

Unit –I

DEFINITION AND SCOPE OF ECONOMICS

Definition and Scope of Economics:

Economics

Definition: Economics is that branch of social science which is concerned with the study of how individuals, households, firms, industries and government take decision relating to the allocation of limited resources to productive uses, so as to derive maximum gain or satisfaction. Simply put, it is all about the choices we make concerning the use of scarce resources that have alternative uses, with the aim of satisfying our most pressing infinite wants and distribute it among ourselves.

Nature of Economics

1. **Economics is a science:** Science is an organised branch of knowledge, that analyses cause and effect relationship between economic agents. Further, economics helps in integrating various sciences such as mathematics, statistics, etc. to identify the relationship between price, demand, supply and other economic factors.
 - **Positive Economics:** A positive science is one that studies the relationship between two variables but does not give any value judgment, i.e. it states 'what is'. It deals with **facts about the entire economy**.
 - **Normative Economics:** As a normative science, economics **passes value judgement**, i.e. 'what ought to be'. It is concerned with economic goals and policies to attain these goals.

Economics is an art: Art is a discipline that expresses the way things are to be done, so as to achieve the desired end. Economics has various branches like production, distribution, consumption and economics, that provide general rules and laws that are capable of solving different problems of society.

Therefore, economics is considered as science as well as art, i.e. **science in terms of its methodology and arts as in application**. Hence, economics is concerned with both theoretical and practical aspects of the economic problems which we encounter in our day to day life.

Scope of Economics

- **Microeconomics:** The part of economics whose subject matter of study is **individual units**, i.e. a consumer, a household, a firm, an industry, etc. It analyses the way in which the decisions are taken by the economic agents, concerning the allocation of the resources that are limited in nature.
It studies **consumer behaviour**, product pricing, firm's behaviour. Factor pricing, etc.
- **Macro Economics:** It is that branch of economics which studies the entire economy, instead of individual units, i.e. level of output, total investment, total savings, total consumption, etc. Basically, it is the study of **aggregates and averages**. It analyses the economic environment as a whole, wherein the firms, consumers, households, and governments make decisions.
It covers areas like national income, general price level, the balance of trade and balance of payment, level of employment, level of savings and investment.

The **fundamental difference between micro and macro economics lies in the scale of study**. Further, in microeconomics, more importance is given to the determination of price, whereas macroeconomics is concerned with the determination of income of the economy as a whole.

Nevertheless, microeconomics and macroeconomics are **complementary** to one another, as they both aimed at **maximising the welfare of the economy as a whole**.

From the standpoint of microeconomics, the objective can be achieved through the **best possible allocation of scarce resources**. Conversely, if we talk about macroeconomics, this goal can be attained through the **effective use of the resources of the economy**.

Adam Smith's Definition of Economics

Adam Smith was a Scottish philosopher, widely considered as the first modern economist. Smith defined economics as "an inquiry into the nature and causes of the wealth of nations."

Criticism of Smith's Definition

1. The wealth-centric definition of economics limited its scope as a subject and was seen as narrow and inaccurate. Smith's definition forced the subject to ignore all non-wealth aspects of human existence.
2. The Smithian definition over-emphasized the material aspects of well-being and ignored the non-material aspects. It was assumed that human beings acted as rational economic agents who mindlessly strived to maximize their own well-being.
3. The Smithian definition prevents the subject from exploring the concept of resource [scarcity](#). The allocation and use of scarce resources are seen as a central topic of analysis in modern economics.

Alfred Marshall's Definition of Economics

British economist Alfred Marshall defined economics as the study of man in the ordinary business of life. Marshall argued that the subject was both the study of wealth and the study of mankind. He believed it was not a natural science such as physics or chemistry, but rather a social science.

Criticism of Marshall's Definition

1. The Marshallian definition, like the Smithian definition, ignored the problem of scarce resources, which possess unlimited potential uses.
2. Marshall's definition restricted economics as a subject to only analyze the material aspects of [human welfare](#). Non-material aspects of welfare were ignored. Critics of the Marshallian definition asserted that it was difficult to separate material and non-material aspects of welfare.
3. The Marshallian definition does not provide a clear link between the acquisition of wealth and welfare. Marshall's critics claimed that it left the subject in a state of perpetual confusion. For instance, there are plenty of activities that might generate wealth but that can reduce human welfare.

Lionel Robbin's Definition of Economics

Lionel Robbin, another British economist, defined economics as the subject that studies the allocation of scarce resources with countless possible uses. In his 1932 text, "An Essay on the Nature and Significance of Economic Science," Robbins said the following about the subject: "Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses."

Criticism of Robbin's Definition

1. Robbin's definition of economics transformed the subject from a normative social science into a positive science with an undue emphasis on individual choice. His definition prevented the subject from analyzing topics such as social choice and social interaction theory, which are important topics within modern microeconomic theory.
2. Robbin's definition prevented it from analyzing macroeconomic concepts such as national income and [aggregate supply and demand](#). Instead, economics was merely used to analyze the action of individuals, using stylized mathematical models.

Modern Definition of Economics

The modern definition, attributed to the 20th-century economist, Paul Samuelson, builds upon the definitions of the past and defines the subject as a social science. According to Samuelson, "Economics is the study of how people and society choose, with or without the use of money, to employ scarce productive resources which could have alternative uses, to produce various commodities over time and distribute them for consumption now and in the future among various persons and groups of society."

The nature of economics

The nature of economics

Economics is the scientific study of the *ownership, use, and exchange of scarce resources* – often shortened to the *science of scarcity*. Economics is regarded as a social science because it uses scientific methods to build theories that can help explain the behaviour of individuals, groups and organisations. Economics attempts to explain *economic* behaviour, which arises when scarce resources are [exchanged](#).

In terms of methodology, economists, like other social scientists, are not able to undertake controlled experiments in the way that chemists and biologists are. Hence, economists have to employ different methods, based primarily on [observation and deduction](#) and the construction of abstract [models](#).

As the social sciences have evolved over the last 100 years, they have become increasingly specialised. This is true for economics, as witnessed by the development of many different strands of investigation including *micro* and *macro* economics, *pure* and *applied* economics, and *industrial* and *financial* economics. What links them all is the attempt to understand how

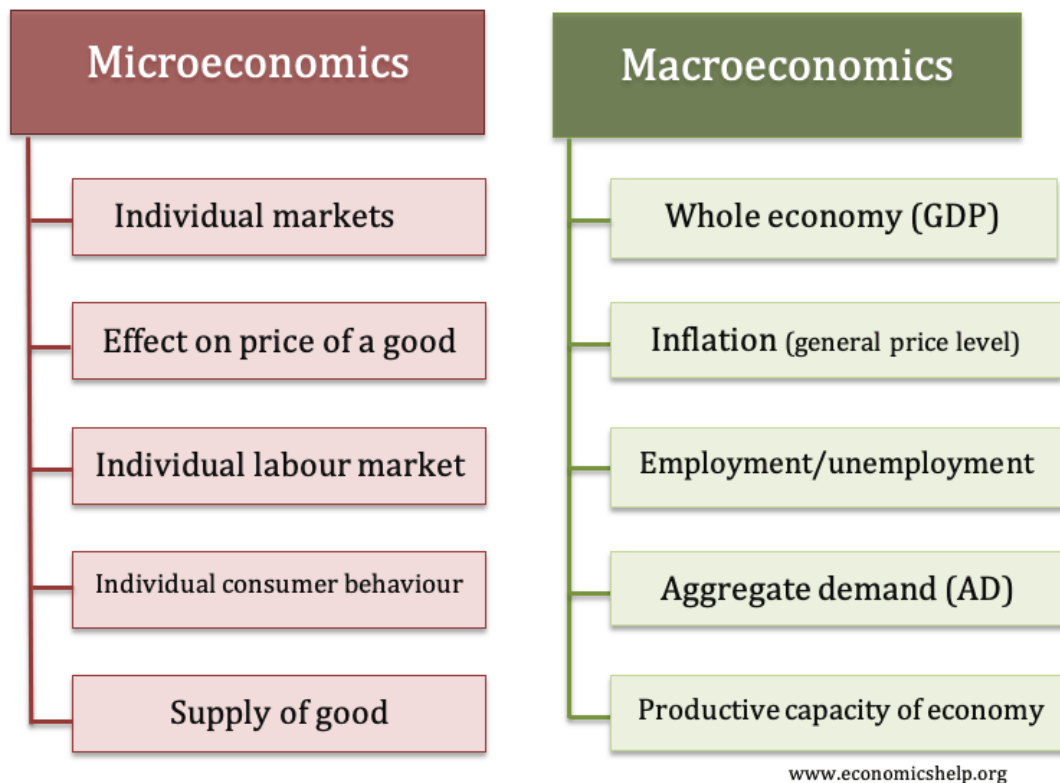
and why exchange takes place, and how exchange creates benefits and costs for the participants.

Difference between microeconomics and macroeconomics

4 February 2017 by Tejvan Pettinger

Readers Question: Could you differentiate between micro economics and macro economics?

- Microeconomics is the study of particular markets, and segments of the economy. It looks at issues such as consumer behaviour, individual labour markets, and the theory of firms.
- Macro economics is the study of the whole economy. It looks at 'aggregate' variables, such as aggregate demand, national output and inflation.



Micro economics involves

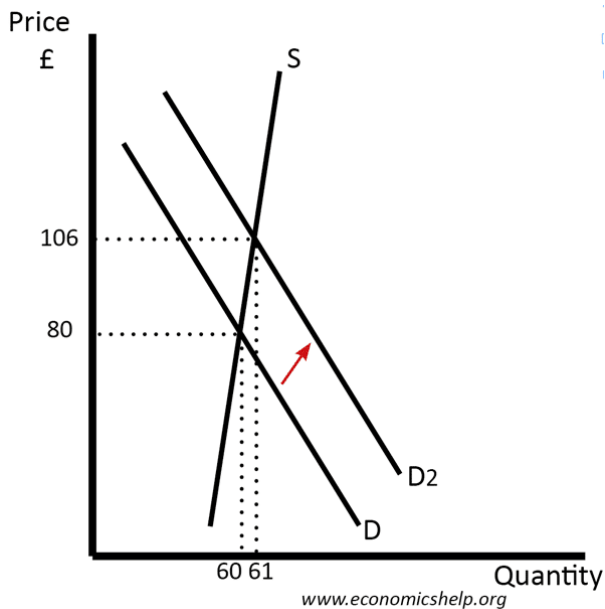
- Supply and demand in individual markets.
- Individual consumer behaviour. e.g. [Consumer choice theory](#)
- Individual labour markets – e.g. demand for labour, [wage determination](#).
- Externalities arising from production and consumption. e.g. [Externalities](#)

Macro economics involves

- Monetary / fiscal policy. e.g. what effect does interest rates have on the whole economy?
- Reasons for inflation and unemployment.
- Economic growth
- International trade and globalisation
- Reasons for differences in living standards and economic growth between countries.
- Government borrowing

Moving from micro to macro

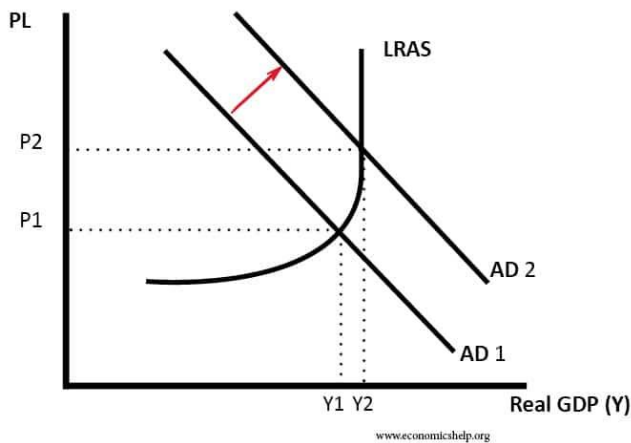
If we look at a simple supply and demand diagram for motor cars. Microeconomics is concerned with issues such as the impact of an increase in demand for cars.



This micro economic analysis shows that the increased demand leads to higher price and higher quantity.

Macro economic analysis

This looks at all goods and services produced in the economy.



- The macro diagram is looking at real GDP (which is the total amount of output produced in the economy) instead of quantity.
- Instead of the price of a good, we are looking at the overall price level (PL) for the economy. Inflation measures the annual % change in the aggregate price level.
- Instead of just looking at individual demand for cars, we are looking at aggregate demand (AD) – total demand in the economy.
- Macro diagrams are based on the same principles as micro diagrams; we just look at Real GDP rather than quantity and Inflation rather than Price Level (PL)

The main differences between micro and macro economics

1. Small segment of economy vs whole aggregate economy.
2. Microeconomics works on the principle that markets soon create equilibrium. In macro economics, the economy may be in a state of **disequilibrium** (boom or recession) for a longer period.
3. There is little debate about the basic principles of micro-economics. Macro economics is more contentious. There are different schools of macro economics offering different explanations (e.g. Keynesian, Monetarist, Austrian, Real Business cycle e.t.c).
4. Macro economics places greater emphasis on empirical data and trying to explain it. Micro economics tends to work from theory first – though this is not always the case.

Differences between microeconomics and macroeconomics

The main difference is that micro looks at small segments and macro looks at the whole economy. But, there are other differences.

Equilibrium – Disequilibrium

Classical economic analysis assumes that [markets return to equilibrium](#) (S=D). If demand increases faster than supply, this causes price to rise, and firms respond by increasing supply. For a long time, it was assumed that the macro economy behaved in the same way as micro economic analysis. Before, the

1930s, there wasn't really a separate branch of economics called macroeconomics.

Great Depression and birth of Macroeconomics

In the 1930s, economies were clearly not in equilibrium. There was high unemployment, output was below capacity, and there was a state of disequilibrium. Classical economics didn't really have an explanation for this dis-equilibrium, which from a micro perspective, shouldn't occur.

In 1936, J.M.Keynes produced his *The General Theory of Employment, Interest and Money*; this examined why the depression was lasting so long. It examined why we can be in a state of disequilibrium in the macro economy. Keynes observed that we could have a negative output gap (disequilibrium in the macro-economy) for a prolonged time. In other words, microeconomic principles of markets clearing, didn't necessarily apply to macro economics. Keynes wasn't the only economist to investigate this new branch of economics. For example, Irving Fisher examined the role of debt deflation in explaining the great depression. But, Keynes' theory was the most wide-ranging explanation and played a large role in creating the new branch of macro-economics.

Since 1936, macroeconomics developed as a separate strand within economics. There have been competing explanations for issues such as inflation, recessions and economic growth.

Similarities between microeconomics and macroeconomics

Although it is convenient to split up economics into two branches – microeconomics and macroeconomics, it is to some extent an artificial divide.

1. Micro principles are used in macroeconomics. If you study the impact of devaluation, you are likely to use same economic principles, such as the elasticity of demand to changes in price.
2. Micro effects macroeconomics and vice versa. If we see a rise in oil prices, this will have a significant impact on cost-push inflation. If technology reduces costs, this enables faster economic growth.
3. Blurring of distinction. If house prices rise, this is a micro economic effect for the housing market. But, the housing market is so influential that it could also be considered a macro-economic variable, and will influence monetary policy.
4. There have been efforts to use computer models of household behaviour to predict the impact on the macro economy.

Deductive and Inductive Methods of Economics (Merits and Demerits)

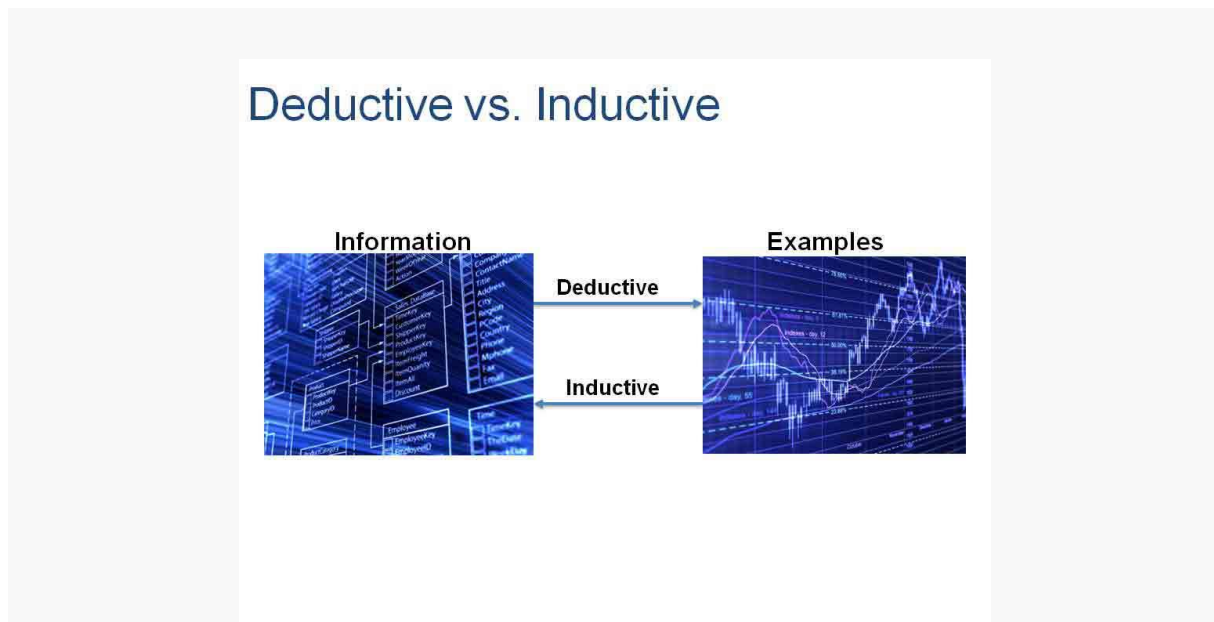


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The Deductive Method:

Deduction Means reasoning or inference from the general to the particular or from the universal to the individual. The deductive method derives new conclusions from fundamental assumptions or from truth established by other methods. It involves the process of reasoning from certain laws or principles, which are assumed to be true, to the analysis of facts.

Then inferences are drawn which are verified against observed facts. Bacon described deduction as a “descending process” in which we proceed from a general principle to its consequences. Mill characterised it as a priori method, while others called it abstract and analytical.

Deduction involves four steps: (1) Selecting the problem. (2) The formulation of assumptions on the basis of which the problem is to be explored. (3) The formulation of hypothesis through the process of logical reasoning whereby inferences are drawn. (4) Verifying the hypothesis. These steps are discussed as under.

(1) Selecting the problem:

The problem which an investigator selects for enquiry must be stated clearly. It may be very wide like poverty, unemployment, inflation, etc. or narrow relating to an industry. The narrower the problem the better it would be to conduct the enquiry.

(2) Formulating Assumptions:

The next step in deduction is the framing of assumptions which are the basis of hypothesis. To be fruitful for enquiry, the assumption must be general. In any economic enquiry, more than one set of assumptions should be made in terms of which a hypothesis may be formulated.

3) Formulating Hypothesis:

The next step is to formulate a hypothesis on the basis of logical reasoning whereby conclusions are drawn from the propositions. This is done in two ways: First, through logical deduction. If and because relationships (p) and (q) all exist, then this necessarily implies that relationship (r) exists as well. Mathematics is mostly used in these methods of logical deduction.

(4) Testing and Verifying the Hypothesis:

The final step in the deductive method is to test and verify the hypothesis. For this purpose, economists now use statistical and

econometric methods. Verification consists in confirming whether the hypothesis is in agreement with facts. A hypothesis is true or not can be verified by observation and experiment. Since economics is concerned with human behaviour, there are problems in making observation and testing a hypothesis.

For example, the hypothesis that firms always attempt to maximise profits, rests upon the observation that some firms do behave in this way. This premise is based on a priori knowledge which will continue to be accepted so long as conclusions deduced from it are consistent with the facts. So the hypothesis stands verified. If the hypothesis is not confirmed, it can be argued that the hypothesis was correct but the results are contradictory due to special circumstances.

Under these conditions, the hypothesis may turn out to be wrong. In economics, most hypotheses remain unverified because of the complexity of factors involved in human behaviour which, in turn, depend upon social, political and economic factors. Moreover, controlled experiments in a laboratory are not possible in economics. So the majority of hypotheses remain untested and unverified in economics.

Merits of Deductive Method:

The deductive method has many advantages.

(1) Real:

It is the method of “intellectual experiment,” according to Boulding. Since the actual world is very complicated, “what we do is to postulate in our own minds economic systems which are simpler

than reality but more easy to grasp. We then work out the relationship in these simplified systems and by introducing more and more complete assumptions, finally work up to the consideration of reality itself.” Thus, this method is nearer to reality.

(2) Simple:

The deductive method is simple because it is analytical. It involves abstraction and simplifies a complex problem by dividing it into component parts. Further, the hypothetical conditions are so chosen as to make the problem very simple, and then inferences are deduced from them.

(3) Powerful:

It is a powerful method of analysis for deducing conclusions from certain facts. As pointed out by Cairnes, The method of deduction is incomparably, when conducted under proper checks, the most powerful instrument of discovery ever wielded by human intelligence.

(4) Exact:

The use of statistics, mathematics and econometrics in deduction brings exactness and clarity in economic analysis. The mathematically trained economist is able to deduce inferences in a short time and make analogies with other generalisations and theories. Further, the use of the mathematical-deductive method helps in revealing inconsistencies in economic analysis.

(5) Indispensable:

The use of deductive method is indispensable in sciences like economics where experimentation is not possible. As pointed out by Gide and Rist, “In a science like political economy, where experiment is practically impossible, abstraction and analysis afford the only means of escape from those other influences which complicate the problem so much.”

(6) Universal:

The deductive method helps in drawing inferences which are of universal validity because they are based on general principles, such as the law of diminishing returns.

Demerits of Deductive Method:

Despite these merits, much criticism has been levelled against this method by the Historical School which flourished in Germany.

1 .Unrealistic Assumption:

Every hypothesis is based on a set of assumptions. When a hypothesis is tested, assumptions are indirectly tested by comparing their implications with facts. But when facts refute the theory based on the tested hypothesis, the assumptions are also indirectly refuted. So deduction depends upon the nature of assumptions. If they are unrealistic, in this method, economists use the *ceteris paribus* assumption. But other things seldom remain the same which tend to refute theories.

2. Not Universally Applicable:

Often the conclusions derived from deductive reasoning are not applicable universally because the premises from which they are deduced may not hold good at all time and places. For instance, the

classicists assumed in their reasoning that particular conditions prevailing in England of their times were valid universally. This supposition was wrong. Prof. Lerner, therefore, points out that the deductive method is simply “armchair analysis” which cannot be regarded as universal.

3. Incorrect Verification:

The verification of theories, generalisations or laws in economics is based on observation. And right observation depends upon data which must be correct and adequate. If a hypothesis is deduced from wrong or inadequate data, the theory will not correspond with facts and will be refuted. For instance, the generalisations of the classicists were based on inadequate data and their theories were refuted. As pointed out by ircholson, “the great danger of the deductive method lies in the natural aversion to the labour of verification.”

4. Abstract Method:

The deductive method is highly abstract and requires great skill in drawing inferences for various premises. Due to the complexity of certain economic problems, it becomes difficult to apply this method even at the hands of an expert researcher. More so, when he uses mathematics or econometrics.

5. Static Method:

This method of analysis is based on the assumption that economic conditions remain constant. But economic conditions are continuously changing. Thus this is a static method which fails to make correct analysis.

6. Intellectually:

The chief defect of the deductive method “lies in the fact that those who follow this method may be absorbed in the framing of intellectual toys and the real world may be forgotten in the intellectual gymnastics and mathematical treatment.”

The Inductive Method:

Induction “is the process of reasoning from a part to the whole, from particulars to generals or from the individual to the universal.” Bacon described it as “an ascending process” in which facts are collected, arranged and then general conclusions are drawn.

The inductive method was employed in economics by the German Historical School which sought to develop economics wholly from historical research. The historical or inductive method expects the economist to be primarily an economic historian who should first collect material, draw generalisations, and verify the conclusions by applying them to subsequent events. For this, it uses statistical methods. The Engel’s Law of Family Expenditure and the Malthusian Theory of Population have been derived from inductive reasoning.

The inductive method involves the following steps:

1. The Problem:

In order to arrive at a generalisation concerning an economic phenomenon, the problem should be properly selected and clearly stated.

2. Data:

The second step is the collection, enumeration, classification and analysis of data by using appropriate statistical techniques.

3. Observation:

Data are used to make observation about particular facts concerning the problem.

4. Generalisation:

On the basis of observation, generalisation is logically derived which establishes a general truth from particular facts.

Thus induction is the process in which we arrive at a generalisation on the basis of particular observed facts.

The best example of inductive reasoning in economics is the formulation of the generalisation of diminishing returns. When a Scottish farmer found that in the cultivation of his field an increase in the amount of labour and capital spent on it was bringing in less than proportionate returns year after year, an economist observed such instances in the case of a number of other farms, and then he arrived at the generalisation that is known as the Law of Diminishing Returns.

Merits of Inductive Method:

The chief merits of this method are as follows:

(1) Realistic:

The inductive method is realistic because it is based on facts and explains them as they actually are. It is concrete and synthetic because it deals with the subject as a whole and does not divide it into component parts artificially

(2) Future Enquiries:

Induction helps in future enquiries. By discovering and providing general principles, induction helps future investigations. Once a generalisation is established, it becomes the starting point of future enquiries.

(3) Statistical Method:

The inductive method makes use of the statistical method. This has made significant improvements in the application of induction for analysing economic problems of wide range. In particular, the collection of data by governmental and private agencies or macro variables, like national income, general prices, consumption, saving, total employment, etc., has increased the value of this method and helped governments to formulate economic policies pertaining to the removal of poverty, inequalities, underdevelopment, etc.

(4) Dynamic:

The inductive method is dynamic. In this, changing economic phenomena can be analysed on the basis of experiences, conclusions can be drawn, and appropriate remedial measures can be taken. Thus, induction suggests new problems to pure theory for their solution from time to time.

(5) Historico-Relative:

A generalisation drawn under the inductive method is often historico-relative in economics. Since it is drawn from a particular historical situation, it cannot be applied to all situations unless they are exactly similar. For instance, India and America differ in their factor endowments. Therefore, it would be wrong to apply the industrial policy which was followed in America in the late

nineteenth century to present day India. Thus, the inductive method has the merit of applying generalisations only to related situations or phenomena.

Demerits of Inductive Method:

However, the inductive method is not without its weaknesses which are discussed below.

(1) Misinterpretation of Data:

Induction relies on statistical numbers for analysis that “can be misused and misinterpreted when the assumptions which are required for their use are forgotten.”

(2) Uncertain Conclusions:

Boulding points out that “statistical information can only give us propositions whose truth is more or less probable it can never give us certainty.”

(3) Lacks Concreteness:

Definitions, sources and methods used in statistical analysis differ from investigator to investigator even for the same problem, as for instance in the case of national income accounts. Thus, statistical techniques lack concreteness.

(4) Costly Method:

The inductive method is not only time-consuming but also costly. It involves detailed and painstaking processes of collection, classification, analyses and interpretation of data on the part of trained and expert investigators and analysts

(5) Difficult to Prove Hypothesis:

Again the use of statistics in induction cannot prove a hypothesis. It can only show that the hypothesis is not inconsistent with the known facts. In reality, collection of data is not illuminating unless it is related to a hypothesis.

(6) Controlled Experimentation not Possible in Economics:

Besides the statistical method, the other method used in induction is of controlled experimentation. This method is extremely useful in natural and physical sciences which deal with matter. But unlike the natural sciences, there is little scope for experimentation in economics because economics deals with human behaviour which differs from person to person and from place to place.

Further, economic phenomena are very complex as they relate to man who does not act rationally. Some of his actions are also bound by the legal and social institutions of the society in which he lives. Thus, the scope for controlled experiments in inductive economics is very little. As pointed Out by Friedman, “The absence of controlled experiments in economics renders the weeding out of unsuccessful hypo-these slow and difficult.”

Conclusion:

The above analysis reveals that independently neither deduction nor induction is helpful in scientific enquiry. In reality, both deduction and induction are related to each other because of some facts. They are the two forms of logic that are complementary and co-relative and help establish the truth.

Marshall also supported the complementary nature of the two methods when he quoted Schmoller: "Induction and deduction are both needed for scientific thought as the right and left foot are needed for walking." And then Marshall stressed the need and use of integrating these methods.

Now-a-days, economists are combining induction and deduction in their studies of economic phenomena in various fields for arriving at generalisations from observed facts and for the indirect verification of hypotheses. They are using the two methods to confirm the conclusions drawn through deduction by inductive reasoning and vice versa. Thus true progress in economic enquiries can be made by a wise combination of deduction and induction.

Positive And Normative Economics

Positive Economics

Positive economics is a stream of economics that focuses on the description, quantification, and explanation of economic developments, expectations, and associated phenomena. It relies on objective data analysis, relevant facts, and associated figures. It attempts to establish any cause-and-effect relationships or behavioral associations which can help ascertain and test the development of economics theories.

Positive economics is objective and fact-based where the statements are precise, descriptive, and clearly measurable. These statements can be measured against tangible evidence or historical instances. There are no instances of approval-disapproval in positive economics.

Here's an example of a positive economic statement: "Government-provided healthcare increases public expenditures." This statement is fact-based and has no value judgment attached to it. Its validity can be proven (or disproven) by studying healthcare spending where governments provide healthcare.

Normative Economics

Normative economics focuses on the ideological, opinion-oriented, prescriptive, value judgments, and "what should be" statements aimed toward economic development, investment projects, and scenarios. Its goal is to summarize people's desirability (or the lack thereof) to various economic

developments, situations, and programs by asking or quoting what should happen or what ought to be.

Normative economics is subjective and value-based, originating from personal perspectives, feelings, or opinions involved in the decision-making process. Normative economics statements are rigid and prescriptive in nature. They often sound political or authoritarian, which is why this economic branch is also called "what should be" or "what ought to be" economics.

An example of a normative economic statement is: "The government should provide basic healthcare to all citizens." As you can deduce from this statement, it is value-based, rooted in personal perspective, and satisfies the requirement of what "should" be.

Importance of Positive and Normative Economics

Common observations indicate that discussions around public policies typically involve normative economic statements. A higher degree of disagreements persists in such discussions because neither party can clearly prove their correctness.

Though normative statements are generalized and subjective in nature, they act as the necessary channels for out-of-the-box thinking. Such opinions can form the foundation for any necessary changes that may have the potential to completely transform a particular project. But normative economics cannot be the sole basis for decision-making on key economic fronts. Positive economics fill in for the objective angle that focuses on facts and cause-and-effect. Coupled with positive economics, normative economics may be useful in establishing, generating, and fulfilling new ideas and theories for different economic goals and perspectives.

A clear understanding of the difference between positive and normative economics may lead to better policy-making if policies are made based on a balanced mix of facts (positive economics) and opinions (normative economics). Nonetheless, numerous policies on issues ranging from [international trade](#) to [welfare](#) are at least partially based on normative economics.

Differences between Static and Dynamic Economics

1. Time Element:

In static economic analysis time element has nothing to do. In static economics, all economic variables refer to the same point of time.

Static economy is also called a timeless economy. Static economy, according to Hicks, is one where we do not trouble about dating.

On the contrary, in dynamic economics, time element occupies an important role. Here all quantities must be dated. Economic variables refer to the different points of time.

2. Process of Change:

Another difference between static economics and dynamic economics is that static analysis does not show the path of change. It only tells about the conditions of equilibrium. On the contrary, dynamic economic analysis also shows the path of change. Static economics is called a 'still picture' whereas the dynamic economics is called a 'movie' of the market.

3. Equilibrium:

Static economics studies only a particular point of equilibrium. But dynamic economics also studies the process by which equilibrium is achieved. As a result, there may be equilibrium or may be disequilibrium. Therefore, static analysis is a study of equilibrium only whereas dynamic analysis studies both equilibrium and disequilibrium.

4. Study of Reality:

Static analysis is far from reality while dynamic analysis is nearer to reality. Static analysis is based on the unrealistic assumptions of perfect competition, perfect knowledge, etc. Here all the important economic variables like fashions, population, models of production, etc. are assumed to be constant. On the contrary, dynamic analysis takes these economic variables as changeable.