2 Fundamental Concepts and Terminologies

Introduction

Economics studies the rational behaviour of human beings. In the context of rationality, activities conducted are called economic activities and in order to begin the study of economics as a science, it is necessary and helpful to get clarity about some frequently used concepts and basic terminologies of economics.

This chapter provides a clear understanding of (1) goods, services and factors (2) concepts of and difference between price and value (3) wealth and welfare (4) trade cycle.

2.1 Price and Value

In everyday language, we use the words 'price' and 'value' alternatively to denote the same meaning. For instance, we make statements like, "this good is expensive", "this good is valuable", "this good has a high price". When these statements are made they are made without drawing a difference between price and value.

In economics, the concepts of price and value are different and it is necessary to first understand the concept of value. Value can be understood from two viewpoints. (1) from viewpoint of use; called use-value (2) from viewpoint of exchange; called exchange value.

2.1.1 Use-Value : The use-value is determined by the usefulness of a commodity to a consumer for her/his various needs. For example, food, water, sunlight etc. have a high use-value for all people in general.

2.1.2 Exchange-Value : When a commodity/service is exchanged for another commodity/service then the worth of one unit of this commodity is measured in terms of the amount of other commodity which it can exchange for. Such worth is called exchange-value. For example, if 1 kg of wheat exchanges for 1 kg of rice then the exchange value of one kg wheat is 1 kg of rice.

2.1.3 Relationship between Use-Value and Exchange-Value : If a commodity has high use-value then it is not necessarily said to have a high exchange-value. But if a commodity has high exchange-value then it surely has some use value. Exchange value is determined by the scarcity of a resource in relation to its need/use (scarcity of supply in relation to its demand). Goods are demanded if they have some use value. And, if they are scarce in supply in relation to their demand or their supply (flow in the market) is controlled by a few people then they have a higher exchange value. For example, precious metals, diamonds etc. On the other hand, if goods are highly useful but have unlimited supply then they do not have exchange value or may have very low exchange value. For example, though air and sunlight have very high usefulness for life, they have no exchange-value as they are abundant in supply. In earlier times, even water was a good with high use-value but no exchange value. However, in present times, the availability of water is reducing in relation to its need and use by people and so it has started commanding an exchange-value.

In economics, use of the word value is usually in context of exchange-value of a commodity with another commodity.

Thus, value means the worth of one unit of a commodity in terms of units of another commodity in exchange.

Price : If a commodity is exchanged for money then such monetary exchange value is termed as 'price'.

Price means the exchange value (worth) of a commodity measured in terms of units of currency.

2.2 Goods and Services

Goods : Commodities which have physical existence are called goods. In economics they are meant to satisfy the needs of consumption.

Services : Commodities which are intangible or do not have a physical existence are called services. In economics they are meant to satisfy the needs of human life.

Economics studies activities pertaining to production, consumption and distribution of goods or services. The nature of goods and services is different though both are important in economics.

Food is a good (commodity) but cooking is a service. Units of goods or stock of goods can be measured cardinally. Services generally cannot be measured in cardinal (quantative/numerical) terms. However, the time spent after providing a service can be measured. The impact of a service in satisfaction of human wants is also abstract. For example, the need for knowledge and curiosity is satisfied by the service of education. However the exact contribution of the service of education in knowledge creation is abstract. However a book is a good and it may be possible to tell about the amount of information obtained from the book.

2.3 Types of Goods

The various goods and services in economics can be classified as,

2.3.1 Physical (Tangible) Goods and Intangible Goods : Some goods have physical existence like, ball, bat, television, refrigerator, stove, mobile phone and so on. These can be measured. Whereas, some goods do not have physical existence, cannot be measured cardinally and those are called services. For example, education, medical consultancy, rendition of music, cooking and so on.

2.3.2 Non-economic Goods and Economic Goods : Goods which do not command exchange value are called non-economic goods. They are abundant in supply and do not go through the economic process of production and distribution, though they are consumed by people. For example, sunlight, air and so on.

Goods which command an exchange value in the market are called economic goods. They command an exchange value as they are scarce in supply in relation to their demand and their supply can be held under control.

2.3.3 Durable Goods and Perishable Goods : Goods which come to the market can be durable or perishable.

Durable goods can be used for a long period of time and repeatedly. For example, shoes, clothes, television, and refrigerator and so on. Perishable goods cannot last for a long time and are consumable only once. For example, milk, fruits and so on.

2.3.4 Private Goods and Public Goods : Goods are classified as private goods and public goods based on their ownership and nature of use.

Private goods are goods which can be possessed and owned by a private individual; she/he takes all decision regarding these goods. These goods possess the characteristics of excludability and competitiveness. Excludability means, once a good is owned and being used by one individual, another individual cannot possess and use it at the same time. And, individuals have to compete for the ownership of these goods. For example, a packet of biscuit purchased by one child in a market which has competition among buyers; comes under the ownership of this child, and another child is excluded from having the same packet of biscuit. The individual who pays a price gets the good and others cannot have the same unit. For example, one who does no pay price for a mobile phone, does not get it.

On the contrary, public goods can be used by many individuals at the same time. They possess the characteristics of joint demand and collective consumption. Such goods are jointly demanded by many people. If one individual uses it the other cannot be excluded from its use and in this way they are collectively consumed. Hence these are called public goods. They are either provided for by the government for all or some people pay for it together. For example, a public garden or the garden of a housing society.

In short, private goods are owned and used by private individuals and public goods are owned by the government or group of people and are used collectively.

2.3.5 Consumers' Goods and Producers' Goods : Goods can satisfy human wants directly or indirectly. When a consumer consumes a good and this good is capable of satisfying a particular want directly then it is called a consumer good. These goods have passed the final stage of production. For example, cooked food. They satisfy human wants directly.

When a good is used at the intermediate stage of production of a final good, when it is purchased by a producer to produce a final good, when it is not directly consumed by the consumers but this good helps in the production of a final good then such a good is called a producer's good. For example, cotton used to make cloth, machines used in factories to produce garments, a tractor which facilitates in producing food grains, a utensil used to cook food etc. They satisfy human wants through the final good and not directly.

2.4 Wealth and Welfare

The concepts of wealth and welfare frequently appear in economic discussions and are very important in economics and hence must be clearly understood at this stage.

2.5 Meaning and Characteristics of Wealth

Since the time when Adam Smith gave the definition of economics in the context of wealth, the subject of wealth became extremely important in economics.

Meaning : In the understanding of Alfred Marshall's idea, wealth is something which is useful, scarce, capable of getting exchanged, and can be owned by somebody.

Chracteristics : The following characteristics can be derived about wealth:

2.5.1 It should Possess the Characteristic of Usefulness : It must be useful in satisfying human wants or needs. Therefore, goods which are useful in satisfying needs of human beings are wealth. For example, house, vehicle, precious jewellery etc.

2.5.2 It should be Scarce : Those commodities which are scarce in supply in relation to their demand and possess exchange-value besides being useful are called wealth. Goods which are useful but not scarce and do not have exchange-value like sunlight and air are not called wealth in economics.

2.5.3 It should have Physical or Intellectual Existence : Wealth should have an existence which can be exchanged.

The ability to understand, the aptitudes of human beings, their physical abilities etc. are the innate abilities and assets of human beings and are usually not exchanged.

In today's world, however, the intellectual abilities of human beings like the ability to create new ideas are exchanged for money in the market and hence the intellectual ability to create novel ideas and goods is called wealth.

Yet, the ability of a scientist to think is her quality and not wealth but the novel idea created by the scientist is wealth.

2.5.4 Wealth Constitutes Goods which are Capable of Exchange : Wealth is an economic concept and therefore must be capable of getting exchanged. Wealth is meant to satisfy present as well as future consumption and other needs and therefore must be capable of exchange. A house purchased today satisfies the present need of housing and can be sold in future to buy other goods. Precious metals, land etc. also possess this characteristic.

2.5.5 Durability : Wealth must possess durability. Durable goods can be used for future exchange and for satisfying future needs and therefore become wealth. Goods which perish after single use cannot be used for future transactions and are therefore not wealth. For example, land, house, precious jewellery are durable goods and hence can be considered wealth along with their other characteristics. Shares are also wealth.

Food grains which are produced by a farmer are not wealth if they perish in a very short time. Likewise labour of a labourer is also not called wealth. However, if food grains can be stored in cold storage for a long time and their market value increases in future then those become wealth. Hence new technology can redefine wealth.

2.6 Types of Wealth

Wealth can be classified as (1) Individual Wealth and Societal Wealth (2) National Wealth and International Wealth

2.6.1 Individual Wealth and Social Wealth : Wealth under the ownership of an individual and meant for private consumption is called individual wealth. For example, a house. Wealth under the ownership of society and meant for collective consumption is called societal wealth. For example,. Dam.

2.6.2 National Wealth and International Wealth : Wealth belonging to a nation and possessed and treasured by a nation is called national wealth. It helps to generate exchange value directly or indirectly for a nation For example, rivers, mountains, litreature and scriptures etc. Internatinal wealth is that wealth which is not owend by one nation but belongs to the whole world and can be shared by several nations.

2.7 Welfare

Welfare means enhancement of life situations, standard of living; an overall state of improvement.

The concept of welfare is used by all philosophies from spiritual sciences to economics.

All human activities, economic and non-economic are ultimately done with the purpose of improvement of life. Welfare can be measured quantitatively in the context of growth and qualitatively in the context of development.

In economics, subject of welfare can be studied as (1) individual welfare (2) collective welfare.

When an individual seeks to make efforts to improve her/his standard of living and wellbeing, it becomes a subject of individual welfare.

When nations and governments seek to improve growth, development etc. it becomes a subject matter of collective welfare.

2.7.1 Relationship between Wealth and Welfare : Generally when wealth increases, welfare increases as more wealth means higher capacity to generate monetary value, greater power to exchange goods or purchasing power for the owner and hence greater wellbeing. This is largely true in case of individuals.

But when the wealth of a nation increases in the form of national income, the welfare of people will increase only if this national income is equitably distributed among all sections of the society and among all sectors. Besides, a nation's welfare also depends upon social and cultural formation and hence there is not always a direct relation between wealth and welfare in a society.

2.8 Factors of Production

The activity of conversion of raw materials and resources into final goods which satisfy human wants is called production. By converting the nature of resources, their utility increases. Hence production can also be called a process which increases utility of resources. For example, when wood is converted into chairs which are demanded by customers for satisfaction of their wants then the utility of wood increases and this process of conversion is called production.

Now, the agents which help in such a process of conversion or production are called 'Factors of Production'.

There are Four Factors of Production, Viz. Land, Labour, Capital and Entrepreneur :

All these factors are equally important in the process of production. In a system of just distribution of income, the total income generated from various activities is distributed to each factor of production as per their productivity or their contribution in generating that income.

According to Alfred Marshall, there are two basic categories of factors of production (1) Nature (2) Human beings.

2.8.1 Land : In a general understanding, land may mean the surface of earth liveable for mankind. However, in economics, the concept of land is more inclusive. According to Marshall, all natural assets which help in production or economic activities constitute land. That is, climate of a particular part of earth, water resources, fertility, mineral resources all of these constitute land.

Hence land can be said to have the following characteristics:

(1) Land is a gift of nature and is not manmade.

(2) The total supply of land is fixed.

(3) Land is geographically immobile.

(4) All types of land are different in fertility, climatic conditions and so on.

(5) The remuneration of land as a factor of production is called 'rent'.

2.8.2 Labour : Physical or intellectual work by humans in order to earn returns which is done under the supervision by some authority is called labour.

The characteristics of labour are:

(1) Labour cannot be separated from the labourer.

(2) Labour cannot be stored. In a way labour (effort done by a labourer) is perishable.

(3) The mobility of labour is influenced by social and economic reasons.

(4) The efficiency of every labourer is different (which means the capacity of every labourer to perform labour is different).

(5) The supply of labour depends upon population.

(6) The remuneration for labour is called 'wages'.

2.8.3 Capital : In modern times, capital is considered to be a highly important factor of production. All manmade goods which help in production constitute capital. It is different from land and labour as it is a 'produced' factor of production. In other words, it is a manmade factor of production. For example, a tractor is a produced factor of production which further helps in the production of agricultural goods.

There is a difference between capital and wealth. Though several times some goods are factors of production as well as wealth; it is not so always. A good may be a capital good as it helps in production but it may not possess all characteristics of wealth. Or another good may be wealth but not a factor of production.

Characteristics of capital can be stated as:

(1) Capital is a manmade factor of production.

(2) It is the most mobile of all factors of production.

(3) The increasing demand for capital in present times owing to increasing capital intensive methods of production has resulted in increasing scarcity of this factor.

(4) The remuneration of capital is called 'interest'.

2.8.4 Entrepreneur : Entrepreneur is the factor which brings together (coordinates) all other factors of production for the production process (for an economic activity). There is a difference between management and co-ordination. Management of work is done by a manager who is a salaried labourer (employee) of the entrepreneur. Entrepreneur is the person who sets up the enterprise.

Entrepreneur is the risk taker who takes the risk of setting up an activity. This factor does not get fixed return but tries to generate income by running the economic activity successfully. She may incur a loss if the activity does not function well.

Characteristics of enterprise can be stated as:

(1) This factor is the decision maker of the activity.

(2) This factor is known as the risk taking factor.

(3) It possesses the quality of co-ordination. In other words, 'entrepreneurship' is a quality.

(4) The remuneration of this factor is called profit.

2.9 Trade Cycle

Economic activities go through phases of dynamic changes like a human life goes through changes. Such changes are basically of four types :

(1) Irregular changes (2) Seasonal changes (3) Long run regular trend (4) Long run dynamic changes which are cyclical in nature.

2.9.1 Irregular Changes : These are accidental changes which occur in an economic activity. e.g. floods, famines, storms, fire and so on. Such accidents impact an economic activity in the short run and sometimes in the long run.

These changes may generally occur and/or have their impact in some sectors or some regions of an economy only. For example, only in the agricultural sector or only in the industrial sector.

2.9.2 Seasonal Changes : These changes regularly occur in economic activities with changing seasons. For instance, demand for certain goods changes by seasons and accordingly production and employment may change.

2.9.3 Long Run Regular Changes : Some changes occur in a given direction in the form of a trend. These are directional changes which occur in an activity. For example, some regular sales trends.

2.9.4 Cyclical Changes : Dynamic fluctuations arising in an economy over its long run growth leading to rise (upward swing) in growth of economic activities and fall (downward swing) are called trade cycles. The rise and fall in economic activity is cyclical in nature.

Such changes occur in economic activities and growth process of economies also goes through these changes and the study of these dynamic changes called 'trade cycles' is very important in economics.

2.10 Definitions of a Trade Cycle

According to Heberler, "Trade Cycle is an interval that embraces alternating periods of prosperity (good time) and depression (bad time)."

According to Hawtrey, "Trade cycles are continuous phases of good and bad changes occuring in the economy."

Characteristics of a Trade Cycle :

(1) They depict dynamic changes in the economy

(2) They depict the positive and negative changes in the economy.

(3) These arise because of several factors.

(4) Trade cycles have various phases and each phase does not last for a uniform period.

2.11 Phases of a Trade Cycle

A trade cycle has the following four phases: (1) Boom/Inflation (2) Recession (3) Depression (4) Recovery

2.11.1 Boom : This is a period when economic activity reaches the maximum growth level in a given time period. Demands have peaked and so have incomes and profits. Thus, this period is also called 'peak'.

2.11.2 Recession : This period follows the period of boom. When economic activity peaks in a given period and investments and employment have reached the highest possible levels, a slow down occurs. Demand slows down, investment and employment follow.

2.11.3 Depression : The slowdown in the recession phase continues to cause a depression when all activities reach a minimum level under those circumstances. The confidence of buyers, producers and investors in the economic activity is at its lowest. In the phase of recession consumers start expecting further fall in prices and reduce demand in expectation of further price fall. With the fall in demand, production falls and employment falls causing further reduction in the demand. Thus a depression is caused.

2.11.4 Recovery : When depression lasts for some time, the suppressed demand starts emerging, Governments may try to boost investments and employment and certain times technological changes happen in the long run. This leads to a recovery of demand, employment and investment.

These types of cycles occur in all economies and all economic activities in the long run. However, in market oriented economies, these occur more openly while they may be suppressed by the state in the state controlled economies.

Exercise

1. Choose correct option for the following from the options provided :

(1) Which value expresses the importance of a good in human life ?

(A) Exchange-value (B) Use-value (C) Consumption-value (D) Internal-value

(2) What is the monetary payment in exchange of a good called ?

(A) Value (B) Exchange (C) Price (D) Wealth

(3) Which of the following is a physical good ?

(A) Music (B) Education (C) Doctor's advice (D) Refrigerator

(4) Which of the following is not a characteristic of wealth ?

(A) Possesses usefulness
(B) Should be available in abundance
(C) Has an explicit existence
(D) Is capable of being exchanged

(5) Which of the following signifies all forms of 'natural wealth' ?

(A) Capital (B) Labour (C) Land (D) Money

(6) Which is not a type of trade cycle ?

(A) Irregular changes
(B) Seasonal changes
(C) Short run regular changes
(D) Long run regular changes

2. Answer the following questions in one sentence :

(1) State the meaning of value.
(2) Give meaning and example of commodities which are universally and abundantly available.
(3) What is meant by perishable goods in economics ?
(4) Give the meaning and example of consumer goods.
(5) What is meant by individual wealth?
(6) Give the meaning of factors of production.
(7) Give the meaning of wealth.
(8) Give the definition of trade cycle given by Heberler.
(9) How many phases are there in a trade cycle ? Which are those ?

3. Answer the following questions in short :

(1) Give two points of difference between private goods and public goods.
(2) Explain the meaning of commodities and services with examples.
(3) Give the meaning of durable goods with examples.
(4) Which goods are called consumer goods in economics ?
(5) Give the meaning of individual wealth and social wealth.
(6) Give the meaning of wealth given by Prof. Marshall.
(7) Explain the meaning of production.
(8) State the meaning of labour as a factor of production.

4. Answer the following questions in brief points :

(1) Give the meaning of price and value.
(2) Give the types of goods and explain the difference between consumer goods and producers' goods with examples.
(3) Give the types of wealth and explain the difference between national wealth and international wealth with examples.
(4) Give the meaning of factors of production with examples.
(5) Give the meaning of trade cycle and explain the various phases of a trade cycle.

5. Answer the following questions in detail :

(1) Give the meaning and explain the characteristics of wealth in detail.
(2) Give a detailed explanation of the phases of a trade cycle.
(3) Define production and discuss factors of production.

Glossary

Price	:	If a commodity is exchanged for money then the monetary exchange value is termed as 'price'. In other words, price means the exchange value (worth) of a commodity measured in terms of units of currency units.
Value	:	Thus, Value means the worth of one unit of a commodity in terms of units of another commodity in exchange.
Goods	:	Commodities which have physical existence and are meant to satisfy the needs of consumption are called goods in economics.
Wealth	:	Wealth is something which is useful, scarce, capable of getting exchanged, and can be owned by somebody is called wealth. It gives higher capacity to generate monetary value, greater power to exchange goods or purchasing power for the owner and hence greater wellbeing.
Services	:	Commodities which are intangible or do not have a physical existence and are meant to satisfy various needs of human life are called services in economics.
Factors of Production	:	These are agents which help in the economic activities of production, distribution, trade etc.
Trade Cycle	:	Dynamic fluctuations arising in an economy over its long run growth leading to rise (upward swing) in growth of economic activities and fall (downward swing) are called trade cycles. The rise and fall in economic activity is cyclical in nature.
Welfare	:	Welfare means enhancement in the quality of life situations, standard of living; an overall state of improvement.

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