the relationship between inputs and output.
- A business economist has to decide on the optimum size of output and ensure that the firm is not incurring undue costs.
- Production Analysis enables the firm to decide on the choice of appropriate technology and selection of least-cost input-mix to achieve efficient way of producing output, given the inputs.

Cost Analysis:

- It enables the firm to recognize the behaviour of costs when variables such as output, time period and size of plant change.
- The firm will be able to identify ways to maximize profits by producing output at the minimum possible cost.

Kitna output produce karna chahiye?

Labour jyada use karu ya Machines?



The following **Micro –Economic Theories** deal with Internal Issues:

3) Inventory Management

- Inventory management theories pertain to rules that firms can use to **minimize the costs associated with maintaining inventory** in the form of 'work-in-process,' 'raw materials', and "finished goods".
- Inventory policies **affect the profitability of the firm**. Business economists use methods such as **ABC analysis** and mathematical models to help the firm maintain optimum stock of inventories.

4) Resource Allocation

- Business Economics, with the help of advanced tools such as **linear programming**, enables the firm to arrive at the best course of action for optimum utilization of available resources.

*Kitna raw material
warehouse me store karlu?*

*1 Machine – 2 products,
kon sa product jyada bnau?*



The following **Micro –Economic Theories** deal with Internal Issues:

5) Market Structure & Pricing Policies

Market Theory

- Analysis of the structure of the market provides information about the nature and extent of competition which the firms have to face.
- This helps in determining the degree of market power (ability to determine prices) which the firm commands and the strategies to be followed in market management under the given competitive conditions such as, product design and marketing.

Price Theory

- Price theory explains how prices are determined under different kinds of market conditions and assists the firm in framing suitable price policies.

*Monopoly me hu ya perfect
competition me ya
monopolistic me?*

*Main price kaise decide
kru?*



The following **Micro –Economic Theories** deal with Internal Issues:

6) Theory of Capital & Investment Decisions

- For maximizing its profits, the firm has to carefully evaluate its investment decisions and carry out a sensible policy of capital allocation.
- Theories related to capital and investment provides scientific criteria for choice of investment projects and in assessment of the efficiency of capital.
- Business Economics supports decision making on allocation of scarce capital among competing uses of funds.

7) Profit Analysis

- Profits are, most often, uncertain due to changing prices and market conditions.
- Profit theory guides the firm in the measurement and management of profits under conditions of uncertainty.
- Profit analysis is also immensely useful in future profit planning.

Machines lelu ya marketing me paise lgau? Loan lelu ya khud ke paise lgau?

Profit target achieve ni hua to? Loss hogya to?



The following **Micro –Economic Theories** deal with Internal Issues:

8) Risk & Uncertainty Analysis

- Business firms generally operate under conditions of risk and uncertainty.
- Analysis of risks and uncertainties helps the business firm in arriving at efficient decisions and in formulating plans on the basis of past data, current information and future prediction.

Government ne mera product ban kardiya to?

Phir se koi Pandemic agya to?



The major **Macro –Economic** factors which affects Business:

- The Type of Economic System (*Capitalist, Socialist & Mixed Economy*)
- Stage of Business Cycle (Expansion, peak, contraction & Trough)
- The general trends in national income, employment, prices, saving and investment.
- Government's economic policies like industrial policy, competition policy, monetary and fiscal policy, price policy, foreign trade policy and globalization policies.
- Working of financial sector and capital market
- Socio-economic organizations like trade unions, producer and consumer unions and cooperatives
- Social and political environment

*We cannot control these factors,
but decisions lete time inko
consider karna padega.*



Revision Capsules

The book named 'An Inquiry into the Nature and Causes of the Wealth of Nations' (1776) usually abbreviated as 'The Wealth of Nations', by Adam Smith is considered as the first modern work of Economics.

These two fundamental facts are:

- Human beings have unlimited wants
- 'The means to satisfy these unlimited wants are relatively scarce' from the subject matter of Economics

Micro Economics is basically the study of the behaviour of different individuals and organizations within an economic system

In Macro-Economics, we study the behaviour of the large economic aggregates, such as, the overall levels of output and employment, total consumption, total saving and total investment, exports, imports and foreign investment and also how these aggregates shift over time

While Business Economics is basically concerned with Micro Economics, Macro economic analysis also has got an important role to play

Nature

- A Science
- Based on Micro Economics
- Incorporates elements of Macro Economics
- An Art
- Pragmatic
- Normative

Nature of Business Economics

- Business Economics is a Science
- Based on Microeconomics
- Incorporates elements of Macro Analysis
- Business Economics is also an Art
- Use of Theory of Markets and Private Enterprises
- Pragmatic in Approach
- Interdisciplinary in Nature
- Normative in Nature

Revision Capsules

The scope of Business Economics is quite wide. It covers most of the practical problems a manager or a firm faces.

There are two categories of business issues to which economic theories can be directly applied,

1. Internal issues or operational issues (this can be solved using Micro Economics)
2. External issues or environmental issues (this can be solved using Macro Economics)

Business decisions cannot be taken without considering these present and future environmental factors. As the management of the firm has no control over these factors, it should fine-tune its policies to minimise their adverse effects.

Microeconomics applied to Internal or Operational Issues

- ❖ Demand Analysis and Forecasting
- ❖ Production and Cost Analysis
- ❖ Inventory Management
- ❖ Market Structure and Pricing Policies
- ❖ Resource Allocation
- ❖ Theory of Capital and Investment Decisions
- ❖ Profit Analysis
- ❖ Risk and Uncertainty Analysis

Macroeconomics applied to External or Environmental Issues

- ❖ The type of economic system
- ❖ Stage of business cycle
- ❖ The general trends in national income, employment, prices, saving and investment.
- ❖ Government's economic policies like industrial policy, competition policy, and fiscal policy, foreign trade policy and globalization policies.
- ❖ Working of central banks and financial sector and capital market and their regulation.
- ❖ Socio-economic organisations like trade unions, producer and consumer unions and cooperatives.
- ❖ Social and political environment.

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