



NATURE AND SCOPE OF BUSINESS ECONOMICS



UNIT 1: INTRODUCTION

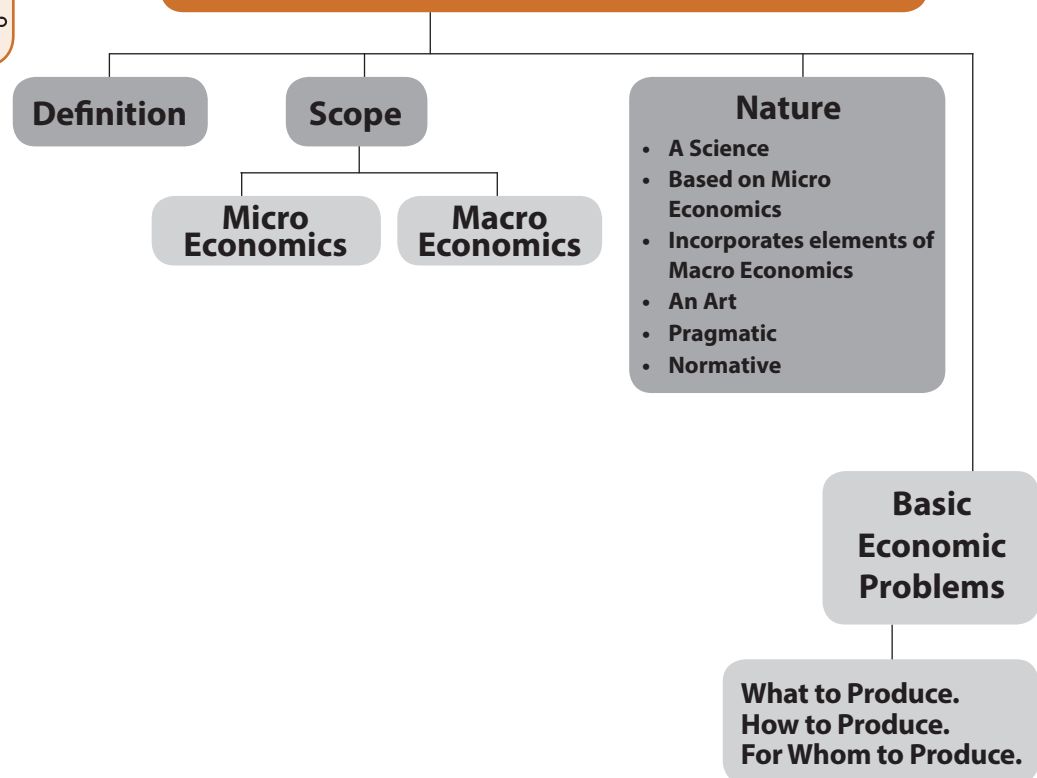
LEARNING OUTCOMES

At the end of this Chapter, you will be able to:

- ◆ Explain the Meaning of Economics.
- ◆ Describe the Meaning and Nature of Business Economics.
- ◆ Describe the Scope of Business Economics.

CHAPTER OVERVIEW

NATURE AND SCOPE OF BUSINESS ECONOMICS



 **1.0 INTRODUCTION****1.0.0 What is Economics about?**

The term 'Economics' owes its origin to the Greek word 'Oikonomia' which means 'household'. Till 19th century, Economics was known as 'Political Economy.' The book named 'An Inquiry into the Nature and Causes of the Wealth of Nations' (1776) usually abbreviated as 'The Wealth of Nations', by Adam Smith is considered as the first modern work of Economics.

Before we start with the meaning of Business Economics, it is important for us to understand what Economics is about. For this, consider the following situation:

It is your birthday and your mother gives you ₹ 1000 as birthday gift. You are free to spend the money as you like. What will you do? You have many options before you, such as:

Option 1 : You can give a party to your friends and spend the whole money on them.

Option 2 : You can buy yourself a dress for ₹ 1000.

Option 3 : You can go for a movie and eat in a restaurant of your choice.

Option 4 : You can buy yourself a book and save the rest of the money.

What do you notice? You have many options before you. Given a choice, you would like to spend not only on your friends, but would also like to go for a movie, eat in a restaurant, buy a dress and a book and save some money. However, you cannot have all of them at the same time. Why? Because you have only ₹1000 with you. Had your mother given you ₹ 2000, you might have satisfied more of your desires. But, she has not. Now, you find yourself in a dilemma as to which of the above options to choose. You will have to go for one option or a combination of one or more options. What do you do? You evaluate the various alternatives and choose the one that gives you the greatest satisfaction. Similar dilemma is faced by every individual, every society and every country in this world. Life is like that. Since we cannot have everything we want with the resources we have, we are forever forced to make choices. Therefore, we choose to satisfy only some of our wants leaving many other wants unsatisfied.

These two fundamental facts that:

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

Let us now examine what Economics studies about. Economics is the study of the processes by which the relatively scarce resources are allocated to satisfy the competing unlimited wants of human beings in a society. Of course, the available resources will be efficiently used when they are allocated to their highest valued uses. Economics is, thus, the study of how we work together to transform the scarce resources into goods and services to satisfy the most pressing of our infinite wants and how we distribute these goods and services among ourselves.

This definition of Economics, with the narrow focus on using the relatively scarce resources to satisfy human wants, is the domain of modern neo classical micro economic analysis. Despite being correct, it is incomplete as it brings to our mind the picture of a society with fixed resources, skills and productive capacity, deciding on what specific kinds of goods and services it ought to produce with the given resources and how they ought to be distributed among the members of the society. However, two of the most important concerns of modern economies are not fully covered by this concept.

On the one hand, we find that the productive capacity of modern economies has grown tremendously. Population and labour force have increased, new sources of raw materials have been discovered, and new and better plant and equipments have been made available on farms and in factories and mines. Not only has the quantity of available productive resources increased, their quality has also improved substantially. Better education and newly acquired skills have raised the productivity of labour force, and has led to the discovery of completely new kinds of natural resources such as shale gas and new alternative sources of energy. On the other hand, we know that the resulting growth in production and income has not been smooth. There have been periods in which output not only failed to grow, but also actually declined sharply. During such periods, factories, workers and other productive resources have remained idle due to insufficient demand.

Economics, therefore, concerns itself not just with the crucial concern of how a nation allocates its scarce productive resources to various uses; it also deals with the processes by which the productive capacity of these resources is increased and with the factors which, in the past, have led to sharp fluctuations in the rate of utilisation of these resources.

In the day-to-day events, we come across several economic issues such as changes in the price of individual commodities as well as in the general price level; economic prosperity and higher standards of living of some countries despite general poverty and poor standards of living in others; and some firms making extraordinary profits while others close down etc. These are fundamentally matters connected with economic analysis. The study of Economics will enable us to develop an analytical approach that helps us in understanding and analysing a wide range of economic issues. It would also provide us with a number of models and frameworks that can be applied in different situations. The tools of Economics assist in choosing the best course of action from among the different alternative courses of action available to the decision maker. However, it is necessary to remember that most economic problems are of complex nature and are affected by several forces, some of which are rooted in Economics and others in political set up, social norms, etc. The study of Economics cannot ensure that all problems will be appropriately tackled; but, without doubt, it would enable a student to examine a problem in its right perspective and would help him in discovering suitable measures to deal with the same.

1.0.1 Meaning of Business Economics

Having understood the meaning of Economics, let us now understand what Business Economics is. For this, consider the following situation:

Mr. G. Ramamurthy, the CEO of Worldwide Food Limited, on completion of his presentation turned to his Board of Directors and raised the question "Well ladies and gentlemen, what you say? Shall we go into soft drink business?"

"Give us some time, Sir" remarked Swaminathan. "You are asking us to approve a major decision which will have long term impact on the direction of the company".

"I understand your concern for the company but now the time has come for us to expand our business. Soft drinks market is growing fast and it is closely related to our core business: food" answered Ramamurthy.

"But competition from White Soft Drinks Ltd. and Black Nectar Ltd. is tough. They are already into this business for years" remarked another board member.

"That is right. But we must not forget that the statistics show that there is still room for growth in this market. And also, food business is near maturity." Replied Ramamurthy.

“Don’t forget that even Swati Foods tried entering the soft drink market and failed miserably”, remarked Ashok Agrawal, another board member. “Moreover, the projections you are showing are based on last ten years’ data. What is the guarantee that the trend will continue? He questioned. “Also, we should not forget that Indians have become health conscious and who knows tomorrow what will people prefer?” He continued.

“Well friends, all your concerns are logical, and believe me; I have given much thought to these ‘ifs’ and ‘buts’. My people have spent many days analyzing all available data to arrive at a judgement. Our analysis indicates a strong possibility of earning above-average return on investment in this market, a return that will be more than what we are earning in food industry. We are already working on the details of production, cost, pricing, distribution, financing etc. I fear, if we wait for long, we will be missing an opportunity that may not come again for long. Let’s go ahead and make the most of it” remarked Ramamurthy.

What do you notice in the hypothetical example given above? The management of the company is faced with the problem of decision making.

As we are aware, the survival and success of any business depends on sound decisions. 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. Decision making involves evaluation of feasible alternatives, rational judgment on the basis of information and choice of a particular alternative which the decision maker finds as the most suitable. As explained above, the question of choice arises because our productive resources such as land, labour, capital, and management are limited and can be employed in alternative uses. Therefore, more efficient alternatives must be chosen and less efficient alternatives must be rejected.

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

- ◆ Should our firm be in this business?
- ◆ Should the firm launch a product, given the highly competitive market environment?
- ◆ If the firm decided on launching the product, which available technique of production should be used?
- ◆ From where should the firm procure the necessary inputs and at what prices so as to have competitive edge in the market?
- ◆ Should the firm make the components or buy them from other firms?
- ◆ How much should be the optimum output and at what price should the firm sell?
- ◆ How will the product be placed in the market? Which customer segment should we focus on and how to improve the customer experience? Which marketing strategy should be chosen? How much should be the marketing budget?
- ◆ How to combat the risks and uncertainties involved?

Decision making on the above as well as similar issues is not simple and straightforward as the economic environment in which the firm functions is highly complex and dynamic. The problem gets aggravated because, most of the time, decisions are to be taken under conditions of imperfect knowledge and uncertainty. Decision making, therefore, requires that the management be equipped with proper methodology and appropriate analytical tools and techniques. Business Economics meets these needs of the management by providing a large corpus of theory and techniques. Briefly put, Business Economics integrates economic theory with business practice.

Business Economics, also referred to as Managerial Economics, generally refers to the integration of economic theory with business practice. While the theories of Economics provide the tools which explain various concepts such as demand, supply, costs, price, competition etc., Business Economics applies these tools in the process of business decision making. Thus, Business Economics comprises of that part of economic knowledge, logic, theories and analytical tools that are used for rational business decision making. In brief, it is Applied Economics that fills the gap between economic theory and business practice.

Business Economics has close connection with Economic theory (Micro as well as Macro-Economics), Operations Research, Statistics, Mathematics and the Theory of Decision-Making. A professional business economist has to integrate the concept and methods from all these disciplines in order to understand and analyse practical managerial problems. Business Economics is not only valuable to business decision makers, but also useful for managers of 'not-for-profit' organisations.

1.1 DEFINITIONS OF BUSINESS ECONOMICS

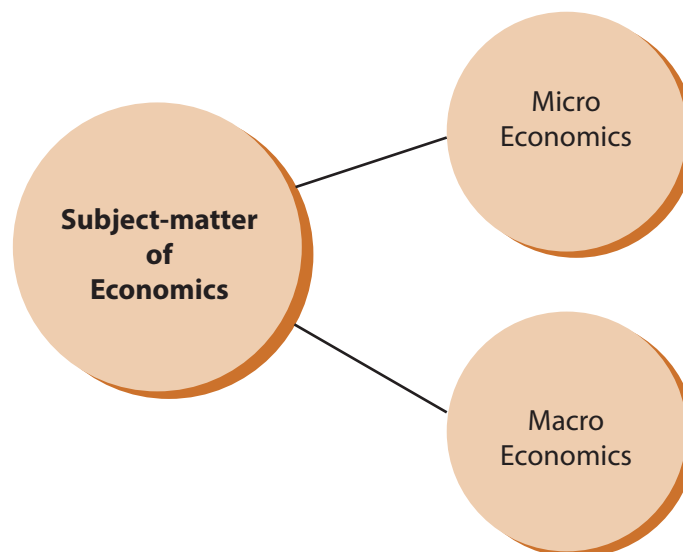
Business Economics may be defined as the use of economic analysis to make business decisions involving the best use of an organization's scarce resources.

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.

Our approach in this text is to focus on the heart of Business Economics i.e. the Micro Economic Theory of the behaviour of consumers and firms in competitive markets. This theory provides managers with a basic framework for making key business decisions about the allocation of their firm's scarce resources.

1.2 NATURE OF BUSINESS ECONOMICS

Economics has been broadly divided into two major parts i.e. Micro Economics and Macro Economics. Before explaining the nature of Business Economics, it is pertinent to understand the distinction between these two.



Micro Economics is basically the study of the behaviour of different individuals and organizations within an economic system. In other words, Microeconomics examines how the individual units (consumers or firms) make decisions as to how to efficiently allocate their scarce resources. Here, the focus is on a 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.

We mainly study the following in Micro-Economics:

- (i) Product pricing;
- (ii) Consumer behaviour;
- (iii) Factor pricing;
- (iv) The economic conditions of a section of people;
- (v) Behaviour of firms; and
- (vi) Location of industry.

Macro Economics is the study of the overall economic phenomena or the economy as a whole, rather than its individual parts. Accordingly, in Macro-Economics, we study the behaviour of the large economic aggregates, such as, the overall levels 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. However, 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.

A few areas that come under Macro Economics are:

- (i) National Income and National Output;
- (ii) The general price level and interest rates;
- (iii) Balance of trade and balance of payments;
- (iv) External value of currency;
- (v) The overall level of savings and investment; and
- (vi) The level of employment and rate of economic growth.

While Business Economics is basically concerned with Micro Economics, Macro economic analysis also has got an important role to play. Macroeconomics analyzes 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 example, knowledge regarding conditions of inflation and interest rates will be useful for the business economist in framing suitable policies. Moreover, the long-run trends in the business world are determined by the prevailing macroeconomic factors.

Having understood the meaning of Micro and Macro Economics, we shall examine the nature of Business Economics:

Nature of Business Economics

The economic world is extremely complex as there is a lot of interdependence among the decisions and activities of economic entities. Economic theories are hypothetical and simplistic in character as they are

based on economic models built on simplifying assumptions. Therefore, usually, there is a gap between the propositions of economic theory and happenings in the real economic world in which the managers make decisions. Business Economics enables application of economic logic and analytical tools to bridge the gap between theory and practice.

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 tools of decision sciences such as Mathematics, Statistics and Econometrics with Economic Theory to arrive at appropriate strategies for achieving the goals of the business enterprises. It follows scientific methods and empirically tests the validity of the results.
- ♦ *Based on Micro Economics:* Business Economics is based largely on Micro-Economics. A business manager is usually concerned about achievement of the predetermined objectives of his organisation so as to ensure the long-term survival and profitable functioning of the organization. Since Business Economics is concerned more with the decision making problems of individual establishments, it relies heavily on the techniques of Microeconomics.
- ♦ *Incorporates elements of Macro Analysis:* A business unit does not operate in a vacuum. It is affected by the external environment of the economy in which it operates such as, the general price level, income and employment levels in the economy and government policies with respect to taxation, interest rates, exchange rates, industries, prices, distribution, wages and regulation of monopolies. All these are components of Macroeconomics. A business manager must be acquainted with these and other macroeconomic variables, present as well as future, which may influence his business environment.
- ♦ Business Economics is an art as it involves practical application of rules and principles for the attainment of set objectives.
- ♦ *Use of Theory of Markets and Private Enterprises:* Business Economics largely uses the theory of markets and private enterprise. It uses the theory of the firm and resource allocation in the backdrop of a private enterprise economy.
- ♦ *Pragmatic in Approach:* Micro-Economics is abstract and purely theoretical and analyses economic phenomena under unrealistic assumptions. In contrast, Business Economics is pragmatic in its approach as it tackles practical problems which the firms face in the real world.
- ♦ *Interdisciplinary in nature:* Business Economics is interdisciplinary in nature as it incorporates tools from other disciplines such as Mathematics, Operations Research, Management Theory, Accounting, marketing, Finance, Statistics and Econometrics.
- ♦ *Normative in Nature:* Economic theory has developed along two lines – positive and normative. A positive or pure science analyses cause and effect relationship between variables in an objective and scientific manner, but it does not involve any value judgement. In other words, it states 'what is' of the state of affairs and not what 'ought to be'. In other words, it is descriptive in nature in the sense that it describes the economic behaviour of individuals or society without prescriptions about the desirability or otherwise of such behaviour. As against this, a normative science involves value judgements. It is prescriptive in nature and suggests 'what should be' a particular course of action under given circumstances. Welfare considerations are embedded in normative science.

Business Economics is generally normative or prescriptive in nature. It suggests the application of economic principles with regard to policy formulation, decision-making and future planning. However, if the firms are to establish valid decision rules, they must thoroughly understand their environment.

This requires the study of positive or descriptive economic theory. Thus, Business Economics combines the essentials of normative and positive economic theory, the emphasis being more on the former than the latter.

1.3 SCOPE OF BUSINESS ECONOMICS

The scope of Business Economics is quite wide. It covers most of the practical problems a manager or a firm faces. There are two categories of business issues to which economic theories can be directly applied, namely:

1. Microeconomics applied to operational or internal Issues
2. Macroeconomics applied to environmental or external issues

Therefore, the scope of Business Economics may be discussed under the above two heads.

1. Microeconomics applied to operational or internal Issues

Operational issues include all those issues that arise within the organisation and fall within the purview and control of the management. These issues are internal in nature. Issues related to choice of business and its size, product decisions, technology and factor combinations, pricing and sales promotion, financing and management of investments and inventory are a few examples of operational issues. The following Microeconomic theories deal with most of these issues.

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

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

- ◆ *Production and Cost Analysis:* Production theory explains the relationship between inputs and output. A business economist has to decide on the optimum size of output, given the objectives of the firm. He has also to ensure that the firm is not incurring undue costs. Production analysis enables the firm to decide on the choice of appropriate technology and selection of least - cost input-mix to achieve technically efficient way of producing output, given the inputs. Cost analysis enables the firm to recognise the behaviour of costs when variables such as output, time period and size of plant change. The firm will be able to identify ways to maximize profits by producing the desired level of output at the minimum possible cost.
- ◆ *Inventory Management:* Inventory management theories pertain to rules that firms can use to minimise the costs associated with maintaining inventory in the form of 'work-in-process,' 'raw materials,' and 'finished goods.' Inventory policies affect the profitability of the firm. Business economists use methods such as ABC analysis, simple simulation exercises and mathematical models to help the firm maintain optimum stock of inventories.
- ◆ *Market Structure and Pricing Policies:* Analysis of the structure of the market provides information about the nature and extent of competition which the firms have to face. This helps in determining the

degree of market power (ability to determine prices) which the firm commands and the strategies to be followed in market management under the given competitive conditions such as, product design and marketing. Price theory explains how prices are determined under different kinds of market conditions and assists the firm in framing suitable price policies.

- ◆ *Resource Allocation:* Business Economics, with the help of advanced tools such as linear programming, enables the firm to arrive at the best course of action for optimum utilisation of available resources.
- ◆ *Theory of Capital and Investment Decisions:* For maximizing its profits, the firm has to carefully evaluate its investment decisions and carry out a sensible policy of capital allocation. Theories related to capital and investment provide scientific criteria for choice of investment projects and in assessment of the efficiency of capital. Business Economics supports decision making on allocation of scarce capital among competing uses of funds.
- ◆ *Profit Analysis:* Profits are, most often, uncertain due to changing prices and market conditions. Profit theory guides the firm in the measurement and management of profits under conditions of uncertainty. Profit analysis is also immensely useful in future profit planning.
- ◆ *Risk and Uncertainty Analysis:* Business firms generally operate under conditions of risk and uncertainty. Analysis of risks and uncertainties helps the business firm in arriving at efficient decisions and in formulating plans on the basis of past data, current information and future prediction.

2. Macroeconomics applied to environmental or external issues

Environmental factors have significant influence upon the functioning and performance of business. The major macro economic factors relate to:

- ◆ the type of economic system
- ◆ stage of business cycle
- ◆ the general trends in national income, employment, prices, saving and investment.
- ◆ Government's economic policies like industrial policy, competition policy, monetary and fiscal policy, price policy, foreign trade policy and globalization policies
- ◆ working of financial sector and capital market
- ◆ socio-economic organisations like trade unions, producer and consumer unions and cooperatives.
- ◆ social and political environment.

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



SUMMARY

- ◆ An economy exists because of two facts, i.e. human wants are unlimited and the resources are scarce.
- ◆ Economics is the study of processes by which the relatively scarce resources are allocated to satisfy the competing unlimited wants of human beings in a society.
- ◆ The subject matter of Economics is divided into two parts – Micro and Macro Economics
- ◆ Microeconomics examines how the individual units (consumers or firms) make decisions as to how to efficiently allocate their scarce resources.
- ◆ Macroeconomics study the behaviour of the large economic aggregates, such as, the overall levels of output, total consumption, total saving and total investment and how these aggregates shift over time.
- ◆ Business Economics integrates economic theory with business practice and relies on economic analysis in the formulation of business policies.
- ◆ While Business Economics is basically concerned with Micro Economics, Macro economic analysis has got an important role to play. Macroeconomics analyzes the environment in which the business has to function.
- ◆ Business Economics is a normative science which is interdisciplinary and pragmatic in approach.
- ◆ There are two categories of business issues to which economic theories can be directly applied, namely: Microeconomics applied to operational or internal Issues and Macroeconomics applied to environmental or external issues.
- ◆ Business Economics makes use of microeconomic analysis such as, demand analysis and forecasting, production and cost Analysis, inventory management, market structure and pricing policies, resource allocation, theory of capital and investment decisions, profit analysis and risk and uncertainty analysis.
- ◆ Business Economics also considers Macroeconomics related to economic systems, business cycles, national income, employment, prices, saving and investment, Government's economic policies and working of financial sector and capital market.

Study of Inventory Management, Product and Promotion Policy, Resource Allocation, Capital Budgeting, Risk and Uncertainty Analysis are outside the scope of this book. They will be taught in other subjects – Financial Management, Strategic Management etc. at higher levels of CA course.