UNIT I

LESSON 3 **MANAGERIAL ECONOMICS-A POSITIVE OR NORMATIVE SCIENCE**

STRUCTURE

3.1 INTRODUCTION

We observe that there are different types of people or stakeholders who use economics in different ways. For example, a practising economist or a policy practitioner uses economic tools and information to make any suggestion or critical analysis. Generally, such people use economic theories and tools for proper understanding and specific forecasting of economic variables. It is because use of economic sciences is generally for proper decision making and accuracy in economic forecasting. Thus, positive statements are about facts. They state what the reality is. To be specific, economics is strictly positive in character and is concerned with merely positive statements. Since positive statements are about facts, any disagreement over such statement or analysis can be handled properly only by use of facts and their analysis. Thus, positive economics is one that deals with the real life situations or the facts or evidences. Any inferences are derived and disputed based upon such facts and analysis only. Normative economics is based on the normative statements. Normative statements are concerned with what are to be? In this case, economics is not concerned with real life experiences rather, it is concerned with, how things should operate. As against the positive economics, the normative economics cannot be challenged based upon any fact. For example, if a political leader projects his party's vision in election that the unemployment rate should be brought down to 2.0 per cent, this statement is not based upon any analysis or fact, rather it is desire or the wish or the norm applied by the particular political party. Now, if the political party comes to the power the policy maker must tune the system to realise this target. Despite there being differences between positive economics and normative economics, economics is a science having both positive and normative aspects. It is more so because economics is a social science.

According to Ross D. Eckert and Richard H. Leftwich, (1988), "Economic policy-making-conscious intervention in economic activity with the intent of altering the course that it will take-is essentially normative in character. But if economic policy-making is to be effective in improving economic well-being, it must obviously be rooted in sound positive economic analysis. Policy-makers should be cognised of the full range of consequences of the policies they recommend." ("The Price System and Resource Allocation", New York, 10th edition, p. 10) According to Samuelson and Nordhaus, (2000), positive and normative economics may be interpreted as under. "Positive economics deals with questions such as: why do doctors earn more than janitors? Does free trade raise or lower wages for most Americans? …Although these are difficult questions to answer, they can all be resolved by reference to analysis and empirical evidence. That puts them in the realm of positive economics." "Normative economics involves ethical precepts and norms of fairness. Should poor people be required to work if they are to get government assistance? Should unemployment be raised to ensure that price inflation does not become too rapid? … There are no right or wrong answers to these questions because they involve ethics and values rather than facts. They can be resolved only by political debate and decisions, not by economic analysis alone."

3.2 OBJECTIVES

The objectives of this lesson are to explain the:

- Positive and Normative science of economics.

- Inductive and deductive methods of economics.

3.3 METHODOLOGY OF ECONOMICS

Economics is also like a science but it is a social science. It deals mainly with the human behaviour. Therefore, many economists argue that economics can not be as precise a science as the natural sciences like physics, chemistry etc. The latter can be studied in the laboratory conditions where variables can be easily controlled during experiments. However, social sciences like economics cannot be easily controlled. Still over a period of time economic sciences have gained maturity to develop its methodologywhich is proving now to be quite efficient and such methodologies can be used for efficient analysis of the economic relationships and predictions can be made with sufficient accuracythat generate a sense of confidence and faith. There are two broad methods used in the economic sciences.

1. The deductive method

2. The inductive method

1. *The deductive method*: This method involves going from general to particular. Certain hypotheses or postulates regarding human behaviour are taken to be true and then with the help of logical reasoning and examination, Nature and Scope of Economics.

Here in this lesson we try to figure out the cause and effect relationship between the factors under consideration. The following steps are involved in the deductive method.

I. Firstly, a problem needs to be identified and then it should be properly specified for the study.

II. The assumptions required in the study should be clear. Appropriate assumptions are crucial in economic analysis.

III. After specifying the assumptions, hypotheses should be clearly framed. The hypothesis formulation requires likely relationship among the different economic variables.

IV. In the last phase, hypotheses should be tested through different tools like mathematical economics and econometrics.

V. Based on the above analysis proper inference needs to be derived for specific economic decision making.

2. *The inductive method*: Although deductive method has strong points of merit to depend upon, this methodology seems to suffer from certain weaknesses. Therefore, economists belonging to the historical school and many other economists have favoured the inductive or empirical method.

The method of induction involves going from particular to general. Here the appeal is to facts, rather than reasoning and an attempt is made to arrive at conclusions from the known facts of actual life. The inductive method required the following steps:

I. The first step, as under the deductive method, is selecting and specifying the problem that is to be studied.

II. The second step involves collection of data pertaining to the problem selected for study.

III. The stage of collection is followed by classification and then analysis of the data by appropriate statistical techniques.

IV. The fourth stage is that of 'inference', *i.e.* drawing conclusions from the statistical analysis conducted. The conclusions are presented in the form of economic generalisation.

3.4 ECONOMIC GOALS

Any science moves with certain goals to be achieved. Economics has become now a crucial branch of knowledge. Being a social science it keeps on revising its goals from time to time. The list might be quite large, but we would like to focus only on certain major goals of economics as given under:

1. *A low rate of unemployment*: People willing to work should be able to find jobs reasonably quickly. Widespread unemployment is demoralising and it represents an economic waste. Society forgoes the goods and services that the unemployed could have produced.

2. *Price stability*: It is desirable to avoid rapid increases-or decreases- in the average level of price.

3. *Efficiency*: When we work, we want to get as much as we reasonably can take out of

our productive efforts. For this, efficient technology becomes quite useful.

4. *An equitable distribution of income*: When many live in affluence, no group of citizens should suffer stark poverty. Given this, developing countries are strategising goals like participatory growth and inclusive growth.

5. *Growth*: Continuing growth, which would make possible an even higher standard of living in the future, is generally considered an important objective.

6. *Economic freedom and choice*: Any economy should grow and develop in such a manner that people should get more choices and there should not be any outside pressure on their choices.

7. *Economic welfare*: Economic policies should be pursued in such a manner that welfare of the people or the social benefits get maximised.

8. *Sustainable development*: It has become a major challenge for economists to carry on the process of economic growth in such a manner that the resources are optimally utilized not only for intergenerational equity but also for sustainable development in quite long run.

3.5 MANAGERIAL ECONOMICS- A POSITIVE OR NORMATIVE SCIENCE

Most of the managerial economists are of the opinion that managerial economics is fundamentally normative and prescriptive in nature. It is concerned with what decisions ought to be made. The application of managerial economics is inseparable from consideration of values or norms, for it is always concerned with the achievement of objectives or the optimisation of goals. In managerial economics, we are interested in what should happen rather than what does happen. Instead of explaining what a firm is doing, we explain what it should do to make its decision effective.

Positive Economics:

A positive science is concerned with 'what is'. Robbins regards economics as a pure science of what is, which is not concerned with moral or ethical questions. Economics is neutral between ends. The economist has no right to pass judgment on the wisdom or folly of the ends itself.

He is simply concerned with the problem of resources in relation to the ends desired. The manufacture and sale of cigarettes and wine may be injurious to health and therefore morally unjustifiable, but the economist has no right to pass judgment on these since both satisfy human wants and involve economic activity.

Normative Economics:

Normative economics is concerned with describing what should be the things. It is, therefore, also called prescriptive economics. What price for a product should be fixed, what wage should be paid, how income should be distributed and so on, fall within the purview of normative economics?

It should be noted that normative economics involves value judgments.Almost all the leading managerial economists are of the opinion that managerial economics is fundamentally normative and prescriptive in nature.

It refers mostly to what ought to be and cannot be neutral about the ends. The application of managerial economics is inseparable from consideration of values, or norms for it is always concerned with the achievement of objectives or the optimisation of goals.

Managerial economists are generally preoccupied with the optimum allocation of scarce resources among competing ends with a view to obtaining the maximum benefit according to predetermined criteria.

To achieve these objectives they do not assume ceteris paribus, but try to introduce policies. The very important aspect of managerial economics is that it tries to find out the cause and effect relationship by factual study and logical reasoning. The scope of managerial economics is so wide that it embraces almost all the problems and areas of the manager and the firm.

3.6 IMPORTANCE OF ECONOMICS IN OUR LIFE

Economics is the study of how finite resources are consumed by demand, according to the costs imposed by their supply in relation to that demand. In other words, economics tells us that a freeze in Florida that damages the orange crop will cause the price of orange juice to change and how the price will modify demand over time.

Modern economic theory is said to have originated in “The Wealth of Nations,” a book written by Scottish scholar Adam Smith in 1776. The theory holds that rational self interest pursued by individuals and businesses in a free market society leads to optimal economic conditions.

The studyof economics helps formulate an understanding of the effects of financial actions and reactions byindividuals and institutions. This understandingallows the projection of future economic conditions based on current indications.

An understanding of economics assists governments in managing macroeconomic conditions such as limiting a recession by inducing recovery. However, economic theory is not foolproof because it is a social science based on the interplay between culture and money. Economic effects change as cultural customs change.

3.7 CENTRAL PROBLEMS OF AN ECONOMY

Every economy faces some problems. These problems are associated with growth, business cycles, unemployment and inflation. The macroeconomic theory is designed to explain how supply and demand in the aggregate interact to concern with these four problems. Economists these very important national problems as macroeconomic problems - that is, as problems that could not be understood or solved without an understanding of the workings of the economic system as a whole. The four distinctively macroeconomic problems are:

1. *Recession*
2. *Unemployment*
3. *Inflation*
4. *Economic Growth or Stagnation*

A. Recessions, Depressions and Economic Fluctuations

The event that created modern macroeconomics was called "the Great Depression," but the general term for decreasing national production, in modern economics, is a recession.

But why do economists regard a recession as a problem?

It is not self-evident that a drop in production is a bad thing. For example, it might be that people want to enjoy more leisure, and spend less time producing goods and services. If production dropped for that reason, we would have no reason to think of it as an economic problem. But, in some periods of recession, we have evidence that this was not what happened. In many recession periods, businesses that announced they were hiring had long lines of people who wanted to apply, with many more people than they could hire. This suggests that the people standing in line for a job had more leisure than they wanted, and would have preferred jobs and income to buy more goods and services. In the 1930's, some people sold apples or pencils in the street to get a little income, typically much less than they would have had in their old jobs. Again, this suggests that people had too much leisure and would have preferred more work and income. If this is so, then it seems that something was going wrong. In different terms, it seemed that the recession had caused unemployment. Another possibility is that production might drop because a war or disaster had destroyed factories and other capital goods. But, in 1933, it seems very unlikely that the productive capacity of the economy could have dropped by 30%. There had been no war. And in fact, factories had been closed that could have been reopened and put to work, at the same time as many people were looking for work. Perhaps these circumstances show why the recession is regarded as a major economic problem.

B. Unemployment

Our second macroeconomic problem is unemployment. This problem is highly correlated with recession, but is distinct, and we need to look at it in its own terms. Unemployment occurs when a person is available to work and currently seeking work, but the person is without work. The prevalence of unemployment is usually measured using the unemployment rate, which is defined as the percentage of those in the labour force who are unemployed.

Economists distinguish between various types of unemployment. For example, cyclical, frictional, structural and classical, seasonal, hardcore and hidden. Real-world unemployment may combine different types. The magnitude of each of these is difficult to measure, partly because they overlap.

Unemployment is a status in which individuals are without job and are seeking a job. It is one of the most pressing problems of any economy especially the underdeveloped ones. This has macroeconomic implications too some of which are discussed below:

Reduction in the Output: The unemployed workforce could be utilised for the production of goods and services. Since they are not doing so, the economy is losing out on its output.

Reduction in Tax Revenue: Since income tax is an important part of the revenue for the government. The unemployed are unable to earn, the government loses out on the income tax revenue.

Rise in the Government Expenditure: The government has to give unemployment insurance benefits to the claimants. Hence the government will lose from both sides in terms of unemployment benefits and loss of tax revenue.

C. Inflation

In economics, inflation is a rise in the general level of prices of goods and services in an economy over a period of time. A rising price level – inflation- has the following disadvantages:

1. It creates uncertainty, in that people do not know what the money they earn today will buy tomorrow.
2. Uncertainty, in turn, discourages productive activity, saving and investing.
3. Inflation reduces the competitiveness of the country in international trade. If this is not offset by a devaluation of the national currency against other currencies, it makes the country's exports less attractive, and makes imports into the country more attractive, which in turn tends to create unbalance in trade.
4. Inflation is a hidden tax on "nominal balances." That is, people who hold bonds and bank accounts in dollars lose the value of those accounts when the price level rises, just as if their money had been taxed away.
5. The inflation tax is capricious-some lose by it and some do not without any good economic reason.
6. As the purchasing power of the monetary unit becomes less predictable, people resort to other means to carry out their business, means which use up resources and are inefficient.