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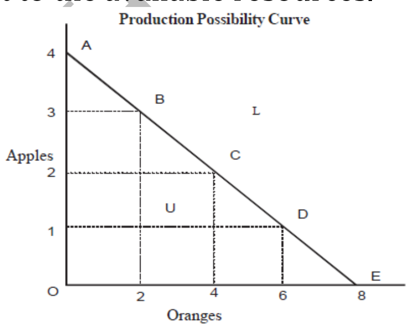
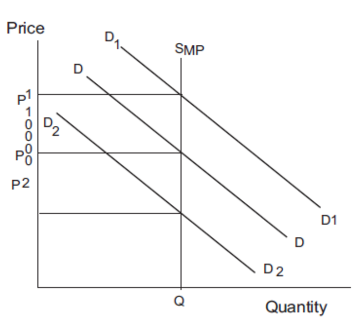
TENTATIVE ANSWER KEY

SUBJECT: ECONOMICS **MARKS : 90**

Q. NO	CONTENT	MARKS
	SECTION -I **CHOOSE THE CORRECT ANSWER**	**20X1=20**
1.	b) Lionel Robbins	
2.	c) Subsistence economy	
3.	d) Classification of wants	
4.	c) Potential Price - Actual Price	
5.	d) The total utility reaches the maximum	
6.	c) Shifts of the demand curve	
7.	d) X and Y goods are complementary	
8.	d) All the above	
9.	d) Creation of utility	
10.	c) Accepts innovations	
11.	d) TFC / Q	
12.	a) Long run average cost curve	
13.	c) MC = MR	
14.	d) Horizontal	
15.	a) Monopolistic competition	
16.	c) Income and Employment	
17.	d) Aggregate demand and aggregate supply	
18.	c) Consumption, Income	
19.	a) Central Bank	
20.	a) New year	
	SECTION -II	**7X2=14**
21.	**ALFRED MARSHALL DEFINITION ECONOMICS AS:** ❖ "A **study of mankind** in the ordinary business of life". ❖ An altered form of this definition is : "Economics is **a study of man's actions** in the **ordinary business of life**"	2
22.	**CAUSES FOR WANTS:** ❖ Elementary causes ❖ Social causes ❖ Customs and habits ❖ Advertisements. ❖ Psychological Causes.	2
23.	**TYPES OF ELASTICITY OF DEMAND:** ❖ Price elasticity of demand ❖ Income elasticity of demand ❖ Cross-elasticity of demand	2

24.	**BREAK EVEN POINT:** No profit, No loss point The firm is making neither profits nor losses. The points are called Break even points.	2
25.	**THE CONDITIONS OF PRICE DISCRIMINATION** 1. The demand must not be **transferable from the high priced market to the low priced market**. If rich people do not buy the high-priced deluxe edition of the book, but wait for the low-priced popular edition to come out, then personal discrimination will fail. 2. The monopolist **should keep the two markets or different markets separate** so that the commodity will not be moving from one market to the other market.	2
26.	**TRANSFER EARNINGS** Transfer earnings refer to the amount that a **factor could earn in its best paid alternative** employment. It represents the opportunity cost of its present employment.	2
27.	**QUASI - RENT** According to Marshall, 'Quasi-rent is the income derived from machines and other appliances for production by man'	2
28.	**FORMULA FOR MARGINAL PROPENSITY TO CONSUME;** MPC = $\frac{\text{Change in consumption}}{\text{Change in income}}$ MPC = $\frac{\Delta C}{\Delta Y}$	2
29.	**THE INSTRUMENTS OF QUANTITATIVE CREDIT CONTROL** 1. Bank Rate policy 2. open Market operations 3. Variation of Cash Reserve ratios	2
30.	**DEFINITION OF TAX ACCORDING TO PROF. SELIGMEN.** According to Prof. Seligman, "A tax is a compulsory contribution from the person to the State to defray the expenditure incurred in the common interest of all without any reference to the special benefits conferred".	2
	SECTION -II	**7X3=21**
31.	**THE CRITICISMS AGAINST ADAM SMITH'S WEALTH DEFINITION.** ❖ There is a lot of criticism against Adam Smith's definition of economics. It has got a bad name for economics. Some social scientists like Ruskin and Carlyle called it "a dismal science", "a dark science". But this criticism is unfair, because it is based on a misunderstanding about the nature and scope of economics. ❖ As this definition emphasized "wealth", they thought it is all about money. They concluded that economics taught men and women how to make money. ❖ So they called it a selfish science as in their opinion it emphasized on "the means to get rich". Moreover, early economists used the term "wealth" in the sense of welfare. ❖ A great demerit of Adam Smith's definition is that there is overemphasis on wealth. There is no doubt that we have to study about wealth in economics. ❖ Hence the proper study of mankind should be man and not wealth alone. When we discuss Adam Smith's definition of economics, we have to keep in mind the time in which he lived. He was writing his book at a time when England was on the eve of Industrial Revolution.	3

	❖ So it is only natural that Adam Smith emphasized on wealth and considered economics as “an enquiry into the nature and causes of the wealth of nations”.	
32.	**MERITS OF MIXED ECONOMY** **1. Efficient resource utilisation:** The resources are utilized efficiently as good features of both capitalism and socialism coexist. If there is misallocation of resources, the State controls and regulates it. This ensures the efficient utilization of resources. **2. Prices are administered:** The prices are not fixed always by forces of demand and supply. In the case of goods which are scarce, the prices are administered by the government and such goods are also rationed. **3. Social Welfare:** In a mixed economy, planning is centralized and there is overall welfare. Workers are given incentives and reward for any innovations. There is social security provided to the workers. Inequalities of income and wealth are reduced.	3
33.	**PRODUCTION POSSIBILITY CURVE** ❖ A society as whole has limited resources. It has to decide what to produce with the limited resource. It has to make choice about the quantity of different commodities. Choice emanates from scarcity. Thus our choice is always constrained or limited by scarcity of our resources. Suppose we have enough resources we can produce all that we want. ❖ All such choices can be made with help of production possibility curve. The production-possibility curve separates outcomes that are possible for the society to produce from those which cannot be produced subject to the available resources.  ❖ All possible combinations lying on the production possibility curve show the combinations of the two goods that can be produced by the existing resources. Any combination lying inside the production curve such as U in the figure indicates that resources are not being fully employed in the best-known way. Any point outside the production possibility frontier, such as L implies that the economy does not have adequate resources to produce this combination. But a shift outside the production possibility frontier certainly indicates economic development. This is possible by technological advancement and increase in supply of factors of production.	3
34.	**GIFFEN PARADOX** ❖ Sir Robert Giffen discovered that the poor people will demand more of inferior goods if their prices rise and demand less if their prices fall. Inferior goods are those goods which people buy in large quantities when they are poor and in small quantities when they become rich.	

	❖ For example, poor people spend the major part of their income on coarse grains (e.g. ragi, cholam) and only a small part on rice. When the price of coarse grains rises, they will buy less rice. ❖ To fill up the resulting gap, more of coarse grains have to be purchased. Thus, rise in the price of coarse grains results in the increase in quantity of coarse grains purchased. ❖ This is called 'Giffen Paradox'. In these cases, the law of demand has an exception.	3
35.	**MARKET PERIOD** ❖ Market period is the period during which the ability of the firms to affect any changes in supply in response to any change in demand is extremely limited or almost nil. ❖ Thus supply is more or less fixed in the market period without any change. However, the demand may vary during this period. The equilibrium price will be determined according to the changes in demand, given the fixed supply. Market Period  ❖ As the supply is fixed in the market period, it is shown as a vertical line SMP. It is also called as inelastic supply curve. ❖ When demand increases from DD to D1D1, price increases from P to P1. ❖ Similarly, a fall in demand from DD to D2D2 pull the price down from P to P2. The market for perishables can be a good illustration. ❖ The demand for plantain fruits increases during the festival season, so the prices will naturally go up as the supply cannot be increased immediately to meet the demand. ❖ Thus, demand determines the equilibrium price in the market period.	3
36.	**FUNCTIONS OF AN ENTREPRENEUR** 1. Identifying Profitable Investible Opportunities 2. Deciding the size of unit of production 3. Deciding the location of the production unit 4. Identifying the optimum combination of factors of production 5. Making innovations 6. Deciding the reward payment 7. Taking Risks and facing uncertainties	3
37.	**THE METHODS OF CONTROLLING MONOPOLY.** **1. Legislative Method:** Government can control monopolies by legal actions. Anti-monopoly legislation has been enacted to check the growth of monopoly. In India, the Monopolies and Restrictive Trade Practices Act was passed in 1969. **2. Controlling Price and Output:** This method can be applied in the case of natural monopolies. Government would fix either price or output or both.	3

	3. Taxation: Taxation is another method by which the monopolistic power can be prevented or restricted. Government can impose a lump-sum tax on a monopoly firm, irrespective of its level of output. Consequently, its total profit will fall. **4. Nationalisation:** Nationalising big companies is one of the solutions. Government may take over such monopolistic companies, which are exploiting the consumers. **5. Consumer's Association:** The growth of monopoly power can also be controlled by encouraging the formation of consumers associations to improve the bargaining power of consumers.	
38.	**LIMITATIONS OF MARGINAL PRODUCTIVITY THEORY OF DISTRIBUTION.** 1. Every product is a joint product and its value cannot be separately attributed to either labour or capital. Again, it is rather difficult to measure the "productivity" of certain categories of labour like doctors, lawyers and teachers who render services. 2. The theory takes into account only the factors operating on the side of demand by ignoring the supply side. 3. The theory is based on the assumption of perfect competition and full employment. But in the real world, we have only imperfect competition; we do not have perfect competition. 4. In practice, it is rather difficult to vary the use of the factors of production. 5. The theory does not carry with it any ethical justification. If we accept the theory, it means that factors get the value of what they produce.	3
39.	**THE ASSUMPTIONS OF KEYNESIAN THEORY OF SIMPLE INCOME DETERMINATION;** Keynes made the following assumption to explain income determination in a simple way. 1. There are only two sectors viz. consumers (C) and firms (I). 2. Government influence on the economy is nil. In other words government expenditure (G) is zero. As there is no taxation, all personal income will become disposable income. 3. The economy is a closed one without any influence of foreign trade (X-M) that is, X-M is zero. 4. Wages and prices remain constant. 5. There are unemployed resources and hence less than full employment equilibrium prevails. 6. There is no variation in the rate of interest. 7. Investment is autonomous and it has no effect on price level or rate of interest. 8. The consumption expenditure is stable.	3
40.	**THE DIFFICULTIES OF BARTER SYSTEM.** ❖ Barter is the direct exchange of goods for goods. It is a system of trading without the use of money. ❖ For example, barter requires double coincidence of wants. That is, a person must have what the other person wants and vice versa. And this is not always possible. ❖ For instance, if a person who has a cow wants a horse in exchange, the other person must have it and he must need a cow. Otherwise exchange cannot take place. Again, there is the difficulty of storage.	3

- Money serves as a store of value.
- In the absence of money, a person has to store his wealth in the form of commodities and they cannot be stored for a long period.
- For some commodities are perishables and some will lose their value.

	SECTION -III	7X5=35

41. **THE FOLLOWING ARE THE BASIC CHARACTERISTIC FEATURES OF SOCIALISM.**

1. **Social Welfare Motive:**
In socialist economies, social or collective welfare will be the prime motive. Unlike capitalism, profit will not be the aim of policy making. The decisions will be taken keeping the maximum welfare of the people in mind. Thus social well-being of people will be the purpose of development.

2. **Limited Right to Private Property:**
The right to private property is limited. All properties of the country will be owned by the State. That is, the ownership is collective in nature. Hence no individual can accumulate too much property as in the case of capitalism.

3. **Central Planning:**
Most of the economic policy decisions will be taken by a centralized planning authority. Each and every sector of the economy will be directed by well designed planning.

4. **No Market Forces:** (5)
In a centralized planned system of development, market forces have only a limited role to play. Production, commodity and factor prices, consumption and distribution will be governed by development planning with welfare motive.

Merits of Socialist Economy

1. **Efficient use of resources**: The resources are utilized efficiently to produce socially useful goods without taking the profit margin into account. Production is increased by avoiding wastes of competition.

2. Economic Stability: Economy is free from business fluctuations. Government plans well and everything is well coordinated to avoid over-production or unemployment. There is stability because the production and consumption of goods and services are well regulated.

3. Maximisation of Social Welfare: All citizens work for the welfare of the State. Everybody receives his or her remuneration. The State concentrates on the production of basic necessaries instead of luxury goods. The State provides free education, cheap and congenial housing, public health amenities and social security for the people.

4. Absence of Monopoly: The elements of corporation and monopoly are eliminated since there is absence of private ownership. The state is a monopoly but produces quality goods at reasonable price.

5. Basic Needs are met: In socialist economies, basic human needs like water, education, health, social security, etc, are provided. Human development is more in socialist countries.

6. No extreme Inequality: As social welfare is the ultimate goal, there is no concentration of wealth. Extreme inequality is prevented in socialist system.

(OR)

THE LAW OF DIMINISHING MARGINAL UTILITY WITH A DIAGRAM

Definition

According to Marshall, "The **additional benefit** which a person derives from a given increase of his stock of a thing **diminishes with every increase in the stock that he already has**".

Assumptions of the Law

1. The units of consumption must be in **standard units** e.g., a cup of tea, a bottle of cool drink etc.
2. All the units of the commodity must be **identical** in all aspects like taste, quality, colour and size.
3. The law holds good only when the process of consumption **continues** without any time gap.
4. The consumer's **taste, habit or preference must** remain the same during the process of consumption.
5. The **income** of the consumer remains constant.
6. The prices of the commodity consumed and its **substitutes** are constant. 5
7. The consumer is assumed to be a **rational economic man**. As a rational consumer, he wants to maximise the total utility.
8. Utility is **measurable**.

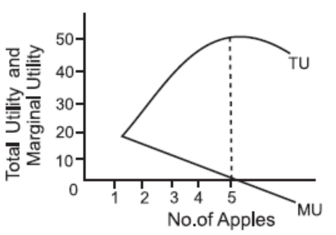
Explanation

<table>
<tr><td rowspan="3">When person X Continuously eats apples</td><td>Circumstances</td><td>Apples</td><td>Marginal Utility</td></tr>
<tr><td>While Hungry</td><td>1st Apple</td><td>High Marginal Utility (Great Pleasure)</td></tr>
<tr><td>While not in Hungry (after hungry)</td><td>2nd Apple</td><td>Low Marginal Utility</td></tr>
</table>

Total and Marginal utility schedule

Units of apple	Total utility	Marginal utility
1	20	20
2	35	15
3	45	10
4	50	5
5	50	0
6	45	-5
7	35	-10

Total and Marginal Utility curves



Explanation of Table and Diagram: Table gives the utility derived by a person from successive units of consumption of apples. From Table and figure it is very clear that the marginal utility (addition made to the total utility) goes on declining. The consumer derives 20 units of utility from the first apple he consumes. When he consumes the apples continuously, the marginal utility falls to 5 units for the fourth apple and becomes zero for the fifth apple. The marginal utilities are negative for the 6th and 7th apples. Thus when the consumer consumes a commodity continuously, the marginal utility declines, reaches zero and then becomes negative.

Importance of Law of DMU

i) The Law of Diminishing Marginal Utility (DMU) is the **foundation for various other economic laws.**

(ii) The Law of DMU **operates in the case of money also**.

(iii) This law is a handy tool for the **Finance Minister for increasing tax rate** on the rich.

(iv**) Producers are guided by the operation the Law** of DMU, unconsciously.

Criticism

(i) Deriving utility is a psychological experience, In reality, **utility cannot be measured**.

(ii) a single commodity consumption mode is **an unrealistic assumption**. In real life, a consumer consumes more than one good at a time.

(iii) According to the Law, a consumer should **consume successive units** of the same good continuously. In real life it is not so.

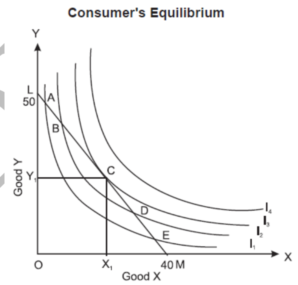
(iv) In real life, the marginal utility derived from the consumption of a good **cannot be measured precisely in monetary terms**.

(v) As **utility itself is capable of varying from person to person,** marginal utility derived from the consumption of a good cannot be measured precisely.

42. **ASSUMPTIONS OF INDIFFERENCE CURVE ANALYSIS**

1. The consumer is rational. So, he prefers more goods to less goods.
2. He purchases two goods, X and Y only.
3. The price that a consumer pays for a commodity indicates the level of utility derived by him.
4. His income remains constant
5. His tastes, Preference , habits remain unchanged.

Consumer's equilibrium using indifference curve approach.



- When a consumer has limited income, he spends it in such a manner so as to obtain maximum level of satisfaction.
- A consumer gets maximum satisfaction when marginal utilities from his different purchase are equal.
- The consumer gets the maximum possible satisfaction from his given income at point 'C' on the indifference curve - IC_3
- At the point of equilibrium (point c) the price line LM is tangential to the indifference curve I_3
- The slope of the indifference curve represents the marginal rate of substitutions.
- The budget line show the ratio of prices between the two goods.
- The indifference curve I_3 show the ratio of prices between the two goods as indicated by the price line LM are equal.
- This point indicated the ideal combination between the two commodities, giving highest satisfaction with limited income.
- At the point, therefore the consumer is in equilibrium
- Condition for consumer equilibrium is $MRS_{XY} = P_X / P_Y$

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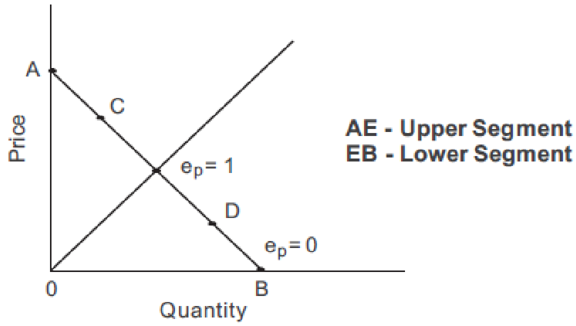
(OR)

POINT METHOD OF MEASUREMENT OF PRICE ELASTICITY OF DEMAND

We can calculate the price elasticity of demand at a point on the linear demand curve. Formula to find out ep through point method is,



$$e_p = \frac{\text{Lower segment of the demand curve}}{\text{Upper segment of the demand curve}}$$

For example, in figure 4.11, the length of the demand curve AB is 4 cm

Exactly at middle point of AB demand curve,

1) e_p at point e $e_p = \frac{EB}{EA} = \frac{2}{2} = 1 \quad \therefore$ ep = 1

2) e_p at point D = (middle point of EB portion of demand curve)

$$\frac{DB}{DA} = \frac{1}{3} = 0.3 \quad ep < 1$$

3) e_p at point c (middle point of EA portion of demand curve)

$$\therefore ep = \frac{CB}{CA} = \frac{3}{1} = 3 \quad ep > 1$$

4) e_p at point B $= \frac{0}{AB} = \frac{0}{4} = 0$

(o by anything is zero, a mathematical principle) $\therefore$ ep = 0

5) e_p at point A $= \frac{AB}{0} = \frac{4}{0} = \infty$

(Anything by zero becomes infinity a mathematical principle) $\therefore$ ep = ∞

5

43. **DEFINITION - LAW OF DEMAND:**

Alfred Marshall stated that " the greater the amount sold, the smaller must be the price at which it is offered, in order that it may find purchasers; In other words, the amount demanded increases with a fall in price and diminishes with rise in price".

Dx = f (Px, Ps, Y, T, W)

The law of demand states that there is a negative or inverse relationship between the price and quantity demanded of a commodity over a period of time.

Assumptions of the Law

1. No change in the consumer's **income**
2. No change in consumer's **tastes and preferences**
3. No changes in the **prices** of other goods
4. No new **substitutes** for the goods have been discovered
5. People do not feel that the present **fall in price** is a prelude to a further decline in price.

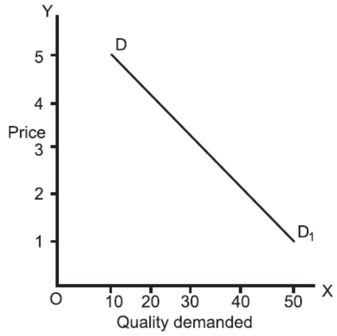
5

Demand Schedule and Demand curve

Demand Schedule

Price (Rs)	Quantity Demanded (Units)
5	10
4	20
3	30
2	40
1	50

Demand Curve



Demand Curve

DD1 is the demand curve. The curve slopes downwards from left to right showing that, when price rises, less is demanded and vice versa. Thus the demand curve represents the inverse relationship between the price and quantity demanded, other things remaining constant.

Why does the demand curve slope downwards?

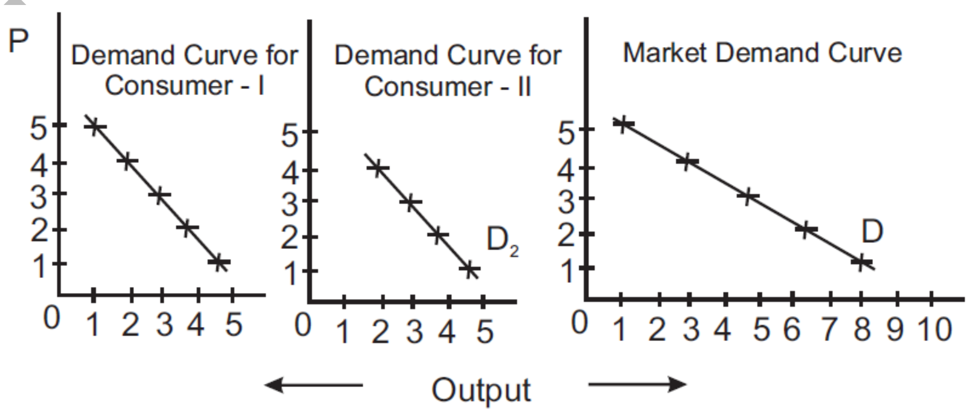
The demand curve slopes downwards mainly due to the law of diminishing marginal utility.

Individual demand and market demand schedules

Price of oranges (Rs.)	Quantity of oranges
5	1
4	2
3	3
2	4
1	5

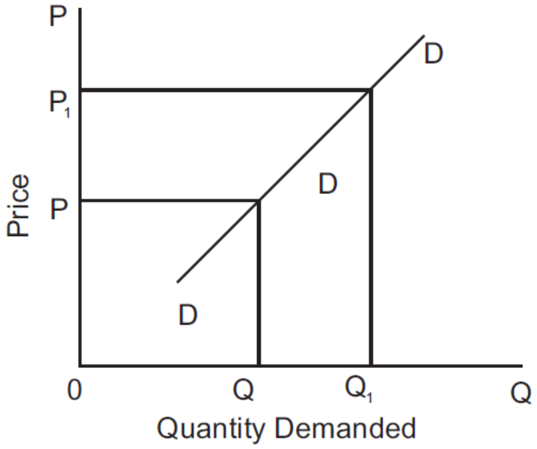
Market demand schedule

Price of Oranges (in Rs)	Quantity demanded		
	Consumer I	Consumer II	MarketDemand
5	1	-	1
4	2	1	3
3	3	2	5
2	4	3	7
1	5	4	9



Exceptions to the Law of Demand

The Law of demand is a general statement telling that prices and quantities of a commodity are inversely related. There are certain peculiar cases in which the law of demand will not hold good. In those cases, more will be demanded at a higher price and less will be demanded at a lower price. The demand curves in those cases slope upwards showing a positive relationship between price and quantity demanded



When the price increases from OP to OP1, quantity demanded also increases from OQ to OQ1 and vice versa. DD is the exceptional or abnormal demand curve. The following is the list of few exceptions to the law of demand.

(1) Veblen Effect

Veblen has pointed out that there are some goods demanded by very rich people for their social prestige. When price of such goods rise, their use becomes more attractive and they are purchased in larger quantities. Demand for diamonds from the richer class will go up if there is increase in price. If such goods were cheaper, the rich would not even purchase.

(2) Giffen Paradox

Sir Robert Giffen discovered that the poor people will demand more of inferior goods if their prices rise and demand less if their prices fall. Inferior goods are those goods which people buy in large quantities when they are poor and in small quantities when they become rich. For example, poor people spend the major part of their income on coarse grains (e.g. ragi, cholam) and only a small part on rice. When the price of coarse grains rises, they will buy less rice. To fill up the resulting gap, more of coarse grains have to be purchased. Thus, rise in the price of coarse grains results in the increase in quantity of coarse grains purchased. This is called 'Giffen Paradox'. In these cases, the law of demand has an exception.

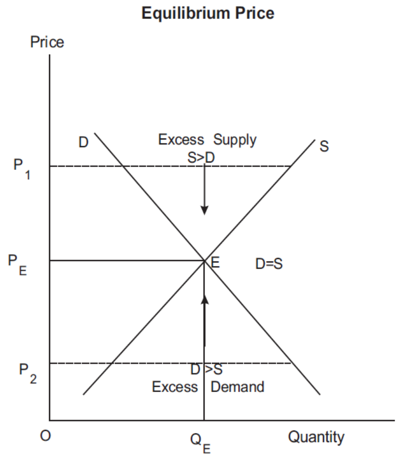
(OR)

THE DETERMINATION OF EQUILIBRIUM PRICE WITH A DIAGRAM

- There is only one price at which the preferences of sellers and buyers meet together.
- At that point the quantity demanded of a commodity by the buyer is equivalent to the quantity the seller is willing to sell.
- This price is called as the equilibrium price and it occurs at the point of intersection of the supply curve and the demand curve.
- In other words, equilibrium refers to a particular pair of prices and quantity.
- The concept of equilibrium is also applied to describe and understand other sub-systems of the economy like agriculture, industry, growth and distribution.

5

P - price
Q - quantity of good
S - supply
D - demand
PE - equilibrium price (or price of market balance)
D>S - Excess of demand - when P<PE
S>D - Excess of supply - when P> PE

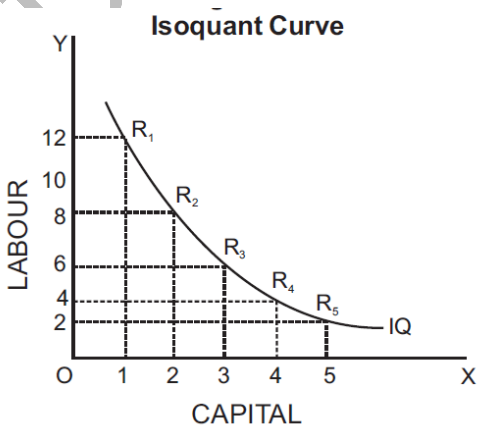


- At price PE , the quantity demanded is equal to quantity supplied, D=S. At other prices, there is no equality between quantity demanded and quantity supplied. In both the cases either the consumer or the firms are dissatisfied
- At any price above the equilibrium price (PE), supply is greater than demand(S>D). Thus there is excess supply.
- Price "discounts" are advertised by sellers in the name of 'annual stock clearance' sales.
- The price is below the equilibrium price PE, there will be excess demand, D>S.
- This may also encourage sellers to supply more.

44. **ISOQUANTS.** 5

The two axes measure the quantities of labour and capital and the curve IQ shows the different combinations that produce 1000 units of output.

Each of the points R1, R2, R3, R4 and R5 on the curve shows a capital-labour combination that can produce 1000 units of output. Therefore the curve is known as an equal product curve or an iso- quant curve.



Thus an isoquant or isoproduct curve represents different combinations of two factors of production that yield the same level of output.

Characteristics of an isoquant

1. The isoquant is downward sloping from left to right i.e. it is negatively sloped.
2. An isoquant is convex to the origin because of the diminishing marginal rate of technical substitution. Marginal rate of technical substitution of factor X (capital) for factor Y (labour) may be defined as the amount of factor Y (labour) which can be replaced by one unit of factor X (capital), the level of output remaining unchanged.

M RTS CL = $\frac{\Delta L}{\Delta C}$

MRTS can be calculated using the above formula

Combination	Units of capital	Units of Labour	$MRTS_{CL}$
A	1	12	
B	2	8	4
C	3	5	3
D	4	3	2
E	5	2	1

Thus the marginal rate of technical substitution is always declining. Hence the isoquant is always convex to the origin. The slope of the isoquant represents marginal rate of technical substitution.

(OR)

Various cost incurred by a firm

Money cost

❖ Money cost or nominal cost is the total money expenses incurred by a firm in producing a commodity.

Real cost

❖ Real cost is a subjective concept. It expresses the pains and sacrifices involved in producing a commodity. The money paid for securing the factors of productions is money cost whereas the efforts and sacrifice made by the capitalists to save and invest, by the workers in foregoing leisure and by the landlords constitute real costs.

Opportunity Cost

❖ The opportunity cost of any good is the next best alternative good that is sacrificed. For example a farmer who is producing wheat can produce potatoes with the same factors. Therefore the opportunity cost of a quintal of wheat is the amount of output of potatoes given up. 5

Accounting cost or explicit cost

❖ Accounting costs or explicit costs are the payments made by the entrepreneur to the suppliers of various productive factors. The accounting costs are only those costs, which are directly paid out or accounted for by the producer i.e. wages to the labourers employed, prices for the raw materials purchased, fuel and power used, rent for the building hired for the production work, the rate of interest on the borrowed capital and the taxes paid.

Economic cost

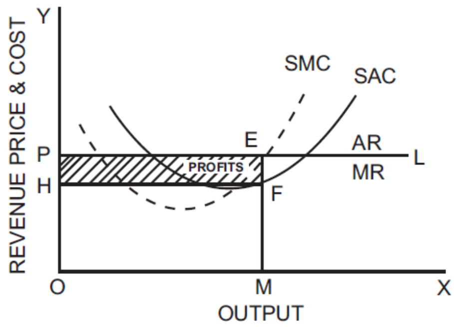
❖ The economic cost includes not only the explicit cost but also the implicit cost. The money rewards for the own services of the entrepreneur and the factors owned by himself and employed in production are known as implicit costs or imputed costs. The normal return on money capital invested by the entrepreneur, the wages or salary for his own services and rent of the land and buildings belonging to him and used in production constitute implicit cost. Thus Economic cost = Explicit cost + Implicit cost.

	Private cost ❖ Private cost is the cost incurred by a firm for production. It includes both implicit costs and explicit costs. **Social cost** ❖ Social costs are those costs, which are not borne by the producing firm but are incurred by others in society. ❖ For example, when an oil refinery discharges its waste in the river causing water pollution, such a pollution results in tremendous health hazards which involve costs to the society as a whole **Fixed cost** ❖ Fixed costs are those which are independent of output, that is, they do not change with changes in output. These costs are a 'fixed' amount, which must be incurred by a firm in the short run whether the output is small or large. **Variable cost** ❖ Variable costs are those costs, which are incurred on the employment of variable factors of production whose amount can be altered in the short run. Thus the total variable costs change with the level of output. It rises when output expands and falls when output contracts. When output is nil, variable cost becomes zero.	
45.	**SHORT RUN EQUILIBRIUM PRICE AND OUTPUT DETERMINATION UNDER PERFECT COMPETITION** **Nature of Revenue curves** ❖ Under perfect competition, the market price is determined by the market forces namely the demand for and the supply of the products. Hence there is uniform price in the market and all the units of the output are sold at the same price. ❖ As a result the average revenue is perfectly elastic. The average revenue curve is horizontally parallel to X-axis. Since the Average Revenue is constant, Marginal Revenue is also constant and coincides with Average Revenue. AR curve of a firm represents the demand curve for the product produced by that firm. **Short run equilibrium price and output determination under perfect competition** 1. Since a firm in the perfectly competitive market is a price-taker, it has to adjust its level of output to maximise its profit. The aim of any producer is to maximise his profit. 2. The short run is a period in which the number and plant size of the firms are fixed. In this period, the firm can produce more only by increasing the variable inputs. 3. As the entry of new firms or exit of the existing firms are not possible in the short-run, the firm in the perfectly competitive market can either earn supernormal profit or normal profit or incur loss in the short period.	5

Super-normal Profit

When the average revenue of the firm is greater than its average cost, the firm is earning super-normal profit.

Short-run equilibrium with super-normal profits



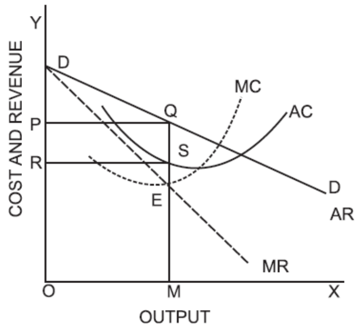
- output is measured along the x-axis and price, revenue and cost along the y-axis.
- OP is the prevailing price in the market. PL is the demand curve or average and the marginal revenue curve.
- SAC and SMC are the short run average and marginal cost curves. The firm is in equilibrium at point 'E' where MR = MC and MC curve cuts MR curve from below at the point of equilibrium.
- Therefore the firm will be producing OM level of output. At the OM level of output ME is the AR and MF is the average cost. The profit per unit of output is EF (the difference between ME and MF).
- The total profits earned by the firm will be equal to EF (profit per unit) multiplied by OM or HF (total output).
- Thus the total profits will be equal to the area HFEP.
- HFEP is the supernormal profits earned by the firm.

(OR)

DETERMINATION OF EQUILIBRIUM PRICE AND OUTPUT UNDER MONOPOLISTIC COMPETITION

The monopolistic competitive firm will come to equilibrium on the principle of equalising MR with MC. Each firm will choose that price and output where it will be maximising its profit..

Short Period Equilibrium of a Monopolistic competitive firm with Profit



- MC and AC are the short period marginal cost and average cost curves.
- The sloping down average revenue and marginal revenue curves are shown as AR and MR.
- The equilibrium point is E where MR = MC. The equilibrium output is OM and the price of the product is fixed at OP.
- The difference between average cost and average revenue is SQ. The output is OM.

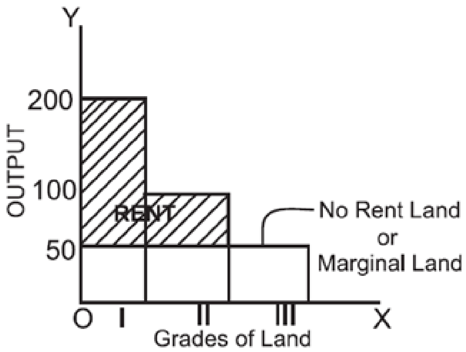
5

- ❖ So, the supernormal profit for the firm is shown by the rectangle PQSR.
- ❖ The firm by producing OM units of its commodity and selling it at a price of OP per unit realizes the maximum profit in the short run.
- ❖ The different firms in monopolistic competition may be making either abnormal profits or losses in the short period depending on their costs and revenue curves.

46. **THE RICARDIAN THEORY OF RENT** 5

- ❖ Ricardian theory of rent is one of the earliest theories of rent.
- ❖ According to Ricardo, "rent is that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil".
- ❖ Rent is payment made for the use of land for its original powers.
- ❖ Rent is a differential surplus.
- ❖ Rent may also arise on account of situational advantage. For example, some lands may be nearer to the market. The producer can save a lot of transport costs. Even if all lands are equally fertile, lands which enjoy situational advantage will earn rent.

Ricardian theory of Rent.



Explanation:

1. Grades of land are shown along the x-axis
2. Output are shown along the y-axis.
3. The shaded area in the diagram indicates rent
4. In this case, grade I and grade II land gets rent.
5. The grade III land will not get rent.
6. First grade lands will get more rent but the third grade land will not get rent. It is known as no-rent land.

Criticism of the Ricardian Theory of Rent

1. According to Ricardo, land has "original and indestructible powers". But the fertility of land may decline after some time because of continuous cultivation.
2. Ricardo believed that rent is peculiar to land alone.
3. Ricardo is of the view that rent does not enter the price of the commodity produced in it. But rent enters the price from the point of view of a single firm.
4. Ricardian theory does not take note of scarcity rent.
5. It is based on perfect competition.

	(OR)	
	CRITICALLY EXAMINE J.B.SAY'S LAW OF MARKETS. **According to Say,** ""supply creates its own demand". This means that production of every good generates sufficient income to ensure that there is enough demand for the goods produced. **Assumptions** 1. **All incomes of the households are spent** on consumption of goods and services. 2. There **is no government activity** (no taxation, public spending, price control etc.). 3. It is a **closed economy** i.e. no relationship with other economies. The **Essential Aspects** of Say's Law can be summarized as: 1. Economy is self-adjusting 2. No general over-production or unemployment is possible 3. All idle resources are fully employed 4. There is economic interdependence between nations 5. Flexible wage rate prevails in the economy **Criticism of Say's Law** 1. Great Depression made Say's law unpopular 2. All incomes earned are not always spent on consumption 3. Similarly whatever is saved is not automatically invested 4. The Law was based on wrong analysis of market 5. It suffers from the fallacy of aggregation	5
47.	**QUANTITY THEORY OF MONEY.** **Definition** The Quantity Theory of Money was formulated by Irving Fisher. **"prices always change in exact proportion tochanges in the quantity of money. If the amount of money is doubled, prices double.If the amount of money is halved, prices fall to half their original level".** **Quantity theory of money with equation of exchange** The quantity theory of money has been put forward in the form of an equation known as the "Equation of Exchange". It is also known as Fisher's equation. $MV = PT$ (or) $P = MV/T$	5

	Equation of Exchange has been modified as follows, ▪ Fisher has explained his theory in terms of his equation of exchange: ▪ $PT=MV+M'V'$ ▪ Where ▪ P = price level, or $1/P$ = the value of money; ▪ M = the total quantity of legal tender money; ▪ V = the velocity of circulation of M; ▪ M' – the total quantity of credit money; ▪ V' = the velocity of circulation of M; ▪ T = the total amount of goods and services exchanged for money or transactions performed by money.	
	(OR)	
	THE OBJECTIVES OF FISCAL POLICY **Meaning** "Fiscal policy is a policy under which the government uses its expenditure andrevenue programmes to produce desirable effects and avoid undesirable effects onthe national income, production and employment". **Objectives of fiscal policy** 1. To **mobilize resources** for financing the development 2. To promote **development in the private sector** 3. To bring about an **optimum utilization of resources** 4. To **restrain inflationary pressure**s in the economy **to ensure economic stability** 5. To **improve distribution of income and wealth in the community for lessening economic in equalities.** 6. To obtain full employment and economic growth; 7. Fiscal policy and capital formation.	(any five points) 5

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