

Chapter 1 NATURE AND SCOPE OF BUSINESS ECONOMICS

UNIT 1 INTRODUCTION

1.0 INTRODUCTION

1.0.0 What is Economics about?

- Originated from the Greek word 'Oikonomia' which means 'household'.
- Till 19th century Economics was known as 'Political Economy'.
- First Modern work of Economics by Adam Smith is named as 'An Enquiry into the Nature and Causes of the 'Wealth of Nations' (1776) abbreviated as 'The Wealth of Nations'.
- There are two fundamental facts that can be concluded with the concept of Economics :
 - (i) Human beings have unlimited wants ;and
 - (ii) The means to satisfy these unlimited wants are relatively scarce forms the subject matter of Economics.

1.0.1 DEFINITION OF ECONOMICS

- Economics is the study of the processes by which the relatively scarce resources are allocated to satisfy the competing unlimited wants of human beings in a society.
- This definition of Economics, with the narrow focus on using the relatively scarce resources to satisfy human wants is domain of modern neo classical micro economic analysis.

1.0.2 MEANING OF BUSINESS ECONOMICS

- Decision Making refers to the process of selecting an appropriate alternative that will provide the most efficient means of attaining a desired end ,from two or more alternative courses of action.
- It means evaluation of feasible alternatives, rational judgment on the basis of information and choice of particular alternative which the decision maker finds as most suitable.
- As we know the question of choice arises because our productive resources such as land, labour, capital and management are limited and can be employed in alternative uses .Therefore more efficient alternatives must be chosen and less efficient alternatives must be rejected.
- Business Economics also reffered as Managerial Economics refers to the integration of economic theory with business practice.
- Business Economics applies tools of economics to make business decision making.

- It is Applied Economics that fills the gap between economic theory and business practice.
- It has close connection with Economic Theory (Micro and Macro Economics), Operation Research, Statistics, Mathematics and the Theory of Decision Making.
- Business Economics is also useful for managers of 'not-for-profit' organisations such as NGO and Voluntary Organisations.

1.1 DEFINITION OF BUSINESS ECONOMICS

- Business Economics may be defined as the use of economic analysis to make business decisions involving the best use of an organisation's scarce resources.
- Joel Dean defined Business Economics in terms of the use of economic analysis in the formulation of business policies.
- Business Economics is essentially a component of Applied Economics as it includes application of selected quantitative techniques such as linear programming ,regression analysis ,capital budgeting ,break even analysis and cost analysis.

1.2 NATURE OF BUSINESS ECONOMICS

Economics has been broadly divided into two parts i.e. Micro Economics and Macro Economics.

1.2.1 MICRO ECONOMICS

- It is the study of the behavior of different individuals and organisations within an economic system.
- It examines how the individual units (consumers or firms) make decisions as to how to efficiently allocate their scarce resources.
- In this the focus is on a small number of or group of units rather than all the units combined and therefore it does not explain what is happening in the wider economic environment.
- Concepts studied in Micro Economics :
 - Product Pricing
 - Consumer Behaviour
 - Factor Pricing
 - The Economic Conditions of a section of people
 - Behaviour of firms
 - Location of Industry.

1.2.2 MACRO ECONOMICS

- It is the study of the overall economic phenomena or the economy as a whole, rather than its individual parts.
- In it we study the behavior of the large economic aggregates such as the overall level of output, total consumption, total saving and total investment and also how these aggregates shift over time.
- It analyzes the overall economic environment in which the firms, governments and households make decisions.
- It should be kept in mind that this economic environment represents the overall effect of the innumerable decisions made by millions of different consumers and producers.
- Concepts studied under Macro Economics are :
 - National Income and National Output
 - The general price level and interest rates
 - Balance of Trade and balance of payments
 - External value of currency
 - The overall level of savings and investment and
 - The level of employment and rate of economic growth.

NOTE :

Micro Economics as well as Macro Economics have an important role to play in Business Economics. Macro Economics analyses the background of economic conditions in an economy which will immensely influence the individual firm's performance as well as its decisions. Business firms need a thorough understanding of the macroeconomic environment in which they have to function.

For eg. Interest rates should be known as they are useful for the business economists in framing suitable policies.

1.2.3 NATURE OF BUSINESS ECONOMICS :

The following points will describe the nature of Business Economics:

- Business Economics is a Science - Science is a systematized body of knowledge which establishes cause and effect relationships. Business Economics integrates the tool of decision sciences such as Mathematics, Statistics and Econometrics with Economic Theory to arrive at strategies to achieve business goals.
- Based on Micro Economics – Business Manager is concerned about achievement of the predetermined objectives of his organization so as to ensure the long term survival and profitable functioning of organization . Since Business Economics is concerned more with the decision making problems it takes help of micro economics tools.

- *Incorporates elements of Macro Analysis* – Macro Economics elements like general price level ,income and employment level in the economy and government policies related to taxation ,interest rates, exchange rates, industries ,prices, distribution ,wages etc. affects the business. Business Manager must be acquainted with these elements as they influence business environment.
- *Business Economics is an Art* – It involves practical application of rules and principles for attainment of set objectives.
- *Use of Theory of Markets and Private Enterprises* – Business Economics uses theory of firm and resource allocation in backdrop of private enterprise economy.
- *Pragmatic in Approach* – Business Economics is practical in approach as it tackles practical problems which the firms face in real world.
- *Interdisciplinary in Nature* – Business Economics uses tools from other subjects like Mathematics ,Operation Research, Management Theory, Accounting, Marketing, Finance, Statistics and econometrics.
- *Normative in Nature* – Economic Theory has developed along two lines – positive and normative.
 - ✓ **POSITIVE :**
 - Positive and Pure Science analyses cause and effect relationship but does not involve any judgement.
 - It states ‘what is’ of the state of affairs.
 - It is descriptive in nature and describes the economic behavior of individuals or society without prescriptions about the desirability of such behavior.
 - ✓ **NORMATIVE :**
 - It involves value judgments.
 - It states ‘what should be’ a particular course of action under given circumstances.
 - It is prescriptive in nature and in it welfare considerations are embedded.
 - ❖ Business Economics requires both the concepts positive and Normative in nature .It is normative as it suggest the application of economic principles for policy formulation and decision making .However it also need to understand the environment thus involves study of positive theory .

- ❖ Thus, Business Economics combines the essentials of Normative and Positive Economic Theory with emphasis more on the former than the latter.

1.3 SCOPE OF BUSINESS ECONOMICS:

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

1. Internal Issues or Operational Issues (Solved using Micro Economics)
2. External Issues or Environmental issues (Solved using Macro Economics)

1. **Internal Issues or Operational Issues (Solved using Micro Economics):**

These are internal issues which arise within the organization and fall within the purview and control of management. Eg. Product Decisions, Consumer's Income, Pricing and Sales Promotion, Financing and Management of Investments. The following Microeconomic theories deal with most of these issues :

- (a) Demand Analysis and Forecasting – It is the technique of predicting future demand of goods and services on the basis of past behaviours of factors which affect demand.
- (b) Production and Cost Analysis – Production analysis enables the firm to decide on the choice of appropriate technology and selection of least cost input mix to achieve technically efficient way of producing output, given the inputs. Cost analysis enables the firm to recognize the behavior of costs when variables such as output, time period and size of plant change.
- (c) Inventory management – It pertains to rules that firms can use to minimize the cost associated with maintaining inventory in form of work in process, raw material, finished goods using techniques like ABC Analysis.
- (d) Market Structure and Pricing Policies – Analysis of the structure of market provides information about the nature and extent of competition which the firms have to face. This helps in determining the degree of market power which the firm commands and the strategies to be followed in market management. Price theory explains how prices are determined under different kinds of market conditions and assists the firm in framing suitable price policies.
- (e) Resource Allocation – Business Economics with the help of advanced tools such as linear programming helps in optimum utilization of resources.
- (f) Profit Analysis – Profit theory guides the firm in management and measurement of profits under conditions of uncertainty and also helps in future profit planning.
- (g) Risk and Uncertainty analysis – Analysis of risks and uncertainties helps the business firm in arriving at efficient decisions and in formulating plans on basis of past data, current information and future prediction.

2. **Macroeconomics applied to External or Environmental Issues** –

The major macro-economic factors relate to:

- (a) The type of economic system.
- (b) Stage of Business Cycle.
- (c) The general trends in national income, employment, prices, saving and investment.
- (d) Social and Political Environment
- (e) Working of central banks and financial sector and capital market and their regulation.
- (f) Socio-economic organisations like trade unions, producer and consumer unions and cooperatives.

Thus, Business decisions cannot be taken without considering these present and future environmental factors.