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CHAPTER

# DEFINITION OF ECONOMICS

## 1.1 INTRODUCTION

Economics is often regarded as the '*queen of social sciences*'. It has acquired a place of unprecedented importance in recent years in view of the fact that it explains some of the very important issues faced by individuals as well as by the society. It is essential and appropriate, as a starting point, to know what economics is all about or what the subject matter of economics is. In fact, every science is concerned with a particular subject. Thus, biology is concerned with biological issues like the constitution and evolution of living organisms; physics deals with matter and energy; political science deals with political issues like the nature of state and government. Therefore, it is natural for us, as students of economics, to ask the basic question: 'What do we study in economics?' or 'What is the subject matter of economics?'

***Economics, as a social science, is concerned with economic questions. It seeks to explain systematically a large variety of questions pertaining to economic behaviour of individuals, the society and the economy.*** Let us enumerate some examples of the economic questions with which we are concerned in economics.

As individuals, we face innumerable economic questions in our daily life. How do we as consumers decide the amount of our income we should spend on the purchase of various goods and services? How do producers decide 'which commodities to produce', 'how to produce' and 'at what prices to sell'? What determines the level of wages? Why do the government employees demand higher dearness allowance when prices go up? Then there are bigger issues faced by the entire economy. What determines the level of national income? Why is India facing the problem of unemployment? How do we explain the existence of massive poverty in our country? Why did many of the advanced countries experience recession during the period 2008–2010? Why is China able to achieve a higher rate of economic growth than India? What are the effects of government's taxation and expenditure policies? Why has the Indian government followed the policy of privatisation and globalisation? Why do the developing economies face the problem of deficits in their balance of payments? What policies need to be followed to curb inflation or to step up exports?

These are some of the questions which we study in economics. Economists are deeply concerned with such questions. Such a listing of questions may give you some idea about the subject matter of economics. It may also make you realise why the subject of economics has acquired such a place of pre-eminence these days. Study of economics is important because it deals with economic questions that concern each one of us in our daily lives as individuals and as citizens of a country. We study economics because it sheds light on various economic issues and it enables us to understand current economic problems and consequences of various economic policies pursued by the government. Economics seeks to develop principles, theories and models that identify the most important determinants or causes of various economic events. The goal is to evolve policies that might prevent or solve various problems like unemployment, inflation, underdevelopment, waste of resources in the economy, etc.

## 1.2 EVOLUTION OF ECONOMIC THOUGHT

It is important to understand how economics has developed as a discipline. Economic questions are as old as mankind. It implies that the prehistoric man too must have faced some of these economic issues. In the past, Economics or Political Economy, as it was called before 1890, formed part of other disciplines like logic, psychology, politics, ethics, etc. Aristotle, the famous Greek philosopher (384–322 BC), who is regarded by some writers as the first economist, was basically preoccupied with the general philosophy of state and society. But while doing so, he did refer to the definition and scope of economics. *He defined economics as the science of management of family and state.* During the ancient and medieval times, economics developed as a science of statecraft. The mercantilists, the advocates of economic thought which prevailed between the 16th and mid-18th centuries, believed that wealth was of paramount importance as a means of making a powerful state. This type of economic thinking resulted in making economics as a science of wealth-earning activities of the individuals as well as the state. Economics became a science of wealth much more clearly in the hands of the classical (traditional) economists. In fact, it emerged as a separate discipline for the first time in the writings of classical economists. Ever since then, economists have started defining the subject matter of economics much more clearly, though somewhat in different ways.

## 1.3 MAJOR DEFINITIONS OF ECONOMICS

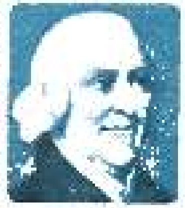
We can have some idea of the nature and scope of economics or the subject matter of economics by enumerating various definitions of economics. Ever since the emergence of economics as a separate discipline more than two centuries ago, economics has been defined differently by different economists. This is not surprising because economics covers a wide range of economic activities faced by human beings and the society. Keynes has aptly remarked, *'Political economy is said to have strangled itself with definitions.'*

For the sake of clear-cut understanding and logical exposition, we can group various definitions of economics under four heads: (1) wealth definition, (2) welfare definition, (3) scarcity definition and (4) growth-oriented definition.

### 1.3.1 Wealth Definition—Adam Smith

Classical economists like Adam Smith, J.S. Mill, Ricardo, Senior and others defined economics as a science of wealth. Adam Smith, who is generally regarded as the father of economics, defined economics as *"A science which enquires into the nature and causes of wealth of nations."* In his famous book, *An Enquiry into the Nature and Causes of the Wealth of Nations*, he emphasised the production, growth and distribution of wealth as the subject matter of economics.

**Adam Smith (1723–90)**



Adam Smith, a Scottish philosopher and economist, is often considered as the father of modern economics. He is well known for his classic work *An Enquiry into the Nature and Causes of the Wealth of Nations*, generally known as *Wealth of Nations*. It is considered to be the first modern work of economics and remains the most important book on the subject of economics till the present day. Adam Smith is considered as the founder symbol of free market economics and supporter of *laissez-faire* (which in French means 'leave alone') policies. He laid the intellectual framework that explains how rational self-interest and competition, through 'the invisible hand' lead to the most efficient use of resources in an economy and thereby promote social welfare. The writings of Adam Smith have had a profound impact on modern economics.

Besides Adam Smith, other classical economists also regarded economics as a science of wealth. Thus, J.B. Say, the noted French economist, regarded economics: ***"As the science which treats of wealth"***. Similarly, Nassau William Senior wrote that ***"The subject treated by the Political Economy... is not happiness but wealth."***

The main features of wealth definition of economics are:

1. **Study of Wealth:** According to the wealth definition, economics is the study of wealth only. The main object of economics is to examine how people earn wealth and spend it. Wealth has been made the focal point of economics by the classical economists.
2. **Causes of Wealth:** Economics seeks to examine causes which lead to an increase of wealth. Wealth can be increased by its production and accumulation.
3. **Economic Man:** The wealth definition of economics considers an *'economic man'* who is aware of his self-interest. The economic man tries to achieve his self-interest by increasing his material gains through acquisition of wealth.

### Criticisms

The classical economists were vehemently attacked from various quarters for emphasising economics as a study of wealth. The wealth definition has been criticised on the following grounds:

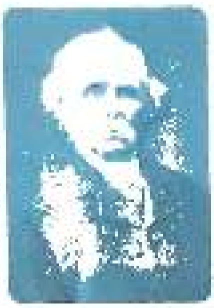
1. **Too Much Emphasis on Materialism:** Classical economists came in for bitter criticism from many thinkers of that time, particularly Thomas Carlyle and John Ruskin. They dubbed economics so defined as a *pig science, a dismal science, bread and butter science, gospel of mammon*, etc. They alleged that by defining economics as a science of wealth, classical economists have ignored the higher values of life such as happiness, love, affection, etc. They emphasised that happy living, and not getting rich, should be the end of human efforts. What matters most is a happy life and not wealth.

   However, this criticism is unwarranted and misplaced. Classical economists never advocated worship of wealth. They have emphasised wealth because it is the basis of physical existence and the basic means of raising the standard of living and achieving economic growth.
2. **Narrow View of Wealth:** Major criticism levelled against classical economists is that they have defined wealth in a very narrow and restricted sense. Wealth, according to them, consists of material or tangible goods. They have excluded non-material goods or services like health and education from the definition of wealth. By taking such a restricted definition of wealth, the classical economists have narrowed down the subject matter of economics to material goods only.
3. **Secondary Place to Man:** Another shortcoming of the 'wealth definition' of economics is that it has given undue emphasis on wealth and, in the process, has reduced man to a secondary place in the study of economics. In fact, the ultimate objective of economics is to promote human and social welfare and wealth is only a means to achieve this end. This problem was taken care of by Alfred Marshall.
4. **It Ignores the Problem of Scarcity:** The definition of wealth ignores the basic cause of economic activity, namely relative scarcity of economic resources.

### 1.3.2 Welfare Definition—Alfred Marshall

The subject of economics had fallen into disrepute towards the close of the 19th century due to overemphasis on the study of wealth by the classical economists. Marshall was the first economist who tried to raise the status of economics in the public mind. He made a fundamental change in the definition of economics. He gave the *'welfare* definition' of economics. He defined economics as follows: ***"Political Economy or Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social***

**Alfred Marshall (1842–1924)**



Alfred Marshall, who was a Professor of Political Economy at Cambridge University, is known as one of the founders of modern economics. His most famous student, J.M. Keynes, described Marshall as the greatest economist of the 19th century. Marshall's book, *Principles of Economics* (1890), was considered as the most influential textbook in economics with world-wide reputation for many years. It decisively shaped the teaching of economics in English-speaking countries. Marshall's main contributions to economics relate to the issues of demand and supply, marginal utility, consumer surplus, economies of scale, cost of production, short term and long term, etc.

***action which is most closely connected with the attainment and the use of the material requisites of well-being. Thus, it is, on the one side, a study of wealth and, on the other and more important side, a part of the study of man."***

The main features of Marshall's definition are:

1. **Study of Mankind:** Marshall placed primary emphasis on the study of mankind. No doubt, he emphasised both mankind and wealth in his definition. He agreed with the classical economists that economics is concerned with wealth, as wealth constitutes material requisites of well-being. Wealth provides the means for existence, comfort and enjoyment of life. He believed that wealth is not an end by itself, but only a means to human welfare. Thus, according to Marshall, it is the study of man which occupies the central place in the study of economics.
2. **Study of Ordinary Business of Life:** Economics is a study of ordinary business of life. An individual has several aspects of life, namely economic, social, religious and political. Economic is concerned only with the economic aspect of human life. Economics, according to Marshall, is not concerned with the social, religious and political aspects of man's life. The ordinary business of life is concerned with the income-earning and income-spending activities of mankind. Economics studies how people earn material means of their livelihood and how they spend these for the satisfaction of their well-being.
3. **Study of Material Welfare:** Marshall emphasised material welfare as the primary concern of economics. According to him, economics is not concerned with total human welfare, but is concerned with material welfare only, i.e., that part of human welfare which is related to wealth. Economics studies those activities which are most closely connected with the attainment and the use of the material requisites of well-being.
4. **Emphasis on Requisites of Well-being:** There is also emphasis on material requisites of well-being. Obviously, the material things like food, clothing and shelter are very important economic objects. Material needs are very basic needs which must be fulfilled before one can think of other needs.
5. **Exclusion of Non-economic Activities:** Marshall has limited the scope of economics to those forces and activities which are amenable to measurement in terms of money. That is why political, social, cultural and religious activities of human beings are excluded from the purview of economics as they are not subject to measurement in terms of money.

Following Marshall, many other economists like Pigou and Keynes also defined economics as a study of economic welfare. Pigou defined *"economics as a study of economic welfare, which is that part of social welfare that can be brought directly or indirectly into relationship with the measuring rod of money".*

## Criticisms

The welfare definitions of Marshall and Pigou were generally and widely accepted. It was generally believed that welfare definitions were successful in identifying the correct subject matter of economics. But this acceptance proved to be short-lived. Soon, welfare definitions came to be criticised, particularly by Lionel Robbins. The main criticisms levelled against welfare definitions are:

1. **Economics Regarded as a Social Science Only:** Marshall has been criticised for treating economics as a social science rather than a human science. A social science studies the actions of the individuals living in organised communities as members of the society, whereas a human science studies the human being irrespective of whether he is living as a member of an organised community or living in isolation. In terms of welfare definition, the activities of an isolated individual like Robinson Crusoe or a Himalayan saint lie outside the orbit of economics because both of them are cut off from rest of the society. Thus, welfare definition restricts the scope of economics to the study of persons living in organised communities only. This is something unacceptable because some of the important laws of economics are relevant to an individual, whether he is a member of a community or not.
2. **Impractical Classification of Activities:** A second criticism against welfare definition pointed out by Robbins is that distinction between economic and non-economic activities is unscientific, illogical and illusory since all human activities have an economic aspect. Moreover, welfare is composite and it is very difficult to separate material welfare from the total welfare.
3. **Materialistic Aspect:** Robbins has criticised welfare definitions on the ground that these definitions include only material things within their purview. They exclude non-material things like the services of doctors, lawyers, teachers, etc., from their orbit. These services have nothing material in them. However, these services also satisfy our urgent needs and thereby promote welfare. Hence, it is incorrect to say that economics is concerned with material things only.
4. **Restricted Scope of Economics:** Robbins has also criticised welfare definitions as they restrict the scope of study of economics. Economics studies several activities which hardly promote economic welfare. Many goods like liquor, cigarettes and guns do not promote economic welfare, yet production of these goods constitutes economic activity and hence it is studied in economics.
5. **Vague Concept of Material Welfare:** The welfare definitions are also subject to criticism on the ground that material welfare cannot be quantitatively measured. Welfare is a subjective thing; it is psychic in nature. It relates to the mental make-up of a person. It differs according to time, place and individual. Thus, welfare cannot be measured in objective terms.

### 1.3.3 Scarcity Definition—Lionel Robbins

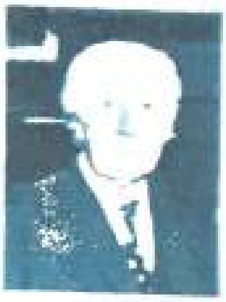
Robbins was not only a critic of the welfare definition of economics, but he also gave a new definition of economics, which has come to be known as '*scarcity definition*'.

According to Robbins, ***"Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses."***

Robbins' definition emphasises four fundamental characteristics of human life:

1. **Unlimited Ends (Wants):** Ends here refer to human wants. A fundamental fact of economic life is that ends or human wants are unlimited. Human wants are not only large in number, but they tend to multiply over time. As one want is satisfied, another want crops up. In view of the multiplicity of wants and the increase in their number over time, it is not possible to satisfy all the wants. However, an important fact

**Lionel Robbins (1898–1984)**



Lionel Robbins was one of the leading and most influential English economists of the 20th century. He was associated with the London School of Economics and Political Science (popularly known as LSE) for over 30 years, both as the Professor of Economics and as the Chairman of the Board of Governors. He wrote on wages, inflation, the economics of war and the history of economic thought. However, his major work was his *Essay on the Nature and Significance of Economics*, in which he gave the famous definition of economics. *His Report on Higher Education* (1963) became a landmark in the development of higher education in UK in the 1960s and 1970s, which led to the formation of modern British University System.

about human wants is that all wants are not of equal intensity. They differ in their importance; some wants are more intense than others. Since wants are unlimited, we have to make a choice between the more important and less important wants. Obviously, priorities have to be laid down among various wants. It is because of difference in the intensity of different wants that people are able to make a choice between different wants.

2. **Scarce Means:** The second fundamental fact of economic life is that means to satisfy human wants are limited. Means refer to various productive resources such as land, labour, capital, etc., which are needed to produce and procure goods needed to satisfy human wants. Resources are said to be scarce in the sense that the supply of resources is limited as compared to their demand. It should be noted here that the term *scarcity* is used not in the absolute sense but in the relative sense, i.e., in relation to demand. Although supply of resources has increased over time, yet the demand for resources has always outpaced their supply. Thus, resources are limited. Labour is limited by the size of the population; land is limited by area of the country, and so on. In view of the scarce means, only a limited quantity of goods can be produced. As such, goods are scarce in relation to their demand. Since the resources are scarce, all the wants cannot be satisfied. Hence, we have to decide which of the wants can be fulfilled and which ones should be left unfulfilled for the time being. This problem would not have arisen if the resources were available in unlimited quantity. In the words of Prof. Milton Friedman, ***"If the means are not scarce, there is no problem at all; there is Nirvana."*** Scarcity is at the root of most of the human economic problems.

3. **Alternative Uses of Means:** The third fact which Robbins' definition emphasises is that resources can be put to alternative uses. For example, a piece of land can be used to produce wheat, vegetables, etc. Likewise, a labourer can be used on the fields or in the factories. The use of scarce resources in the production of one commodity prevents its use for any other commodity. Therefore, the society has to make a decision as how to allocate the scarce resources in the production of different commodities. The problem of allocation of resources in the production of different commodities would not arise in case the resources were of specific use or of single-use because in that case resources have to be used for the production of that specific commodity only. For example, as the film stars are adept in acting, they would prefer to act in films only.

4. **Choice:** Since the resources are scarce and are also capable of alternative uses and the human wants (ends) are endless, people have to make a choice in allocating these resources for producing different commodities on the basis of their relative importance. Human behaviour, therefore, involves some form of choice in using the scarce resources in producing different

goods in such a way so as to maximise the gains (in the form of more goods) from the use of these resources, i.e., optimal allocation of resources. Robbins has described this problem as the *problem of economising scarce resources*.

The need for choice arises because of scarcity. If everything were available in plenty, there would have been no need for choice. But the harsh reality of life is that all of us face the problem of scarcity and hence have to make choice. We face the problem of choice at all levels—individual, social, national or international.

5. **Economics as a Science:** According to Robbins, economics is a science. It provides a systematic knowledge with regard to human efforts in solving economic problems arising out of scarce means and unlimited wants. Economics is about making choices in the backdrop of scarcity. Economics formulates various economic laws which help in solving economic problems.

### Merits

Robbins' definition of economics is generally and widely accepted by the economists in view of its superiority over the earlier definitions in a number of ways:

1. **Logical Explanation of Economic Problem:** Robbins' definition very clearly brings out the root cause of economic problem, which forms the foundation of economics as a social science. According to Robbins' definition, economic problem arises due to scarcity of means in relation to their demand.
2. **Universal Nature:** The scarcity definition of economics emphasises the universal nature of the subject in the sense that scarcity of means in relation to ends is a universal problem—everywhere and at all times. Rich as well as poor, traditional as well as modern economies face the problem of choice. Scarcity definition of economics is as much applicable to a Robinson Crusoe economy as to a capitalist economy or a socialist economy.
3. **Human Science:** Robbins points out that economics is a human science and not merely a social science. This is because the problem of choice and resource allocation is faced by an individual irrespective of whether he is a member of an organised community or is living in isolation.
4. **Wider View of Economic Activity:** According to Robbins, economics studies all economic activities—whether they relate to the production of tangible (material) commodities or services—provided they involve scarcity of means in relation to ends.
5. **Positive Science:** Robbins emphasises that economics is a positive science. Economics is a systematic body of knowledge which provides the framework within which one can analyse economic problems faced by the society. Robbins' definition imparts economics the nature of a positive science because it regards economics to be neutral between ends. According to Robbins, economics does not tell the individuals as to what ends should be achieved and what ends should be sacrificed. Economics enlightens the individuals, enabling them to make rational decisions, but the decisions have to be made by the individuals themselves.

### Criticisms

But despite the superiority of Robbins' definition, it has been criticised on several grounds:

1. **Narrow View of Economics:** Robbins' definition has been criticised on the ground that it regards economics as a positive science by making it neutral between ends. Many contemporary economists believe that they as economists are required to tell what is good or bad about certain choices. There is general agreement among economists at present that economics is not only a positive science but also a normative science. Positive science

is concerned with 'what is', whereas normative science is concerned with 'what should be' or 'what ought to be'. Thus, critics consider the 'scarcity definition' as narrow and restrictive in nature. If economists have to advise on policy matters, economics cannot remain neutral between ends.

2. **Restricted Subject Matter of Economics:** A serious objection against Robbins' definition is that it has restricted the subject matter of economics by restricting it to the theory of resource allocation, i.e., the theory of product and factor pricing. Robbins' definition is inadequate because it does not take account of many other important economic problems which are also part of the subject matter of economics these days. It does not focus on the important economic issues of economic instability, unemployment, income determination and economic growth and development, etc.
3. **Static Definition:** The greatest defect in Robbins' definition, as pointed out by critics, is that it is static in its contents. According to the critics, Robbins has taken a static view of the scarcity problem. Robbins' definition does not take into account the possibility of increase in resources over time. With economic growth, availability of resources and their efficiency increases. Economics is not only concerned with the present economic problems but also with the future problems. Robbins' definition is regarded as static as it takes into consideration presently available means only.
4. **Economics as a Science:** Robbins has treated economics as a science only. But, in fact, economics is both a science and an art. Scarcity definition of economics has reduced economics into a pure science, a science that is concerned with formulation of economics laws only. But economists these days believe that economics is also concerned with the solution of economic problems. Economists these days are considered not only 'tool-makers' but as 'tool-users'.
5. **Economic Problem May Not Always Arise from Scarcity:** Some critics point out that economic problem does not always arise from scarcity as suggested by Robbins. It can sometimes arise from abundance as well. For example, during the Great Depression of 1930s, it was not the scarcity but abundance of goods (overproduction) which created an economic problem in various capitalist countries of the world.

### 1.3.4 Growth-Oriented Definition—Samuelson

As pointed out above, Robbins' definition of scarcity does not indicate adequately the subject matter of economics as it does not cover many issues, particularly the issue of economic growth.

**Paul A. Samuelson (1915–2009)**

Paul Samuelson was an American economist at the Massachusetts Institute of Technology (popularly known as MIT), who became the first American to receive the Nobel Prize in Economics (1970). Professor Samuelson is often considered as the father of modern economics. He became the most influential and the foremost economist of the second half of the 20th century. He made fundamental contributions to economic science in the fields of welfare economics, public finance, international economics, macroeconomics, consumer theory, etc. He was the author of the best-selling economics textbook of all times entitled *Economics, An Introductory Analysis* (1948). This book has sold nearly 4 million copies in 41 languages. Through this book, Samuelson has introduced millions of people to the subject of economics. He also helped in building MIT into one of the world's great centres of graduate education in economics.

Therefore, some modern economists have tried to redefine economics by emphasising the problem of economic growth.

Professor Paul A. Samuelson has given a new definition of economics, which has come to be known as growth-oriented definition. According to Samuelson, *"Economics is the study of how people and society choose, with or without the use of money, to employ the scarce productive resources, which have alternative uses, to produce various commodities over time and distribute them for consumption now or in the future among various people and groups in the society."*

Samuelson's definition of economics emphasises the following:

1. **Emphasis on Economic Problems:** Like Robbins, Samuelson also emphasises the problem of choice arising out of scarce resources and unlimited wants. Thus, this definition gives a realistic explanation of economic problems.
2. **Long-term Perspective:** The problem of scarcity of resources is not merely confined to the present time but also to the future. Wants are not static; they are dynamic. Wants grow and multiply over time. Along with expansion of wants, resources also increase over time. Hence, we are not merely concerned with the allocation of given resources but also with how the expansion and growth of resources is to be used to cope with increasing human wants. Thus, Samuelson has taken the long-term perspective of economic problems. Herein lies the superiority of Samuelson's definition over that of Robbins.
3. **Dynamic Approach:** Prof. Samuelson has adopted a dynamic approach to the study of economics by taking economic growth as an integral part of economics. As such, his definition has imparted dynamism to economic problems. This has widened the subject matter of economics.
4. **Universal Problem:** Samuelson's definition is not only dynamic in content, it is also wider in scope. Prof. Samuelson has rightly emphasised that the problem of resource allocation is a universal problem, both for barter economies as well as for money-using exchange economies.
5. **Comprehensive:** Samuelson's definition of economics is very comprehensive. It is growth-oriented as well as future-oriented. It has incorporated Marshall's welfare aspect as well as Robbins' scarcity and choice aspect.
6. **Broader Perspective:** Samuelson's definition has broadened the subject matter of economics so as to include consumption, production, exchange, distribution, economic growth, etc.

Of all the definitions of economics discussed above, Samuelson's definition is considered to be the most satisfactory. It presents the problem of choice in its dynamic setting. It has also widened the subject matter of economics. Besides, Samuelson's definition has also a universal appeal. It is applicable to all types of economies—capitalist, socialist and mixed. That is why Samuelson's definition is the most accepted definition of economics today.

It is obvious from the above analysis that economics has been defined differently by different economists and the definition of economics has changed over time. There is no universally accepted definition of economics. This is primarily because economics is a fast growing science, and the subject matter of economics has grown so vast that it is not possible to give a precise definition of economics for all times. The boundaries of economics have been expanding continuously because *'Economics is (still) an unfinished science'* (Zeuthen). That is why modern economists have stopped giving any precise definitions of economics. Therefore, the best way to know what economics is all about or what is the subject matter of economics is to find out what sort of questions economists have been discussing. Jacob Viner very aptly says, *"Economics is what economists do."*

## 1.4 SUBJECT MATTER OF ECONOMICS

The subject matter of economics is presently divided into two major branches: Microeconomics and Macroeconomics. These two terms have now become of general use in economics.

### 1.4.1 Microeconomics

The prefix '*micro*' is derived from the Greek word '*mikros*', meaning 'small'. ***Microeconomics studies the economic behaviour of individual economic units and individual economic variables.*** The unit of study in microeconomics is individual unit rather than the entire economy such as individual households, firms and industries. Thus, the study of economic behaviour of the households, firms and industries forms the subject matter of microeconomics. In other words, microeconomics is a microscopic study of the economy. For example, microeconomics is concerned with how the individual consumer distributes his income among various products and services so as to maximise his utility. Microeconomics also seeks to explain how the individual firms decide at what price to sell the product, how much to produce, what amount of product will maximise their profit, and how to minimise the cost of production. In other words, microeconomics examines how resources are allocated among various individual firms and industries, how the prices of various products are determined, and how the output produced is shared among those who cooperate in the production of this output. Microeconomics also examines whether resources are efficiently allocated. It spells out the conditions for the optimal allocation of resources so as to maximise the output and social welfare. Thus, microeconomics is concerned with the theories of product pricing, factor pricing and economic welfare.

### 1.4.2 Macroeconomics

The prefix '*macro*' is derived from the Greek word '*makros*' meaning 'large'. Macroeconomics is the study of the economy as a whole. The unit of study in macroeconomics is the entire economy rather than a part of it. Macroeconomics deals with the problems faced by the entire economy. Thus, ***macroeconomics deals with the functioning of the economy as a whole***. For example, macroeconomics seeks to explain how the economy's total output of goods and services and total employment of resources are determined and what explains the fluctuations in the level of output and employment. Macroeconomics explains why sometimes the economy is operating at near-about full employment level and why, at some other times, there is a high degree of unemployment; why sometimes there is full utilisation of the economy's productive capacity and why at some other times there is underutilisation of the economy's productive capacity. It also seeks to explain why sometimes the economy experiences a high rate of economic growth and a lower rate of economic growth at some other times; why sometimes the economy faces the problem of a sharp rise in prices, i.e., problem of inflation, and why at some other times the price level remains stable or even falls. In short, macroeconomics deals with the broad economic aggregates or 'bigger' issues, such as full employment or unemployment, full capacity or undercapacity production, a low or high rate of growth, inflation or deflation. In other words, macroeconomics is concerned with the theory of national income, employment, aggregate consumption, savings and investment, general price level, economic growth, etc.

### 1.4.3 Differences between Microeconomics and Macroeconomics

Microeconomics and macroeconomics differ from each other in the following important ways:

1. **Unit of Study**: Microeconomics and macroeconomics differ from each other in terms of the unit of study. Microeconomics studies the economic behaviour of individual economic units. It is concerned with how the individual units make decisions and what affects these decisions. The main individual economic units are individual households, firms, industries and individual markets. The unit of study in macroeconomics, on the other hand, is

the entire economy rather than a part of the economy. Macroeconomics is concerned with the behaviour of the economy as a whole. Speaking metaphorically, microeconomics examines trees, not the forest, while macroeconomics examines the forest and not the trees.

2. **Focus of Study:** Microeconomics differs from macroeconomics in terms of the nature of economic problems studied. Microeconomics deals with the determination of prices and quantities in individual markets. It is concerned with allocation of resources among individual firms and industries. It examines how the output produced is shared among various resource-owners who cooperate in the production of this output. Thus, microeconomics deals with the functioning of various markets—both commodity markets and factor markets—and the relationship among these markets. Macroeconomics, on the other hand, deals with broad economic aggregates like national income, total employment, aggregate consumption, aggregate savings and investment, general price level, economic growth and balance of payments.

   Boulding has defined macroeconomics precisely from the angle of nature of the problems studied. He states, ***"Macroeconomics deals not with individual quantities as such but with aggregate of these quantities; not with individual incomes but with national income; not with individual prices but with the price level; not with individual outputs but with the national output."***

3. **Basic Parameter of the Subject Matter:** One of the main differences between microeconomics and macroeconomics is in terms of the basic parameters of the subject matter of the two. While price is the basic parameter of the subject matter of microeconomics, national income is the basic parameter of macroeconomics.

   In case of microeconomics, economic units like households and producers take economic decisions on the basis of prices in different markets. On the other hand, in macroeconomics, economic decisions relating to aggregate consumption, aggregate investment, etc., are taken on the basis of national income.

4. **Different Perspectives:** Microeconomics and macroeconomics look at the economic issues from different perspectives. According to Stiglitz, ***"Microeconomics is the bottom-up view of the economy; macroeconomics is the top-down view."***

5. **Methods of Study:** Microeconomics uses the technique of '*partial equilibrium analysis*'. In partial equilibrium analysis, we make the assumption of *ceteris paribus* order, i.e., other things being equal. For instance, while formulating the law of demand in microeconomics, we study the relationship between price and demand on the assumption that factors other than the own price of the commodity remain the same. Macroeconomics, on the other hand, uses the technique of '*quasi general equilibrium analysis*'. Mutual dependence of macroeconomic variables is the centerstage of macroeconomics. Thus, macroeconomics studies the interdependence of macroeconomic variables like aggregate demand, aggregate supply, aggregate consumption, aggregate investment, etc.

6. **Nature of Assumptions:** Microeconomics and macroeconomics differ from each other on the basis of the nature of assumptions. In microeconomics, it is assumed that total output, income and employment, general price level, etc., (i.e., economic variables of macroeconomics) are given. On the basis of these assumptions, microeconomics explains how allocation of resources takes place and how prices of different commodities are determined. It studies the problem of optimal allocation of resources. On the other hand, macroeconomics assumes allocation of

resources, distribution of output, spending on particular goods and services, relative prices, etc., (i.e., economic variables of microeconomics) as given. On the basis of these assumptions, macroeconomics explains how aggregate output, income, employment and price level, etc. are determined in the economy as a whole.

### 1.4.4 Interdependence of Microeconomics and Macroeconomics

Although we have drawn a sharp distinction between microeconomics and macroeconomics, we should not get an impression from this that the two are independent ways of analysing the economic issues. Microeconomic analysis and macroeconomic analysis are complementary to each other; they do not supplant but supplement each other. That is why Shapiro says, *"strictly speaking, there is only one economics"*. In practice, analysis of the economy cannot be conducted separately in two watertight compartments. Microeconomic variables and macroeconomic variables are interdependent. Therefore, as we analyse microeconomic variables, we have to take account of macroeconomic variables that may affect the microeconomic variables, and vice versa.

Both microeconomic theory and macroeconomic theory are important in their own ways. When we say that macroeconomics deals with 'bigger' issues of economic life, it does not mean that macroeconomic theory is more important. After all, the entire economy is made up of its parts. Therefore, microeconomic theory is equally important in its own way. Moreover, the basic goal of both the theories is the same—the maximisation of material welfare of the people. From the macro point of view, the nation's material welfare will be maximised by achieving full utilisation of productive resources of the economy. However, from the micro point of view, the economic welfare will be maximised by achieving optimal allocation of resources. Therefore, for the students of economics, study of both microeconomics and macroeconomics is equally vital so as to have complete knowledge of the subject matter of economics. Otherwise, the description and understanding of economics would be like the description of an elephant by four blind men who gave four different descriptions of the elephant by touching its different parts. Prof. Paul A. Samuelson has rightly remarked, *"There is really no opposition between microeconomics and macroeconomics. Both are vital. You are less than half-educated if you understand one while being ignorant of the other."*

Before 1930, economists concentrated their attention exclusively on microeconomics. Macroeconomics was regarded as a junior partner. It was, therefore, given a passing reference. The classical economists believed that the economy normally operates at full employment level and, therefore, the actual level of output in the economy was simply whatever could be produced with full employment of resources. According to them, the economy could depart from full employment situation only temporarily. They believed that the automatic forces of competition would take the actual level of output back to the full employment level. Therefore, these economists were not concerned with the problem of unemployment. The fact that there were relatively few situations of prolonged unemployment and depression before 1930 gave support to this belief of classical economists. However, the situation changed dramatically during 1930s. During this decade, there was widespread unemployment in the advanced capitalist countries of the world. Actual output was only 75 per cent of the potential output, i.e., the output produced with full employment of resources, and 25 per cent of the potential output was not produced. It was this which led to the development of macroeconomic theory by the famous economist, J.M. Keynes. Keynes' famous book, *The General Theory of Employment, Interest and Money* provided a theory to explain the phenomenon of depression. Keynes provided a theory about the determination of employment and output. He explained that the economy can operate at any level of employment, with full employment being only one possible level. In fact, according to him, economy normally operates at less than full employment level. Ever since then, economists have shown immense interest in macroeconomics issues, and macroeconomics has assumed an unprecedented importance today.

The contemporary economists have shown their interest both in microeconomics and macroeconomics.

## SUMMARY

- **Introduction:** Economics is a social science concerned with economic questions. It seeks to explain systematically questions pertaining to economic behaviour of the individual, the society and the economy.
- **Evolution of Economic Thought:** Economic questions are as old as mankind. Economics in the past was known as Political Economy. Economics in the early days was considered as a science of management of households and state. Economics at a later stage was regarded as a science of wealth. Economics emerged as a separate discipline in the writings of the classical economists.
- **Major Definitions of Economics**
  - ***Wealth Definition:*** Classical economists such as Adam Smith, J.B. Say, Nassau William Senior, etc., defined economics as a science of wealth.

    **Criticisms:** 1. It has ignored the higher values of life, 2. Narrow concept of wealth, i.e., material goods, 3. It has reduced man to a secondary place, 4. It ignores the problem of scarcity.
  - ***Welfare Definition:*** Developed mainly by Marshall and Pigou. Welfare definition emphasises: 1. Study of mankind, 2. Study of income-earning and income-spending activities of mankind, 3. Study of material welfare, 4. Emphasis on requisites of well-being, 5. Activities measurable in money terms.

    **Criticisms:** 1. It restricts the scope of economics to social science, 2. Material welfare inseparable from total welfare, 3. It includes only material things, 4. It restricts scope of economics, 5. Welfare cannot be indicated in objective terms.
  - ***Scarcity Definition:*** Robbins' scarcity definition emphasises four fundamental characteristics of human life: 1. Unlimited wants, 2. Scarce means, 3. Alternative uses of means, 4. Choice. He considers economics to be a science.

    Robbins' definition has the following plus points: 1. It brings out the root cause of economic problems, 2. It emphasises the universal nature of economic problem, 3. It regards economics as a human as well as a social science, 4. Economics studies all economic activities, 5. Economics as a positive science.

    **Criticisms:** 1. It regards economics as positive science only, 2. It restricts economics to the theory of product and factor pricing only, 3. Static definition of economics, 4. Economics is treated only as a science, 5. Economic problem may not always arise from scarcity.
  - ***Growth-oriented Definition:*** It emphasises: 1. Problem of choice, 2. Increase of wants and resources over time, 3. Economic growth as an integral part of economics, 4. Universal nature of economic problem, 5. Dynamic approach, 6. Comprehensive definition, 7. Broader perspective of economics.

- **Subject Matter of Economics**
  1. ***Microeconomics:*** It is the study of economic behaviour of individual economic units and individual economic variables.
  2. ***Macroeconomics:*** It deals with the functioning of the economy as a whole.

  The two branches are supplementary and important in their own ways.

## TEST YOURSELF QUESTIONS

### Very Short Answer Questions (2 marks each)

1. State the 'wealth' definition of economics. (See Sec. 1.3.1)
2. What is the 'welfare' definition of economics? (See Sec. 1.3.2)
3. Give Robbins' (scarcity) definition of economics. (See Sec. 1.3.3)
4. What is the 'growth-oriented' definition of economics? (See Sec. 1.3.4)
5. State two features of Marshall's welfare definition of economics. (See Sec. 1.3.2)
6. Give main features of Robbins' definition of economics. (See Sec. 1.3.3)
7. Point out the main features of growth-oriented definition of economics. (See Sec. 1.3.4)
8. What is microeconomics? (See Sec. 1.4.1)
9. Define macroeconomics. (See Sec. 1.4.2)
10. Give two differences between microeconomics and macroeconomics. (See Sec. 1.4.3)

### Short Answer Questions (3 marks each)

1. Explain the 'wealth' definition of economics. (See Sec. 1.3.1)
2. Explain the 'welfare' definition of economics. (See Sec. 1.3.2)

### Long Answer Questions (6 marks each)

1. Critically examine the 'scarcity' definition of economics. (See Sec. 1.3.3)
2. What is the 'growth-oriented' definition of economics? Explain the main virtues of this definition. (See Sec. 1.3.4)
3. Which definition of economics is the best? Give reasons in support of your answer. (See Sec. 1.3.4)
4. Differentiate between microeconomics and macroeconomics. (See Sec. 1.4.1, 1.4.2 and 1.4.3)