CHAPTER 2

BASIC CONCEPTS OF ECONOMICS

2.1 INTRODUCTION

Economics, like any other subject, has its own terms and concepts. In this chapter we discuss some elementary concepts which are frequently used in economic analysis. In fact, many of these concepts are commonly used in our day-to-day life. We explain here some of the elementary concepts which would be very frequently used in this book. Wants, utility, price, value, wealth, welfare, money, market, investment, income, production, consumption and savings are some of the concepts which are widely used not only in any economics textbooks but also in real life.

2.2 HUMAN WANTS

As explained in the last chapter, economics is concerned with various economic issues pertaining to the economic behaviour of individuals, society and the economy. The basis of all economic activities is the existence of human wants. The process of satisfying human wants is at the root of all economic activities. People work in order to earn an income so as to satisfy their economic wants.

The word *'want'* ordinarily means a wish or desire for something. In ordinary usage, the words *'want'* and *'desire'* are used in the synonymous sense. But in economics, the two are used in different senses. ***'Desire' is the wish to have something***. But ***'want' is an effective desire for a particular thing, which can be satisfied by making an effort to acquire it.*** For instance, I may desire to have a Honda City car, but it would become my want only if I am ready to make an effort, like earning income, to acquire this car.

2.2.1 Classification of Human Wants

Wants for various goods and services can be conveniently divided into two broad categories, namely primary wants and secondary wants.

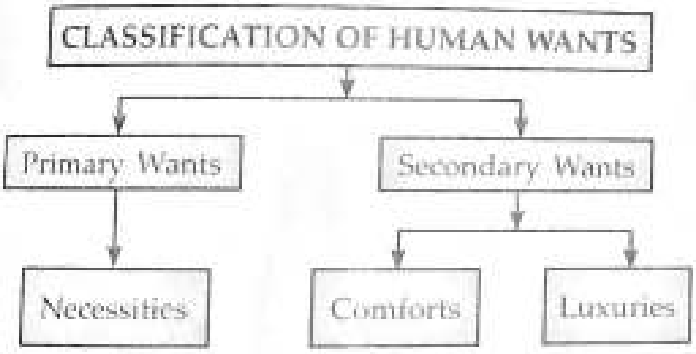
1. **Primary Wants:** Human wants for the basic necessities of life are regarded as primary wants. ***Primary wants refer to wants for those goods which are necessary for the very existence of human life and for the maintenance of normal efficiency.*** These primary wants can be classified into two groups: (*a*) Those wants which are necessary for the very existence of human beings. Food, clothing and shelter are such essential wants. (*b*) Wants for those goods which are necessary for maintaining normal efficiency of individuals. For a factory worker, plenty of food is necessary for maintaining his efficiency. Similarly, tables and chairs may be regarded as necessities for students.
2. **Secondary Wants:** Secondary wants are those wants which arise only after the primary wants are satisfied. ***They relate to wants for those goods which cater to***

comforts and luxuries of life. Secondary wants are classified into two groups:

(a) **Wants for Comforts:** ***These are the wants for those goods which are source of comfort and happiness for people.*** For example, a sofa set in a room, a music system in the house, a refrigerator in the kitchen and a cooler in the bedroom—all these make our life comfortable.

(b) **Wants for Luxuries:** ***Wants for luxuries refer to wants for those goods which are very expensive and which are meant to show the wealth and power of a person.*** These luxuries may not give high benefits as compared to their very high price, but they add to the prestige and are considered to be status symbols by the society. Modern and costly houses, expensive jewellery, expensive cars and air conditioners are examples of luxuries.

The classification of human wants can be shown in the form of a flow chart below:



2.2.2 Features of Human Wants

Human wants have certain features. The main features are as given below:

1. **Wants Are Unlimited:** The basic and the most important feature of human wants is that they are unlimited or endless. Wants start when the child is born and these wants remain with the man till he goes to the graveyard. The history of human civilization bears testimony to the fact that human wants have always been unlimited all the times. Wants are unlimited because people have multiple wants. Many wants are cumulative and at the same time people acquire new wants.
2. **Wants Are Complementary:** Many of the wants are found simultaneously. When two or more goods are wanted together, the want for these goods is said to be complementary. The want for a car creates the want for petrol. A student wants both pen and ink.
3. **Substitution of Wants:** A particular want can be satisfied by one good or the other. For example, if we are thirsty, our thirst can be satisfied by a cold drink or by a glass of juice.
4. **Wants Are Competitive:** Man has limited income with which he can purchase either one commodity or the other. Therefore, these commodities will compete with each other. For example, if a student has ₹1000 with him, he can spend it in a restaurant or opt for a movie or he can watch a cricket match in a stadium. Thus, there is competition among these three wants.
5. **Wants Multiply:** An important characteristic of human wants is that they tend to multiply over time. With the growth of human knowledge and science and technology, new goods have been produced. This has led to creation of new wants. For instance, the want for a microwave oven has been created after the discovery of such an oven sometime back.
6. **Wants Recur:** The basic characteristic of human wants is that they can be satisfied only temporarily. Therefore, they appear again and again and have to be satisfied every time. Take the case of food. Having a meal in the morning does not mean that we will not feel hungry in the evening. So, we need to have the meal once again. Thus, human wants are recurrent.
7. **A Single Want Can be Satisfied:** Although all the wants taken together cannot be satisfied, yet it may be possible to satisfy a single want or a few wants. This is because the resources are insufficient to satisfy all the wants simultaneously.

8. **Some Wants Can be Postponed:** Some wants can be postponed while others cannot be. For example, the want for a TV or a car can be postponed in case we don't have enough income to purchase these goods; but the want for food cannot be postponed.

9. **Wants Differ in Their Urgency:** Another important feature of human wants is that they differ in their urgency or intensity. Some wants are more urgent while others are less pressing. This implies that an individual has a scale of preference, i.e., he can arrange his wants in the order of their relative urgency or importance to him. For example, we will like to give food our first preference over all other wants because our want for food is most pressing. More urgent wants are always preferred over less urgent wants. It must be kept in mind that each person has his own scale of preference and this scale of preference may change over time. One person may prefer a cricket match over a movie, another person may prefer a music concert over both a cricket match or a movie.

10. **Wants Remain Ahead of Availability of Goods and Services:** The hard truth of life is that human wants for goods and services have always remained ahead of availability of those goods and services.

Thus, human wants reveal very many important features. These features form the basis of some of the important economic principles.

Features of Human Wants at a Glance

1. Wants are unlimited.
2. Wants are complementary.
3. Substitution of wants.
4. Wants are competitive.
5. Wants multiply.
6. Wants recur.
7. A single want can be satisfied.
8. Some wants can be postponed.
9. Wants differ in their urgency.
10. Wants remain ahead of availability of goods and services.

2.3 CONSUMPTION

Commodities are needed to satisfy human wants. Commodities are divided into two categories, namely goods and services. *Goods* are tangible or material things such as shirts, cars, etc. *Services* are non-tangible things such as education, medical, haircuts, music, etc. Goods and services need to be consumed in order to satisfy human wants. ***The act of using goods and services to satisfy human wants is called consumption.*** According to Meyers, *"Consumption is the direct use of goods and services in satisfying human wants."*

Anyone who consumes goods and services to satisfy his or her wants is called a *consumer*. Consumption is the process through which human wants are satisfied. For instance, we use an apple to satisfy our hunger. In some cases, consumption may take place immediately in one act of their use at any point of time. For example, as we eat an apple our hunger is satisfied immediately; this apple is used up and we cannot use it again. But in some other cases, the consumption may take place gradually over a period of time; the same goods can be used again and again to satisfy wants. For instance, in the case of durable consumer goods like clothes, furniture, televisions, cars, etc., consumption takes place for a long time till these goods are completely used up. Every time we watch a programme on TV, our want relating to entertainment is met. The use of TV satisfies our want for a long time till this TV becomes unusable.

2.3.1 Sustainable Consumption

In the light of the need for sustainable development, we talk about sustainable consumption these days. *Sustainable consumption is the consumption of goods and services which meets the needs of people and*

improves the quality of life without having any adverse impact on the environment and needs of the future generations.

Current consumption patterns in most of the countries are destroying the environment, depleting stock of natural resources, distributing resources in an inequitable manner (between people and the countries), contributing to social problems such as poverty, and adversely affecting sustainable development. Therefore, what is important is that the consumption pattern should be such that it assists in sustainable development and at the same time does not adversely affect the needs of future generations. To achieve this objective, such goods and services should be used which minimise the use of natural resources, improve the efficiency of resources and reduce environmental damages, pollution and emission of wastes so that the interest of the future generations is not jeopardized. We should consume those goods which are more efficient in resource use and are less polluting. Sustainable consumption also implies that the consumption of the current generations as well as future generations should improve in quality.

2.3.2 Significance of Consumption

Significance of consumption arises from the following facts:

1. Consumption is the primary motive for economic activities. All economic activities like production, exchange and distribution arise due to the consumption requirement in an economy.
2. Consumption is the end purpose of all economic activities. Economic activity starts with the act of production of goods and services and ends with the use of these goods and services for consumption.
3. Consumption is the index of standard of living. The level of consumption and the types of goods consumed determine the standard of living of the people.
4. Consumption is the basis of economic welfare. Economic welfare refers to the total satisfaction obtained from the consumption of economic goods. The larger the consumption of goods and services, the larger is the economic welfare.
5. Consumption is the major determinant of employment. The level of employment in an economy depends on the aggregate demand. Aggregate demand depends largely on total consumption.

2.4 UTILITY

The act of consumption of goods and services is able to satisfy our wants because goods and services possess utility. Goods and services will be purchased for consumption only if they possess utility. Therefore, it is important to understand the concept of utility.

Utility refers to the want-satisfying power of a commodity. It is the ability or capacity of a commodity to satisfy human wants. According to Prof. Hibdon, ***"Utility is the ability of a good to satisfy a want."*** In objective terms, ***utility may be defined as the amount of satisfaction derived from a good or service at a particular point of time.*** The utility of an apple is the satisfaction obtained from consuming it at a particular moment of time.

Utility is the property or quality common to all commodities wanted by a person. For example, bread has the power to satisfy hunger; books fulfil our desire for knowledge; a TV satisfies our desire for entertainment. All the goods which people want to acquire possess utility.

2.4.1 Features of Utility

Following are the main features of utility:

1. **Utility is Subjective:** Utility is subjective, i.e., it cannot be observed and identified. It depends on the individual's own subjective estimate of the amount of satisfaction he is likely to get from a good or service. It resides in the mind of the people. The consumer knows it by introspection.
2. **Utility is Not Measurable:** Since utility is subjective, it cannot be measured in objective terms. It cannot be quantified

and cannot be measured by any measuring rod. However, some economists maintain that utility can be measured. For example, according to Marshall, the amount of money an individual is prepared to pay for a unit of commodity can be taken as the measure of its utility.

3. **Utility is Relative:** Utility is not absolute but relative in view of its subjective nature. It is relative to a person's need. Therefore, it varies from person to person. Moreover, utility of a thing to a person depends on his intensity of desire for the commodity; the greater the need, the greater is the utility. Furthermore, utility is not constant. It varies from place to place, time to time and circumstance to circumstance. For example, a chapati or a plate of rice gives more utility to a person when he is hungry as compared to a situation when his belly is full. Similarly, woollen clothes give more utility in a cold place than in a hot place.
4. **Utility is Different from Usefulness:** Utility should not be confused with usefulness; the two are different. A commodity may possess utility even though it may not be useful. For example, liquor may have harmful effects, but even then liquor has utility so long as it satisfies the want of a drinker. In other words, a harmful good may also have utility. Thus, the utility of a commodity has nothing to do with its usefulness; it may or may not be useful, but so long as it has some use to an individual, it has utility.
5. **No Moral or Legal Connotations:** Utility has no ethical or legal connotations. Utility has no ethical or moral implications. It is neutral, between good and bad, between useful and harmful. A commodity may be considered immoral for some, but still it may possess utility. For example, eating eggs may be a religious taboo for some persons, but if a non-vegetarian person eats an egg, it satisfies his hunger. In the same way, utility is free from legal implications. Possession of a gun by a dacoit may be illegal, but it has utility for him.
6. **Utility is Abstract:** Utility is abstract in the sense that it cannot be seen or touched.

Features of Utility at a Glance

1. Utility is subjective.
2. Utility is not measurable.
3. Utility is relative.
4. Utility is different from usefulness.
5. Utility has no moral or legal connotations.
6. Utility is abstract.

2.4.2 Total and Marginal Utility

Total utility refers to the entire amount of satisfaction obtained from consuming a given quantity of a commodity. According to Lipsey, *"Total utility refers to the total satisfaction from the amount of the commodity consumed."*

Thus, if we eat three chapatis at dinner time, total utility is the total amount of satisfaction obtained from consuming three chapatis.

Marginal utility is the additional utility arising from the consumption of one more unit of a commodity. According to Prof. Boulding, *"The marginal utility is the utility which results from a unit increase in consumption."* Thus, marginal utility of consuming the third mango is the increase in total utility as the consumption of mangoes is increased from two mangoes to three mangoes.

Let the number of mangoes consumed be equal to 'n'. Then, the last mango consumed is the nth mango and (n – 1)th mango is the one before last. Marginal utility of nth mango, therefore, equals the total utility of n mangoes minus total utility of (n – 1) mangoes.

Symbolically, $\boxed{MU_{nth} = TU_n - TU_{n-1}}$

Let us illustrate the difference between total utility and marginal utility with the help of a numerical example given in Table 2.1. This table shows a person's total utility and marginal utility associated with his purchases of mangoes each day.

Table 2.1: Utility Schedule for Mangoes

Units of Mangoes	*Total Utility (utils)*	*Marginal Utility (utils)*
0	0	undefined
1	10	10 (10 – 0)
2	17	7 (17 – 10)
3	21	4 (21 – 17)
4	22	1 (22 – 21)
5	22	0 (22 – 22)
6	19	–3 (19 – 22)

Suppose a person buys and consumes two mangoes, he expects to get a utility of 17 utils (or say units). Suppose, this person now consumes three mangoes; he gets a total utility of 21 utils. In our example, the third mango is the additional (or one more) mango. The total utility on account of this mango increases by 4 utils (21 – 17 = 4). The marginal utility of the third mango is, therefore, 4 utils. Similarly, marginal utility of the 4th mango is 1 util (22 – 21 = 1). The fifth mango provides the same amount of total utility, 22 utils. Thus, the fifth mango does not add to total utility. Therefore, the marginal utility of the fifth mango is zero. The total utility of six mango is less than the total utility of five mangoes. This decrease in total utility means that marginal utility is a negative value. As total utility decreases from 22 utils to 19 utils, marginal utility equals –3. When marginal utility is negative, we say that a good provides disutility.

Diminishing Marginal Utility: It is generally observed that as the amount consumed of a commodity increases, the utility derived from the additional units, i.e., marginal utility, goes on decreasing. This is illustrated in the last column of Table 2.1. The table shows that as the consumption of mangoes increases, the marginal utility from each successive mango consumed goes on decreasing. For example, marginal utility obtained from the consumption of the third mango is 4 utils, while the consumption of the second mango gives the marginal utility of 7 utils.

This tendency of decrease in the marginal utility with successive increase in consumption of a commodity is known as ***'the law of diminishing marginal utility'*** in economics.

2.5 PRODUCTION

As stated above, goods and services are needed to satisfy people's wants. Therefore, goods need to be produced. ***The act of making goods and services is called production.*** In everyday speech 'production' refers to the act of creating something. In this sense, production involves the physical conversion of raw materials into tangible goods. For example, in a cotton textile mill, cloth is produced or manufactured by using different kinds of raw materials like yarn, chemicals, etc. In the past, even some economists defined production in this sense. Thus, according to Adam Smith, production means the creation of material or tangible goods. He excluded intangible goods or services from production.

This is a restricted material concept of production. Later economists rejected this restricted material production concept. At present, the term *production* is used in the wider and comprehensive sense. In the wider sense, ***production means the creation of utility.*** According to A.H. Smith, ***"Production is the process that creates utility in goods."*** Any activity that makes an object useful is called production. Production in this sense includes not only material goods, but it also includes various services such as services of the lawyers, doctors, teachers, hair-dressers, musicians, etc., since both tangible goods and services provide utility. Services also satisfy people's wants in the same way as the goods do. Similarly, trading and transport services are regarded as part of production since production is not complete until the goods that have been produced have actually reached the consumers.

Thus, production is nothing but a process of adding utility to the object. Utility can be added to an object in the following ways:

1. **Form Utility:** Form utility is one of the ways by which utility can be increased. It involves changing the form of a good

from raw material to the finished product. For example, a carpenter makes a table from a piece of wood. By changing the shape of wood, he is making the wood more useful. Converting raw cotton into cotton cloth, converting iron into machines etc., are other examples of form utility.

2. **Place Utility**: Utility can also be increased by transferring goods from one place to another. For example, transferring goods from the factory to retail shop creates place utility.
3. **Time Utility**: Time utility is created when goods are made available at the time when they are needed. For example, by holding stocks of goods until they are required, time utility is created.
4. **Service Utility**: Service utility results from the provision of personal services by the individuals such as doctors, teachers, engineers, transporters, bankers, retailers, etc.

Thus, production is the process of adding utility to the object through form utility, place utility, time utility and service utility. *Anyone who helps to make goods or services is called a producer.* Thus, producers are those who transform resources into products.

2.6 FACTORS OF PRODUCTION

Goods and services are produced with the help of factors of production. *Productive resources are known as factors of production.* According to Lipsey, *"Resources used to produce goods and services are called factors of production."* They are called factors of production because they are used in the process of production. Factors of production are sometimes called *inputs*. Factors of production are usually classified by economists into four main groups: land, labour, capital and entrepreneurship.

Land in economics is used not in the sense of soil, but is rather used in a wider sense. *Land,* as economists use the term, *includes all those free gifts of nature such as land, forests, minerals, etc., which are commonly called natural resources.*

Labour is the human effort, both physical and mental, involved in the process of production. In everyday common practice, labour refers to the work done by manual workers like agricultural labourers and factory workers. But in economics, labour refers not only to work done by manual workers like agricultural and industrial workers, but also to the mental work done by office clerks, teachers, doctors, ballet dancers, etc.

Capital is defined as the man-made or produced means of production, consisting of such things as machinery, tools, equipments and factory buildings, which are used in future production, i.e., in making other goods and services in future. It is important to note two points here: First, capital is produced by human beings; it is not a gift of nature. Second, capital is used as a resource to produce other useful goods or services.

There is a fourth type of input used in production. It is a special type of human resource; it consists of entrepreneurship. *An entrepreneur is the one who organises production, takes important decisions regarding production and bears the risk and uncertainty involved in production.* When a new firm is set up, someone must organise the new firm, arrange finances, hire employees and undertake risks. That person is an entrepreneur. He also takes the responsibility of introducing new products and new techniques. Without an entrepreneur, no business organisation can operate. Clearly, entrepreneur is the core of a free-enterprise economy. The reward for the services of the entrepreneur is profit.

2.6.1 Characteristics of Factors of Production

Factors of production have the following main characteristics:

1. Production is the outcome of cooperation among all the factors of production. For producing any commodity, it is necessary to combine all the four factors of production.
2. Though all the factors need to be combined in every productive activity, there is no necessity, however, to combine all the

factors in a fixed way. For example, the production of handloom cloth requires a large quantity of labour and simple machines (handloom), while in a modern textile mill, a large quantity of automatic machines but only a few workers are required to produce cloth.

3. An important characteristic of factors of production is that it is the services of the factor rather than the factor itself that contributes to production. For example, a labourer helps in production by using his skill and knowledge.
4. All the factors of production have a physical existence. They are tangible resources; something you can see, touch and handle. The labour force and the entrepreneurs consist of men and women; land and capital consist of physical assets like agricultural land, forests, machinery, plants, factory buildings, etc.
5. An important fact about factors of production is that the demand for productive factors is a *'derived demand'*. Derived demand refers to the fact that when firms demand a factor of production they do so not because that factor input gives direct satisfaction to the firms, but because that factor input enables them to produce a good which consumers desire to purchase. The demand for the factors of production is thus derived indirectly from consumers' demand for final products. For instance, the amount of labour demanded in the production of pens depends upon the demand for pens that the workers help to produce.
6. Lastly, all factors of production do not have the same mobility. The term *'mobility' refers to the ease with which a factor can move from one employment to another employment or from one place to another place.* In general, labour and entrepreneurs are more mobile as compared to land and capital.

Characteristics of Factors of Production at a Glance

1. There is cooperation among factors of production.
2. Factors of production can be combined in different ways.
3. Factor services contribute to production.
4. Factors of production have physical existence.
5. Demand for factors of production is a derived demand.
6. Factors of production differ in their degree of mobility.

2.7 PRICE

In a free-enterprise economy, all goods and services carry price tags with them. *The price of a commodity is the unit or amount of money that has to be given to get this commodity.* The price of a good or a service expressed in monetary units is also called *'absolute price'* or *'money price'*. Thus, when we say that the price of a shirt is ₹1000, it means that we have to give ₹1000 to get this shirt. Prices are the essence of a free-enterprise economy. A whole set of prices prevail in such an economy. Goods and services have prices because, on the one hand, they are useful and, on the other hand, they are scarce in relation to the amount which people would like to have. Consumers will not be prepared to pay a price for a product unless it is useful to them. Similarly, goods may be very useful, but if they are available in an unlimited amount, they cannot command a price. For example, air is very useful to all of us, but it is not scarce and hence it does not command a price. *Goods like air, which are the gift of nature, are known as 'free goods' and they do not have a price.* By contrast, economic goods are scarce and they command a price. Economic goods are produced by using factors of production or resources. Scarcity is a fundamental problem faced by all the economies because not enough resources are available to produce all the goods and services that people would like to consume. Economic goods have a price because they are useful as well as scarce in their availability. It is only because economic goods are useful that they are demanded by buyers, and only because they are scarce that sellers are prepared to sell them at a price.

Thus, goods and services are available at a price because it involves some cost in producing these goods and services with the use of scarce resources. Consumers have to pay some price if they want to acquire food, clothes, etc. Consumers buy goods and services at these prices. Producers will be willing to sell goods only if they get an appropriate price. Similarly, the services of the various factors of production have some price. Producers buy these factor services at some price. For example, if the producers want to buy labour services, they are required to pay some price in the form of wages. Thus, a whole set of prices prevails in an economy where millions of goods and services, and hundreds of factor services are sold and purchased.

Prices are determined through the market forces of demand and supply. The buyers create the demand for goods and the sellers offer the supply of these goods to meet the demand of the buyers. There is competition among the buyers to buy goods. Similarly, there is competition among the sellers to sell goods. It is through the interaction of the competitive forces of demand and supply that the equilibrium price of a good, service or a factor service is determined. ***Equilibrium price is the price at which quantity demanded equals quantity supplied.*** Competition among buyers and sellers ensures that the price ultimately settles down at the equilibrium, i.e., at the level where quantity demanded equals quantity supplied. The price is a very sensitive index. Prices respond to changes in demand and supply. Any change in demand or supply conditions brings about change in equilibrium price. This is known as the price mechanism.

2.7.1 General Price Level

General price level refers to the average level of prices of all goods and services produced in the economy. It is usually just called the price level. The general price level may increase or decrease during a particular time period. When there is a large increase in the general price level, it is known as *inflation*. On the other hand, a large decrease in the general price level is called *deflation*.

2.8 INFLATION

Inflation is generally defined as the process of persistent and appreciable rise in the general price level. It is important to note some important facets of this definition of inflation.

1. Inflation refers to a *process of rising prices* and not a state of high prices.
2. Inflation refers to a situation of *appreciable* or *considerable* rise in prices. A modest rise in the price level, say between 1 and 2 per cent per annum, is not considered as an inflationary rise. It is only when the price rise becomes excessive and unhealthy that it is regarded as inflationary in character.
3. Rise in price should be *prolonged* in order to be called as inflationary price rise. Inflation does not refer to a one-time rise in the price level but rather to persistent rise in the price level.
4. Inflation is measured as the rate of increase in the price level as indicated by the price index such as Consumer Price Index (CPI) and Wholesale Price Index (WPI).

2.8.1 Demand-Pull and Cost-Push Inflation

Economists have traditionally explained inflation in terms of forces operating from the demand and supply sides. Accordingly, we often talk about '*demand-pull inflation*' and '*cost-push inflation*'.

Inflation originating from the demand forces is called demand-pull inflation. Demand-pull inflation occurs when the demand for goods and services exceeds the supply available at the existing price, i.e., when there is excess demand for goods and services. If aggregate demand increases rapidly and exceeds the economy's production, price will begin to rise. Demand will beat the limited supply of commodities and will bid up prices. The essence of demand-pull inflation is too much spending put against a limited supply of goods.

Inflation can be caused by forces operating from the supply side as well. ***Cost-push inflation refers to inflationary rise in prices which arise due to increase in costs.*** Cost-push inflation may be caused by increase in wage cost and/or increase in the profit margin. For instance, if money wages increase, cost per unit will increase. As a consequence, producers raise their prices to cover the higher cost. Sometimes, producers may raise the prices of their products so as to earn higher profits. In recent times, there has been inflation because of a sharp jump in prices of petroleum products.

India has been facing the problem of inflation for quite sometime now. The country is experiencing both demand-pull and cost-push inflation. Prices have been increasing sharply partly because there is a large increase in demand for a number of products. At the same time, prices of a large number of commodities have been increasing because of increase in wages and profit margin of the producers. Increase in oil prices has also led to increase in prices of almost all the products.

2.9 VALUE

Value of a commodity refers to the valuation placed by a household on the consumption of a commodity. The word 'value' has two different meanings, namely (*i*) value-in-use and (*ii*) value-in-exchange.

1. *Value-in-use relates to consumption value of a commodity.* It expresses the utility derived from the consumption of a particular commodity. A necessity like water has a very high value-in-use or consumption value.
2. *Value-in-exchange relates to market value of a commodity.* It is the rate at which a particular good or service can be exchanged for other goods and services. For example, under a barter system of exchange, if a weaver is prepared to exchange 1 metre of cloth with 5 kg of rice, then the value in exchange of 1 metre of cloth is 5 kg of rice. Thus, value in exchange is the power of purchasing other goods. In modern monetised economies, the exchange value of goods is expressed in terms of money.

Value (value-in-exchange) of a commodity can be expressed in terms of nominal value and real value. ***Nominal value of a commodity refers to the value of a commodity measured in monetary units such as rupee.*** For example, if 1 metre of cloth can be exchanged (or sold) for ₹200, its nominal value is ₹200. ***Real value of a commodity refers to the purchasing power of a commodity in terms of other commodities.*** In our example above, real value of 1 metre of cloth is equal to 5 kg of rice.

Value-in-exchange or the market value of a commodity bears no necessary relation with value-in-use or consumption value. Commodities which have high value-in-use may have little value-in-exchange; and, on the contrary, those commodities which have great value-in-exchange have little value-in-use. Necessary commodities, such as water, have low exchange value (price) but very high value-in-use or consumption value. On the other hand, luxury commodities such as diamonds which have a low consumption value (value-in-use), have a high market value (value-in-exchange). This was termed as *paradox of value* by early economists.

The early economists could not provide an explanation of water-diamond paradox, i.e., why water has a very low price compared with diamonds though water is much more useful than diamonds. Modern economists have given an explanation of this paradox in terms of the fact that the market value or price of a commodity depends on demand and supply. Water has a very low price because it is available in plentiful amount. On the other hand, diamonds have a very high price because they are relatively scarce.

2.10 MARKET

As explained above, prices are determined by the forces of demand and supply. Forces of demand and supply operate within the framework of a market. Markets constitute an integral part of a free-enterprise economy. A market helps in buying and selling of goods and services.

What is a market? ***The word 'market', in the ordinary sense, means a physical place where commodities are bought and sold such as Connaught Place, Chandni Chowk, vegetable market, or Bombay Stock Exchange, etc.*** Thus, the concept of market in this ordinary sense gives an idea of a single place to which people go to buy something. However, development in the means of transport and communication and expansion of banking network have helped in extending the concept of market well beyond the idea of a single physical place. Thus, in case of many commodities like gold, there may be a world market as these commodities can be purchased anywhere in the world at a uniform price.

In economics, however, market is not taken in the sense of a particular place. The essential feature of a market, irrespective of its size and extent, is that buyers and sellers should be able to strike a bargain. Therefore, in economics, ***a market means a system or a set-up in which the buyers and sellers of a commodity are able to interact and communicate with each other and strike a deal about the price and the quantity to be bought and sold.*** According to J.L. Edwar, *"A market is the mechanism by which buyers and sellers are brought together. It is not necessarily a fixed place."*

There are two distinguishing facts about a market so defined:

1. The market need not be located in a particular place. The geographical area of a market may be large or small depending on how scattered the buyers and sellers are. It may be a small market like a local market, or as large as the world market like world market for wheat, cars, computers, aeroplanes, etc.
2. Buyers and sellers need not have personal contact with each other. They need to have a system of communication with each other to make a transaction. Thus, transactions or deals can be made through correspondence, telephone, etc.

The size of a market refers to the amount of goods and services demanded in that market. The larger is the amount of goods and services demanded in a market, the larger is the size of market.

2.10.1 Types of Markets

It is important to distinguish between two types of markets, namely goods market and factor market.

1. **Goods Markets:** ***Goods markets are those markets where goods and services are bought and sold.*** The sellers in such markets are usually firms; the buyers may be households (consumers), other firms or the government. Cloth market and car market are examples of goods markets.
2. **Factor Markets:** ***Factor markets are those markets where factor services are bought and sold*** such as labour market, capital market, etc. The buyers in such markets are the entrepreneurs and the sellers are the owners of factors of production. For example, in the labour market, buyers are the entrepreneurs and sellers are the workers.

2.11 MONEY

Goods and services, as well as the factor services, are sold and purchased in modern economies with the use of money. These economies are based on specialisation and division of labour. As a result of specialisation, people produce a particular commodity in greater quantity than they could consume themselves and trade most of it to obtain all the other things they require. Thus, specialisation has been accompanied by exchange. *Exchange is the act of trading the surplus goods people have to obtain the other things which they require.*

Before money was invented, goods were exchanged for goods. This was the beginning of the barter system of exchange. *Barter system refers to the system of exchange where goods and services are exchanged directly for other goods and services.* For example, a farmer may exchange wheat with the cloth produced by a weaver. Primitive exchange was carried on with the help of barter system. Barter system prevails even today in some of the traditional and tribal communities. *The economy based upon the barter exchange is known as barter economy.*

The barter system of exchange was a highly inefficient and clumsy system of exchange. It involved a waste of human efforts. It restricted the scope of specialisation and division of labour. It was an obstacle to the expansion of the economy. It was to overcome various difficulties of the barter system that every society invented some kind of money.

Modern economies are money-using economies. ***The economy using money as a system of exchange for carrying out various types of economic transactions is known as money economy.*** Most transactions in these economies are carried out with the use of money. Crowther defines money as *"anything that is generally acceptable as a means of exchange and, at the same time, acts as a measure and store of value."* The basic characteristic of money is that it is generally accepted as a means of payment for goods and services. General acceptability as a means of payment or as a medium of exchange is the unique feature of money. Money is generally and widely used as the medium of exchange through which purchases or sales are made.

At present, money consists of currency and deposit money.

Currency comprises currency notes and coins. Currency notes refer to paper money. Currency notes are issued by the central bank of a country, which in India is known as the Reserve Bank of India. 5, 10, 20, 50, 100, 500 and 2000 rupee notes in India are examples of currency notes. ***Coins*** refer to metallic coins. 50 paise coins and 1, 2, 5 and 10-rupee coins are examples of coins.

Deposit money or bank money refers to the deposit held with the banks on the basis of which cheques can be drawn. Cheques are widely used these days in making payments, particularly for trade and business transactions.

2.12 INCOME

Income can be defined as a flow of goods and services or flow of money accruing to an individual or all the people in an economy over some specified time. In modern monetised economies, income is expressed in money terms such as an individual earning an income of ₹50,000 a month. Income measured in terms of some monetary unit like rupee, dollar, etc., is known as *money income*. Some people earn an income by selling commodities they themselves have produced by their own labour. For example, a small farmer may produce rice with the help of his family members and thereby earns an income by selling rice in the market.

But in the modern economies characterised by specialisation and division of labour, people sell their factor services to firms and receive money income in the form of various factor incomes like wages, rent, interest, etc. Production of a commodity or service is the outcome of combined efforts of different factors namely land, labour, capital and entrepreneur. Firms purchase or hire services of these factors of production and pay remunerations in the form of rent of land, wages of labour, interest on capital and profits of entrepreneur. Thus, *factor income is the income earned by an individual largely by selling his factor services to firms.* Wages, interest, rent and profits are various categories of factor income.

The same applies to the economy as a whole. All the firms in the economy produce goods and services, the sum total of which is known as the nation's output. Production requires factors of production whose owners are paid for factor services provided. It thus generates national income. National income is defined as the value of all final goods and services produced by the normal residents of a country in a year. According to Dornbusch and Fischer, *"National income is the value of final goods and services produced by domestically owned factors of production during a given period."*

It is important to note the following points in this definition of national income:

1. In the first place, national income is expressed in monetary terms. Thousands of diverse goods and services are produced in the economy. We cannot add together unlike items such as apples and oranges, or hairpins and aeroplanes, or services of barbers and doctors, since they are expressed in different units like kilograms, metres, etc. Thus, in order to aggregate all goods and services, it is essential to express them in money terms such as rupee, dollar, etc.
2. Secondly, national income reflects the value of final goods and services, i.e., goods and services sold to the final users like households. Intermediate products, i.e., those goods and services which are further processed before they are used or sold to buyers, are excluded from national income because their value is already included in the value of final products. For example, national income includes the value of bread and not of flour used in making bread since the value of flour is already included in the value of bread.
3. Thirdly, national income is the flow of final goods and services. Every flow concept like national income is expressed over a particular time period. Conventionally national income is expressed over one year. It is in this sense we say that the national income of India in 2015-16 was estimated at ₹99,82,100 crore.

We often use another national income aggregate known as Gross Domestic Product (GDP). GDP is defined as the value of all final goods and services produced by all enterprises located within the domestic territory of a country. Some of these enterprises may be owned by domestic people while some may be owned by foreign residents. These enterprises give rise to factor income to domestically owned factors of production as well as to the factor services owned by foreign residents. Some of the domestically owned factors of production may earn income by operating abroad. National Income (Gross National Product) differs from GDP to the extent of net factor income from abroad (the difference between the factor income received from abroad and the factor income accruing to the foreigners).

Thus, National Income = GDP + Net factor income from abroad.

We will discuss this in detail in Chapter 7.

2.12.1 Per Capita Income

Per capita income of a country is the average income of the normal residents of a country in a particular year. It is income per head of population. It is obtained by dividing national income of a country by its population.

Symbolically,

$$\text{Per Capita Income} = \frac{\text{National Income}}{\text{Population}}$$

For instance, if national income of a country is ₹99,82,100 crore and the population is 125 crore, in this case per capita income will be

$$₹79,856 \left(\frac{99,82,100 \text{ crore}}{125 \text{ crore}}\right).$$

Per capita income is traditionally taken as an index or measure of economic welfare and economic development. An increase in per capita income leads to an improvement in the living standards of the people as well as the economic development of a country.

2.13 SAVING

Income is received as wages or salaries, rent, interest and profits. Households buy consumer goods they need with this income. However, entire income may not be spent on the purchase of consumer goods. A part of the income may be saved. *Saving refers to that part of the income which is not spent on consumption.* Thus, saving is the income that households receive but do not spend on purchasing goods and services. Households would like to save a part of the income they earn for various reasons like meeting the expenditure on higher education of their children, construction of residential houses, to provide for old age, etc.

Saving done by households in known as *personal saving*. However, saving is done by business and government as well. *Business saving*, i.e., saving by business, is achieved by not distributing to shareholders all the profits made in a year. Some profits are usually retained either to be ploughed back for the expansion of the business or to be held as liquid reserves. *Government saving* is the saving done by the central government, state governments, local authorities and public corporations. Government saving is achieved chiefly through a 'budget surplus', i.e., government revenue exceeding government expenditure. Saving done by an individual income earner is known as ***individual saving.*** Saving by individuals, by families and by business firms is known as ***private saving.*** It is the saving done by everyone other than the government in the economy. ***Aggregate saving*** is the total saving done by all the people in an economy. It is the sum total of private and government saving.

Savings (plural) is the total amount of saving accumulated over time. It is the accumulated value of past saving.

2.14 INVESTMENT

Investment is defined as the act of using production resources for the production of capital goods, i.e., goods that are used for producing other goods and services in the future. It is the act of adding to the existing stock of real capital assets such as machinery, tools, equipments, buildings, stock of goods, etc. These goods are produced largely by firms and they may be bought by firms, by households or by the government. Another name for investment is capital formation. Investment and capital formation are synonymous. The essence of investment is the diversion of a part of society's currently available resources for the purpose of increasing the stock of investment goods so as to make possible an increase in consumable output in future.

The major components of investment goods are:

1. **Producers' Fixed Investment:** It consists of new capital goods such as plants, equipments, tools and machinery. Capital goods are often called producers' fixed investment.
2. **Investment in Residential Housing and Non-residential Structure:** It includes investment made in the construction of residential houses and non-residential structures like office buildings, power plants, brides, roads, etc. A residential house gives utility slowly over a long period. For this reason, housing construction is taken as investment rather than as consumption. Investment in residential housing is different from other forms of investment in that houses are sold to households, while other capital goods are sold to firms.
3. **Investment in Stocks:** All firms keep stock of raw material, semi-finished goods and finished goods in factories or shops for smooth production. A net addition to stocks is considered as an investment because it represents goods produced but not used for current consumption.

The sum total of expenditure on all investment goods—producers' fixed investment, business construction, residential housing, stocks—is called ***gross investment.*** Physical wear and tear of capital goods takes place in the process of production, which is known as depreciation. ***Investment required to keep the existing stock of capital intact by replacing what has been worn out, or otherwise used up in the process of production, is known as replacement investment or depreciation.*** By deducting depreciation from gross investment, we get ***net investment.*** It is the net investment which increases the total stock of capital in the economy.

It is clear from the above definition that investment in economics is taken in the sense of real investment. However, in common parlance, when a person buys shares, bonds or debentures of a company, it is generally said that he has made an investment. This is merely financial investment but not real investment as it does not lead to any addition to the physical stock of capital but merely implies a transfer of financial resources.

2.15 WEALTH

Wealth refers to the stock of all those assets which are a source of income. Wealth is a stock concept and therefore it is expressed at a point of time such as 1 January, 2017.

According to Hanson, ***"Wealth is a stock of goods at a certain time which conform to the requirements of possessing utility, limited in supply, transferability of their ownership from one person to another."***

Anything to be regarded as wealth must possess the following characteristics:

1. **Utility:** It must possess utility, i.e., it must give some satisfaction.

2. **Scarcity:** It must be limited in quantity, i.e., it must be scarce in its supply.
3. **Transferability:** It should be transferable, i.e., its ownership can be transferred from one person to another person.
4. **Exchange Value:** It must possess exchange value. All those goods which have the characteristics of utility, scarcity and transferability possess exchange value.

We may speak of individual wealth as well as national wealth. ***Individual or personal wealth refers to stock of all those assets which are owned by a person.*** At any moment in time, individuals in an economy have a given stock of wealth. This wealth is held in many forms. Different ways of holding wealth by individuals may be grouped into three main categories:

1. Some wealth is held as money in hand or in banks like paper money, coins and chequable deposits with banks.
2. Wealth is partly kept in the form of financial assets other than money such as bonds earning a fixed rate of interest, deposits with the companies, shares of the companies, etc.
3. Real assets in the form of houses, farms and family businesses.

The wealth of an entire nation is called *national wealth* or *social wealth*. It is the total wealth of the residents of a country. ***National wealth is the stock of all tangible (real) wealth that contributes to the production of goods and services.*** Tangible wealth consists of two categories:

1. **Reproducible Assets:** Reproducible assets are man-made and therefore can be reproduced. These assets consists of:
   (*a*) Fixed assets such as machinery and equipments of all kinds and buildings and other structures. Some of these reproducible assets like machines, factories, etc., contribute to the production of goods and services which people want, while others like houses satisfy the wants of the people directly.
   (*b*) Stocks of durable goods, i.e., inventories, which are used for the satisfaction of people's wants directly (stock of consumer goods) and indirectly (stock of raw materials).
2. **Non-reproducible Assets:** Non-reproducible assets consist of natural resources such as land, mineral wealth, forests, etc., which are created by nature. They are regarded as free gifts of nature.

Thus, national wealth, in general practice, includes both reproducible assets and non-reproducible assets. Some economists take a wider definition of national wealth so as to include, in addition, human capital (education, skills, training and health) and technological capital (colleges, universities and libraries).

It is important to note that financial assets held by domestic residents are not part of national wealth because value of the domestic financial assets is offset by the domestic financial liability of the same amount. For example, money deposited by an individual in a bank is an asset for the depositor but a liability for the bank. This deposit in the bank does not represent wealth for the economy as a whole. However, net foreign financial assets are part of national wealth.

2.16 WELFARE

Welfare is taken to mean a sense of satisfaction and happiness, a sense of well-being among the people. Many factors influence this sense of well-being among the people such as consumption of goods and services, environment, family relations, degree of freedom, law and order situation, etc. Some of these factors may increase welfare. For example, more consumption, more leisure, good weather, more freedom and more security increase welfare. Some factors, on the other hand, may reduce welfare. For example, more work, natural disasters like earthquake, political instability, insecurity, etc., reduce welfare.

Some of the factors affecting welfare of the people of a country can be expressed in money terms. For example, factors like national income, consumption, investment, etc., can be expressed in monetary terms. However, some of the factors influencing welfare cannot be expressed in monetary terms. Environment, social relations in the society, understanding among family members, law and order, degree of freedom, etc., are some such factors.

It is possible to distinguish between the two types of welfare:

1. **Economic Welfare:** *Pigou defines economic welfare as that part of social welfare that can be directly or indirectly measured in money terms.* In other words, welfare affected by the factors which can be expressed in monetary terms is called economic welfare. Therefore, welfare which is influenced by factors like national income, per capita income, composition of output, consumption, etc., is termed as economic welfare.
2. **Non-economic Welfare:** *Welfare affected by the factors which cannot be expressed in monetary terms is called non-economic welfare.* It is the welfare influenced by non-economic factors such as environment, social relations in the society, law and order, degree of freedom, etc. Non-economic welfare relates to non-economic values of people in the society. It relates to social, political, moral and other non-economic values. The examples of non-economic welfare are political welfare and moral welfare.

Total welfare of the people of a country is the sum total of economic and non-economic welfare. Since it is the welfare of the society as a whole, it is termed as social welfare. Thus, *social welfare is defined as the sum total of the happiness of all the individuals in the society.* It is the sum total of economic and non-economic welfare.

Welfare is a closely related to wealth. Generally, there is a direct relationship between the amount of wealth and level of economic welfare. The more is the amount of wealth, the more is the level of economic welfare, and vice-versa.

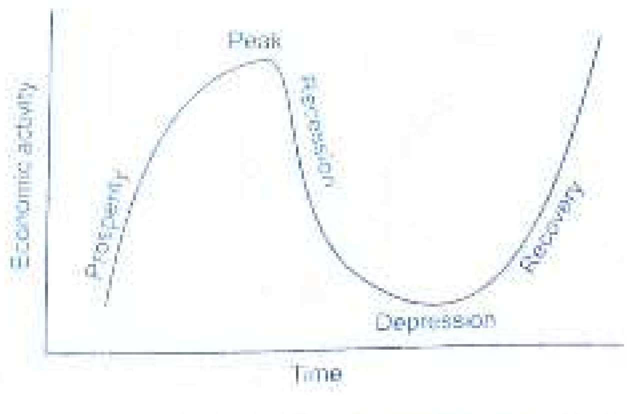
2.17 BUSINESS CYCLE

Business cycle is defined as the recurrent fluctuations in the aggregate economic activity in an economy. Level of economic activity is identified with the level of income, output and employment. Therefore, business cycle in general may be defined as short-run fluctuations in output, income and employment. The business cycle is characterised by alternating periods of expansion and contraction in economic activity. A business cycle consists of expansion occurring at the same time in many economic activities— output, income and employment— followed by similar contraction in the level of output, income and employment. Thus, in a business cycle there are wave-like fluctuations in aggregate output, income and employment.

A typical business cycle is generally divided into four phases:

1. **Expansion or Prosperity:** The expansion or prosperity phase is characterised by expansion in the level of output, employment and income.
2. **Recession:** During the phase of recession, there is a downward trend in the level of economic activity. It is a sustained period of falling level of income, output and employment.
3. **Depression:** Depression is the phase of a severe recession. It is characterised by severe and general decline in the level of economic activity. There is a large reduction in employment, output, income and prices.
4. **Recovery or Revival:** It marks the revival of economic activity from the situation of depression. During this phase, the level of output, employment and income in the economy rise steadily.

The four phases of a business cycle are illustrated in the following diagram:



2.18 AGGREGATE DEMAND AND AGGREGATE SUPPLY

Aggregate demand may be defined as the total amount of goods which all the buyers of final output in the economy desire to purchase. It is the total desired purchases of all the buyers in the economy. In a closed economy, goods are demanded by households for consumption (C). Goods are demanded by the firms or producers for undertaking investment (I). The government also purchases various types of goods (G) to discharge its responsibilities.

Thus,

$$\text{Aggregate demand} = C + I + G$$

Aggregate demand or the quantity of goods which all the buyers in the economy desire to purchase, depends generally on the level of income in the economy.

Aggregate supply refers to the total amount of output which all the firms or producers are willing to produce in an economy. It is the total desired output of all the producers in the economy.

We may also express aggregate demand and aggregate supply in relation to the price level. In this sense, the aggregate demand refers to the total quantity of goods and services which all the buyers of an economy want to buy at different prices. Aggregate supply, on the other hands, refers to the total quantity of goods and services which all the firms are willing to supply at different prices.

2.19 BASIC ECONOMIC ENTITIES IN AN ECONOMY

Economics is concerned with the economic activity of the people. Economic activity refers to the use of scarce resources of the economy in producing goods and services required to satisfy the wants of the people. The centrestage of economic activity in an economy is to satisfy the wants of the people by producing goods and services. Decisions about economic activities of production and consumption in an economy are taken by individuals. In economics, we study the economic behaviour of these individuals.

There are millions of individuals in an economy participating in the functioning of an economy in different capacities— as producers, consumers, traders, workers and so on. For a systematic and organised study of their behaviour, we classify them into three important groups: *households or consumers*, *firms or producers* and *government*. These three groups are regarded as the basic economic entities. They take decision about the basic economic activities of production, consumption and investment. They are the basic decision-makers in every economy.

1. **Households:** *A household is defined as a person or group of people living together who take economic decisions about the types of commodities to be purchased to satisfy the wants of his/their family.* At the same time, households are the main owners of productive resources like land, labour and capital. They, therefore, take decisions about the use of factor services. Thus, households participate in economic activities in two different capacities, namely as the owners and suppliers of productive resources and as the consumers of goods and services produced and supplied by business firms. Households and consumers are used interchangeably in economics.
2. **Firms:** *A firm is defined as the entity which employs factors of production to produce commodities that it sells to other people.* An individual or a unit or an organisation that produces goods and services is called a firm. In economics, we use the terms *firms, producers* or *suppliers* interchangeably. Firms, on the one hand, act as producers in the commodity market and, on the other hand, they purchase factor services required to produce goods and services in the factor market.
3. **The Government:** The government is a very important decision-making economic entity in every economy. *Government refers to a group of organisations which possess legal and political power and exercises some control over other sectors of the economy.* It includes all

government bodies—local authorities, state governments, central government and other organisations belonging to the government such as the central bank of a country. The government gets its income largely from taxes imposed on household and business sectors. It spends the money collected through taxes to discharge various functions in the economy such as administration, law and order, construction of railways, highways, dams, bridges, etc.

2.20 STOCK AND FLOW VARIABLES

Economics uses various economic variables while analysing economic problems. These economic variables are generally grouped into *'stock variables'* and *'flow variables.'*

Stock variables are the variables which are expressed at a point of time. These variables have no time dimension. Stock of capital, wealth, number of persons employed, total bank deposits, total money supply are some examples of stock variables. Thus, we estimate the stock of capital in a factory on a particular day like 1 January 2017.

The flow variables are the variables that are expressed per unit of time, such as per hour, per month or per year. Thus, flow variables have a time dimension. For example, production, national income, consumption, savings, investment, exports, imports, demand, supply etc., are some of the flow variables. Thus, we express national income of India over a period of one year.

SUMMARY

- **Human Wants:** Want is an effective desire for a particular thing, which can be satisfied by making an effort to acquire it. Wants for various goods are classified into; 1. Necessities, 2. Comforts, 3. Luxuries.

  Features of human wants are: 1. Wants are unlimited, 2. Wants are complementary, 3. Wants can be substituted, 4. Wants are competitive, 5. Wants multiply, 6. Wants recur, 7. A single want can be satisfied, 8. Some wants can be postponed, 9. Wants differ in urgency, 10. Wants are ahead of availability of goods and services.
- **Consumption** is the act of using goods and services to satisfy human wants.
- **Consumer** is the person who consumes goods and services to satisfy his/her wants.
- **Utility** refers to the want-satisfying power of a commodity.

  Main features of utility are: 1. Utility is subjective, 2. It is not measurable, 3. It is variable, 4. Utility is different from usefulness, 5. No moral or legal connotation of utility.
- **Total Utility** refers to the entire amount of satisfaction obtained from consuming a given quantity of a commodity.
- **Marginal Utility** is the additional utility arising from the consumption of one more unit of a commodity.
- **Production** is the act of making goods and services. It is the act of creating utility through: 1. Form utility, 2. Place utility, 3. Time utility, 4. Service utility.
- **Factors of Production:** Productive resources are known as factors of production. Land, labour, capital, and entrepreneurs are the factors of production.

  Main characteristics of factors of production are: 1. Production is the outcome of factors cooperation, 2. They are not combined in a fixed way, 3. Factors sell their factor services, 4. They are tangible, 5. Demand for factors of production is derived demand, 6. They are not equally mobile.

- **Price** of a commodity is the amount of money that has to be given to get this commodity. Goods have a price because they are useful and scarce. Prices are determined by the forces of demand and supply. Equilibrium price is the price which equals demand with supply.
- **Inflation** is the process of persistent and appreciable rise in the general price level. Demand-pull inflation originates from the forces operating from the demand side (increase in demand), while cost-push inflation arises due to increase in costs such as wage cost.
- **Value** of a commodity refers to the valuation placed by a household on the consumption of a commodity. Value-in-use relates to consumption value in terms of its utility. Value-in-exchange relates to market value of a commodity, i.e., price of a commodity.
- **Market** means a system or set-up in which the buyers and sellers of a commodity are able to interact and communicate with each other and strike a deal about the price and quantity.
- **Goods Markets** are the markets where goods and services are bought and sold.
- **Factor Markets** are the markets where factor services are purchased and sold.
- **Money** is defined as anything which is generally accepted as a means of exchange and acts as a measure and store of value. It comprises currency and deposits (bank) money.
- **Barter System** refers to the system of exchange where goods and services are exchanged directly for other goods and services.
- **Income** is the flow of goods and services or flow of money over time. Personal income is the income earned by an individual by selling his factor services to firms.
- **National Income** is defined as the value of all final goods and services produced by the residents of a country in a year.
- **Per Capita Income** of a country is the average income of the people of a country in a particular year.
- **Saving** refers to that part of the income which is not spent on consumption. It comprises personal savings, business savings and government savings.
- **Investment** is the act of using productive resources for the production of investment goods. It consists of addition to capital goods, business construction, construction of residential houses and addition in stocks. Investment required to replace the worn-out capital through wear and tear is known as depreciation. Net investment is gross investment minus depreciation.
- **Wealth** is the stock of goods which are a source of income. Household wealth consists of 1. Money, 2. Financial assets like bank deposits, bonds and shares (stock), 3. Real capital.
- **National Wealth** is the stock of all tangible wealth that contributes to the production of goods and services. It comprises 1. Reproducible assets, 2. Non-reproducible assets.
- **Welfare** means a sense of satisfaction, happiness and well-being among the people. Economic welfare is defined as that part of social welfare that can be directly or indirectly measured in money terms. Non-economic welfare is the welfare affected by the factors which cannot be expressed in monetary terms. Social welfare is the sum total of the happiness of all the individuals in the society.
- **A Business Cycle** is defined as the recurrent fluctuations in the aggregate economic activity.
- **Aggregate Demand** is defined as the total amount of goods demanded in the economy.
- **Aggregate Supply** refers to the total amount of output which all the firms or producers are willing to produce.

- **A Household** is defined as a person or group of people living together who take economic decisions about the commodities to be purchased to satisfy the wants of his/their family.
- **A Firm** is defined as the entity which employs factors of production to produce commodities that it sells to other people.
- **The Government** refers to a group of organisations which possess legal power and exercises some control over other sectors of the economy.
- **Stock Variable** is the variable which is expressed at a point of time.
- **Flow Variable** is the variable which is expressed over a period of time.

TEST YOURSELF QUESTIONS

Very Short Answer Questions (2 marks each)

1. Define human wants. (See Sec. 2.2)
2. State two categories of human wants. (See Sec. 2.2.1)
3. Distinguish between primary wants and secondary wants. (See Sec. 2.2.1)
4. Give four main features of human wants. (See Sec. 2.2.2)
5. What is consumption? (See Sec. 2.3)
6. Define utility. (See Sec. 2.4)
7. State four main features of utility. (See Sec. 2.4.1)
8. Distinguish between total utility and marginal utility. (See Sec. 2.4.2)
9. What is meant by production? (See Sec. 2.5)
10. How do we define 'land' in economics? (See Sec. 2.6)
11. Define labour. (See Sec. 2.6)
12. What is meant by capital? (See Sec. 2.6)
13. Mention three main features of factors of production. (See Sec. 2.6.1)
14. What is price? (See Sec. 2.7)
15. How is price of a commodity determined? (See Sec. 2.7)
16. Define inflation. (See Sec. 2.8)
17. Distinguish between demand-pull and cost-push inflation. (See Sec. 2.8.1)
18. Distinguish between value-in-use and value-in-exchange. (See Sec. 2.9)
19. Distinguish between nominal value and real value. (See Sec. 2.9)
20. What is meant by market? (See Sec. 2.10)
21. How would you define money? (See Sec. 2.11)
22. What is meant by barter system of exchange? (See Sec. 2.11)
23. Define per capita income. (See Sec. 2.12.1)
24. Define investment. (See Sec. 2.14)
25. What is national wealth? (See Sec. 2.15)
26. State four features of wealth. (See Sec. 2.15)
27. What is economic welfare? (See Sec. 2.16)
28. Define social welfare. (See Sec. 2.16)
29. What is business cycle? (See Sec. 2.17)
30. State the four phases of trade cycle. (See Sec. 2.17)
31. Define aggregate demand. (See Sec. 2.18)
32. What is meant by aggregate supply? (See Sec. 2.18)
33. What are the basic economic entities in an economy? (See Sec. 2.19)
34. Distinguish between 'stock' and 'flow' variables. (See Sec. 2.20)

Short Answer Questions (3 marks each)

1. What do you understand by human wants? Explain the main features of human wants. (See Sec. 2.2 and 2.2.2)
2. Define utility and explain its basic features. (See Sec. 2.4 and 2.4.1)
3. Explain the concepts of production and investment. (See Sec. 2.5 and 2.14)
4. Discuss the characteristic features of factors of production. (See Sec. 2.6.1)
5. Distinguish between 'value' and 'price'. (See Sec. 2.7 and 2.9)
6. What is meant by market? Distinguish between goods markets and factor markets. (See Sec. 2.10 and 2.10.1)
7. Explain the concepts of income, consumption and saving. (See Sec. 2.3, 2.12 and 2.13)
8. What do you understand by national income? (See Sec. 2.12)
9. Distinguish between economic welfare and non-economic welfare. (See Sec. 2.16)

Long Answer Questions (6 marks each)

1. Define inflation. Distinguish between demand-pull and cost-push inflation. (See Sec. 2.8 and 2.8.1)
2. Define money. What are its components in a modern economy? (See Sec. 2.11)
3. Define national wealth and state its various components. (See Sec. 2.15)
4. Explain basic economic entities in an economy.

   OR

   Explain the following: (*i*) household (*ii*) firm and (*iii*) government. (See Sec. 2.19)